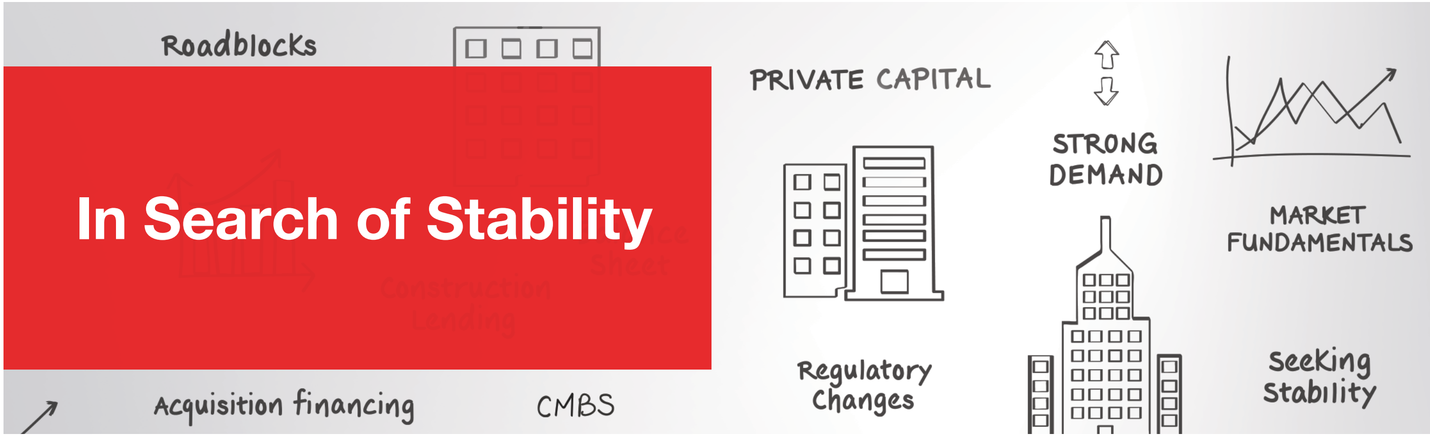
KeyBank
Real Estate Capital



In Search of Stability

At first glance, the market for commercial real estate capital is in good shape. There's strong demand for acquisition financing, and there's no shortage of capital sources interested in commercial real estate debt and equity. So why is there the perception that it is so challenging to get deals done? Despite healthy market fundamentals, some borrowers and lenders alike are finding roadblocks on the way to the closing table.

At a recent Bisnow conference on real estate finance and investment in Chicago, John Hofmann of KeyBank Real Estate Capital and co-panelists were asked to sum up the state of the market in a couple of words. Everyone had responses similar to Hofmann's: "Seeking stability."

The general bearishness of the panelists stems from a combination of factors. First, lenders and investors are uncertain about how the new administration will affect financial regulations and the overall economy. Capital markets have been volatile, and on top of that, banks and CMBS issuers are operating under new regulations, making them more selective. The result is a tale of two markets, with some borrowers enjoying tremendous liquidity with others struggling to refinance deals.

Key Takeaways

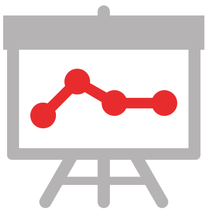
Banks are focusing construction loan volume on existing relationships and well-capitalized developers.

Borrowers seeking stability and flexibility are tapping bridge lenders and banks to reposition their real estate.

As properties surpass previous peak values, investors focus on 'value-add' opportunities and bridge and mezzanine lending.

What's giving everyone the jitters?

Memories of the global recession and its aftermath are still fresh in lenders' minds. Real estate markets are in good shape today, but lenders are watching for signs of a slowdown. In the multifamily sector, a great deal of new supply is coming on line at a time when rent growth has flattened out and affordability has become a major issue. Some retail segments are feeling the pressure of competition from e-commerce. Office and industrial sectors appear solid but could turn quickly if the economy — now in its eighth year of growth — slows down.



Likewise, many borrowers are still recovering from losses they took a decade ago. They're seeking stable debt and equity capital in an environment of rising interest rates and higher debt service coverage (DSC) requirements. They need to come up with more equity than before, and on construction loans many lenders are insisting on recourse provisions.

Deals are getting done

The good news is that deals are still getting done. "We're committing a meaningful amount of capital across our full suite of financial products, but cautious about where we put our money," Hofmann said.

"This is an interesting year for refinancing," Hofmann said. "Clients who, in the past, would have gone to CMBS are now trying to find other opportunities." CMBS deals have restrictive covenants that don't allow for changes to terms as conditions change, and the volatility in pricing can disrupt deals before closing. As a result, borrowers looking for value-add opportunities are moving away from CMBS as a source of financing and are tapping bridge lenders and banks to reposition their real estate.

Some CMBS lenders have exited the business due to the added risk of volatility, plus the requirement that issuers retain a percentage of CMBS volume. But many banks and other lenders continue to offer CMBS financing, and for many borrowers, this remains the best execution. "We have as much volume in our CMBS pipeline as ever," Hofmann said. "Without the availability of CMBS financing, the market would be much closer to a liquidity crunch."

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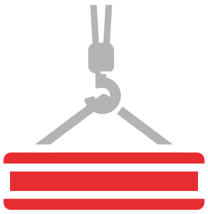
>
> **John Hofmann, VP, Senior Mortgage Banker, KeyBank Real Estate Capital**



Enter private capital

The construction loan market has also experienced dislocation in the past year, in part because new rules on banks' capital reserve requirements effectively limit the number of deals they can do. Construction lenders are also concerned that there could be a recession in the coming years that could leave speculative buildings without tenants, making takeout financing challenging. And while overbuilding isn't a major concern, lenders are keeping an eye on rent growth and supply in the multi-family sector.

As a result, banks have become more selective about the construction loans they will originate. In the past year, loan-to-cost (LTC) ratios have come down, forcing developers to come up with additional equity. The upside of fewer construction projects coming out of the ground is that completed projects have a better chance of leasing up quickly.

Hofmann noted that KeyBank is focusing its construction lending on existing developer clients, and on companies the bank serves in other areas. He's also helping clients connect with mezzanine debt, bridge loans, and equity financing from sources that often include private equity funds.

"We're seeing a lot more private capital coming into the real estate debt market in 2017," Hofmann said. In the acquisition market, competition from foreign and institutional buyers has driven property prices to new highs, leaving little room for upside in buying core properties. Investors on the Bisnow panel said they are looking at more value-add opportunities, as well as bridge and mezzanine financing that offers similar yields and a similar risk profile.

Difficult but doable

Whether with private capital or a combination of sources, properties are getting financed — it's just more complicated these days. Most of the Bisnow panelists said they expect their deal flow to hold steady throughout 2017.

Lenders and borrowers have a shared interest in striking a balance between market liquidity and disciplined underwriting. The current finance environment may be challenging but disciplined underwriting is a good way to avoid a credit crunch or the need for widespread workouts down the road. And the relationships developed during this time of relative instability will pay off for lenders and borrowers over the longer term.

To learn more, contact:

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