KeyBank
Real Estate Capital

In a Volatile Market, We Look at the ROR Too

What is the state of commercial real estate lending in the face of commercial mortgage-backed securities (CMBS) market volatility and historically thin spreads? How are banks responding to the warning from federal regulators in December? How long can the multifamily market—the canary in real estate's coal mine—continue to absorb high levels of units? And what does all this uncertainty mean to borrowers?

These were just some of the questions addressed by Angela Mago, Executive Vice President of KeyBank Real Estate Capital® (KBREC), and other industry leaders on a panel entitled "CRE Lending – Steady As It Goes or a Brave New World?" at the Mortgage Bankers Association Commercial Real Estate Finance (CREF) conference on February 1, 2016. The wide-ranging, interactive discussion came at a time of significant volatility in global capital markets and lower-than-expected CMBS issuance—yet commercial property values are as high as they've ever been, while rents and occupancy levels are on the rise in most product categories. The overarching question for panelists was what the volatility portends: Is it a sign that the market could soon go over another cliff, or that investors and lenders have learned when to step back from the brink?

"When we look at public real estate markets, we see that most Real Estate Investment Trusts (REITs) are trading at discounts to consensus net asset value, not counting niche markets like manufactured housing, self-storage, and seniors housing," Mago said. "This indicates that REIT investors expect real estate asset values to go down. The flow of capital, including foreign capital, has compressed cap rates and has kept asset values very high." Class A properties in many U.S. cities are fetching prices higher than their values at the last cycle's peak in mid-2007, she noted. "Demand from foreign capital is contributing to the situation, just as we saw in 2007. The cycle is repeating itself."

Key Takeaways

"Return on relationship," the value of a client's repeat business and cross-platform opportunities, is as important as individual deal ROI.

Fannie Mae and Freddie Mac overtook banks to regain their position as the most active multifamily lenders in 4Q 2015.

Regulators are watching lenders closely to ensure they capitalize real estate deals properly.

Market volatility could be a sign that a downturn is imminent, or a warning for lenders and investors to hold the line on underwriting standards.

Similar concerns contributed to slackening investor demand for CMBS in 2015, when total issuance of $92 billion fell short of the projected range of $100 billion or more. Originators have recently reportedly lost money on warehousing loans as spreads widened on bond buyer yield expectations, in concert with the broader volatility in the capital markets in Q1 2016. Of particular importance to borrowers: The CREF panelists noted that consensus projections for CMBS issuance this year fall far short of the $180 billion or so of CMBS loans set to expire, which could make it more difficult for some borrowers to secure financing.

Amid volatility, borrowers seek stability

At times like this, when capital markets are characterized by uncertainty and change, borrowers increasingly turn to the stability of lenders they can rely on to work with them on solutions through up and down cycles. At KBREC, the value of the borrower relationship can be as important as the deal at hand. "We look at risk-adjusted returns and the return on economic capital for real estate lending," Mago said. "Because we have an active, permanent mortgage business and an investment banking platform, we find that real estate lending can be lucrative in terms of the use of our capital—so we consider not only the return on capital but also the return on relationship with that client."

Lenders are best able to factor in the value of client relationships when they maintain a level of market consistency, rather than pursuing deals opportunistically. Providing borrowers with options when credit markets are tight helps to build trust that can pay off when competition heats up. A relationship lender with a broad platform, like Key, can offer a range of solutions, tapping into capital markets executions with conduits, life companies and GSEs, as well as providing structured finance and balance-sheet financing options.

By serving markets consistently, lenders may also be better positioned to pursue opportunities as they arise. For example, KBREC's multifamily construction lending volume peaked in 2013, when competition was still relatively light. Since then, KBREC has eased off multifamily construction lending for its own account, with volume declining in 2014 and again in 2015, as competition from smaller banks has heated up.

GSEs retake the lead in multifamily

"Multifamily has been the most favored asset class of banks: the first property type to recover, with steady demand characteristics," Mago said. "Through the first three quarters of 2015, banks were leading the pack in new originations, until the fourth quarter when Fannie Mae and Freddie Mac originations finally overtook banks again."

Demand for apartments continues to be strong for a number of reasons, Mago noted. The Millennial generation is burdened with student debt and delaying home ownership longer than previous generations.

> We look at risk-adjusted returns and the return on economic capital for real estate lending. Because we have an active permanent mortgage business and an investment banking platform, we find that real estate lending can be lucrative in terms of the use of our capital—so we consider not only the return on capital but also the return on relationship with that client.
>
> **Angela Mago, Executive Vice President, KeyBank Real Estate Capital**

KeyBank
Real Estate Capital

Moreover, much of the new apartment inventory is in urban areas driven by dynamic job growth. "One challenge we're looking at in multifamily is affordability—if you look at how much rents have grown in comparison to wages in many markets, you can see it's not a sustainable trend."

Regulatory Q&A

Mago also noted that increased lending and loosening credit underwriting by some banks may be a reason why the OCC issued a bulletin in December that reminds banks what they consider to be prudent underwriting standards. The warning comes on top of new regulations requiring higher capital reserves on acquisition, development and construction loans classified as high volatility commercial real estate (HVCRE). The premise of the HVCRE rule is "to make sure construction loans are well-capitalized." There is some confusion across banks regarding interpretation of the rules. Despite the outstanding questions, however, the rules have not prevented banks from making prudent deals. "It may have affected the total amount of capital out there, but I wouldn't say it has prevented development activity."

> ”
>
> One challenge we're looking at in multifamily is affordability—if you look at how much rents have grown in comparison to wages in many markets, you can see it's not a sustainable trend.
>
> **Angela Mago, Executive Vice President, KeyBank Real Estate Capital**

No one knows which way capital markets and real estate markets will turn in the coming months. The consensus of the CREF panelists was that the market is fundamentally sound, but could be negatively impacted by the presence of too much investment capital—or too little—chasing real estate deals. The fact that many investment players are pushing back on overly aggressive deals might suggest the market is seeking an equilibrium point, but getting to that point can still mean a lot of uncertainty for borrowers in the coming months.

For more on our market outlook and understanding, contact your relationship banker or go to key.com/rec.

KeyBank
Real Estate Capital