CRE Lending in Flux in 2017

Matt Thrasher • published in the January 2017 issue

As 2016 comes to a strong close, we look ahead to 2017 with a hefty measure of confidence and a dash of apprehension. Whether for new developments, acquisitions or refinancing, the process of securing leverage for commercial real estate projects over the last few years has seen staunch competition among lenders overall (institutional and private), resulting in generally favorable financing terms. Exciting new technology ventures in CRE financing continue to add value to the lending process for both lenders and borrowers. However, a number of factors leading into the new year should be considered for anyone seeking financing for their property or project.

In December the Fed raised the key interest rate by 25 basis points to a range of 0.50% to 0.75%. This is only the second time in the last decade that the Fed has raised the key interest rate. This decision was most likely made in part due to wage inflation and the core PCE price index inching closer to the Fed's targets. More importantly, the Fed also hinted that consumers could expect more rate increases in 2017. The short-term outcome could be an increase in financing, as investors and developers seek to act before any future increases. It is still too early to speculate how commercial real estate values will be affected by the change.

Lending conditions over 2016 saw some significant tightening with LTV ratios trending downward as lenders had to meet capital reserve requirements and continued to feel pressure from regulators to limit risky loans, especially those for speculative construction. With the recent rate increase from the Fed, debt service coverage ratios could be expected to stretch further, requiring more equity from buyers and owners seeking to refinance. Loans impacted the most will be those with higher loan to value ratios. In 2017, financing for properties with short-term leases and more frequent pricing resets could be looked upon more favorably by institutional lenders trying to hedge against market volatility. As for long-term held assets with minimal upside, inflation and interest rate hikes could erode gains in rental revenue.

One sector that stands to benefit the most from the shifting financing landscape is multifamily. Any increases in the cost of capital for housing can typically be pushed down to consumers. With it still being relatively difficult for consumers with poor credit to finance homes, the rental pool stands to increase in line with any bump in the cost of homeownership. Lenders may try to get ahead of this by treating multifamily as a slightly less risky asset class, at least in the short to mid-term.

CMBS lending in 2017 faces significant uncertainty. New risk retention requirements, which require issuers to retain at least 5% of any bonds issued, will be effective in 2017. Additionally, of the estimated $103 billion (as of October) in CMBS loans set to mature in 2017, a whopping 47% have LTV ratios higher than 80%. Originated at the height of values and aggressive financing, office and retail sectors make up the largest segments of debt. Owners who secured financing at higher LTV ratios will face additional hurdles as current LTV ratios average 70-75% for best-in-class, stabilized assets.

However, risk retention rules for CMBS financing may end up being short-lived. Currently being legislated, the "Preserving Access to CRE Capital Act" (H.R. 4620) would modify the rules and ease requirements on CMBS. From a political standpoint, additional changes to financing requirements for lenders are also on the table. The incoming administration could amend some of the harsher restrictions on high volatility loan programs, affecting certain acquisition, development and construction loans. According to the 2017 Emerging Trends in Real Estate report released by the Urban Land Institute, 46.4% of survey respondents said they expect more rigorous underwriting standards in 2017 compared to 12.9% the previous year. In addition, respondents were slightly more pessimistic on availability of capital from debt sources compared to 2016. If the incoming administration is successful in easing regulations, it will likely change the overall sentiment of borrowers.

Innovation in crowdfunding for CRE projects continues its progression as more parties are finding real value in alternative methods of gaining access to capital. RealtyMogul, a popular crowdfunding marketplace currently offers both recourse and non-recourse bridge loans as well as mezzanine debt, giving borrowers additional options when selecting the right source of capital for their projects. Sites like PropertyGo, which act as matchmaker between lender and borrower, significantly shorten underwriting timelines that we have come to expect with traditional methods. We should expect the upward trend of adoption of these alternative methods of financing to continue in 2017.

In sum, while there are some things to look forward to, 2017 may prove to be slightly more volatile for the commercial real estate lending landscape. Uncertainties surrounding the election, changes in regulation that may come out of a new administration, constraints on CMBS and construction financing and the maturing real estate cycle should give borrowers pause to consider both short and long term outcomes of borrowing or refinancing in 2017.

Matt Thrasher is the Managing Partner of Thrasher Law Offices PLLC, a law firm specializing in corporate and real estate transactions, with 5 attorneys and offices in Tucson and Phoenix. Matt is licensed to practice law in Arizona and Texas, and is a graduate of Occidental College and Vanderbilt University Law School. Matt can be reached via email at matt@thrasherpllc.com.