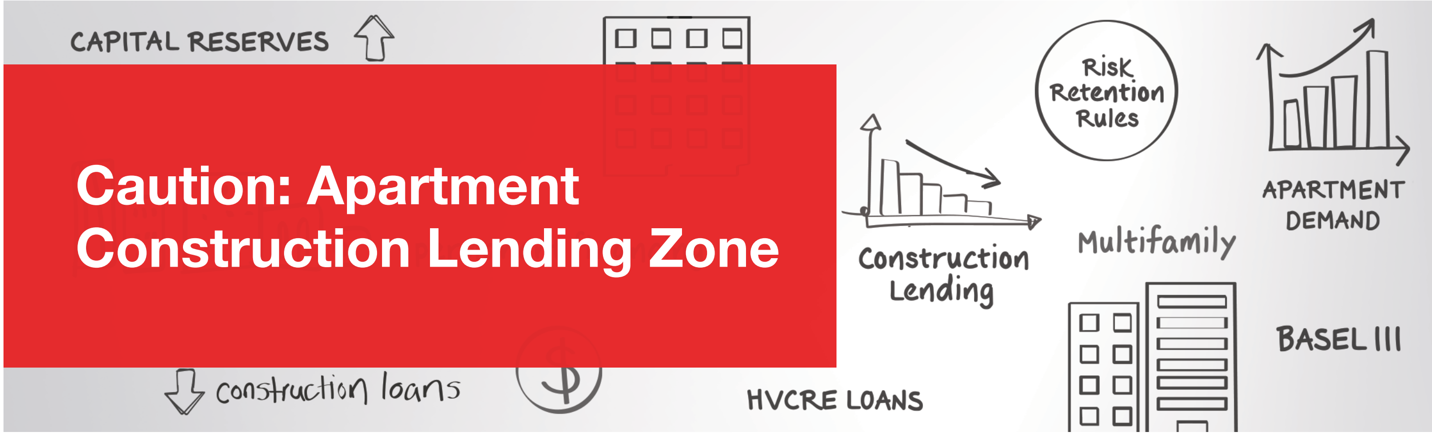
KeyBank



Caution: Apartment Construction Lending Zone

Despite soaring demand, construction lending for apartments just dramatically slowed.

Demand is high, but construction is low in the multi-family sector. While this may sound counter-intuitive, it's actually the very real state of the market because debt financing has become more difficult to secure. Banks are dramatically scaling back their lending volume, causing new multifamily construction starts to fall sharply this year. In fact, lending has become so constricted that many multifamily professionals predict that the slowdown will lead to an apartment shortage by 2018. What's changed? Financial institutions are facing new regulatory constraints that force them to take a more risk-averse position on real estate loans, and it's put a damper on most multifamily lending—particularly for construction.

That's the picture painted by Charlie Williams of KeyBank Real Estate Capital and co-panelist at the opening session of a multifamily-focused Bisnow event in Dallas late this summer. "Construction debt lenders are doing our jobs," Williams said. "Historically we have used construction loans to maximize returns, with the federal government standing behind us." By focusing on development deals with less risk, banks are ensuring that they won't be overextended in the event of an economic downturn.

It may seem like this happened overnight—banks have moved to this defensive crouch fairly suddenly (See The Changing Debt Stack on page 2).

Key takeaways

The multifamily sector is strong, with steady demand.

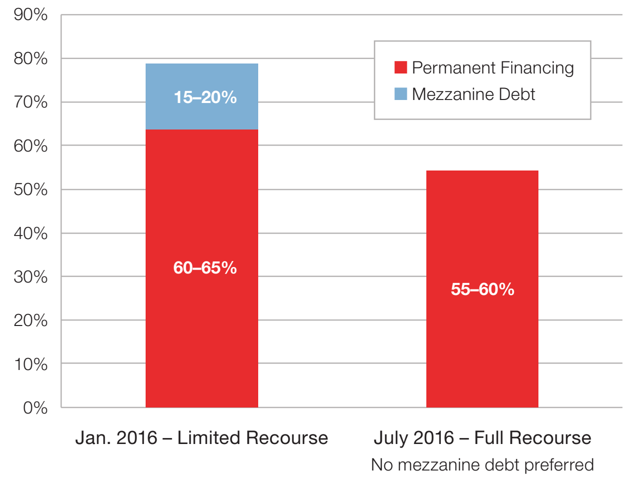
Construction lending has gotten much tougher.

Merchant builders find it difficult to access capital, but developers who hold properties can finance new deals with full recourse.

Many banks have curtailed construction lending, but Key is still making low loan-to-value deals.

Six months ago, according to panelists, a typical capital stack for a new construction loan may have included about 65% debt with limited recourse, 15–20% mezzanine financing and the rest in equity from general partners and limited partners. By contrast, most lenders today have dropped loan-to-value ratios to 50–60%, with full recourse from the general partner. In addition, banks now prefer not to see mezzanine financing in deals.

The Changing Debt Stack

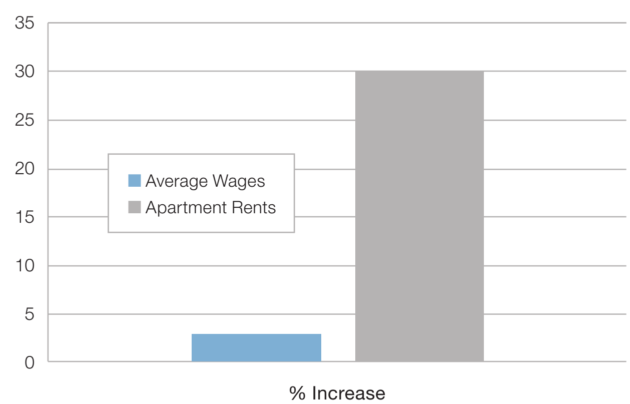


Apartment fundamentals shine

In past cycles, banks based construction loan terms on the risk they expect to see over the next two years. That's not the case today, as apartment markets across the country experience historically low vacancy rates, rising rents, and continuing demand. Williams noted that multifamily occupancy levels are benefiting from demographic trends. Millennials put off home ownership longer than previous generations have, even as retiring Baby Boomers are downsizing from their homes, opting to rent and choosing walkable urban lifestyles in their golden years.

Other panelists observed that rental increases can't continue much longer. Average wages have increased just 2–3% in recent years, while apartment rents have gone up 20–30%, creating an unsustainable growth curve. Indeed, rent growth has been more moderate this year and may level off for a year or two. However, with the slackening pace of new construction in the face of strong demand, panelists agreed that apartments will be in short supply in many markets within the next few years.

Increase in Average Wages vs. Apartment Rents Over Three Years Ending in 2015



Additionally, equity capital is abundant as stabilized multifamily properties on the market attract many bidders willing to buy at historically low cap rates. If the investment market changed dramatically during the 18 months of a typical construction loan, banks might have to extend bridge loans to developers who can't find permanent financing. But there's nothing on the horizon to suggest such a turn of events.

Caution ahead

If not market fundamentals, what's driving banks' caution? The answer is regulation. In particular, Basel III, a set of international standards to reduce risk in the banking sector, and Dodd-Frank, the U.S. financial-industry reform legislation, require banks to set aside 150% of normal capital reserves for any loan classified as high volatility commercial real estate (HVCRE).

Riskier loans require significantly higher capital reserves from banks. Since the success of a bank is based on its return on capital, any investment that ties up a lot of cash is detrimental to its bottom line, regardless of the quality of the underlying asset.

The HVCRE rules actually took effect in January 2015, but it was only in 2016 that banks received answers to all their questions regarding its implementation and realized its full impact. As it became clear that construction loans and highly-leveraged permanent loans were becoming a drag on balance sheets, the "herd mentality" of the finance sector kicked in, and lenders of all stripes backed away from riskier deals.

Virtually all commercial real estate lending is affected by the HVCRE rules to some extent. Permanent financing is harder to get than it used to be, mainly because lenders of all types—CMBS, banks, life companies and even Fannie Mae and Freddie Mac—have a strong preference for low leverage, high borrower equity, and "clean" deals with no issues that could threaten the current income stream. Moreover, banks aren't originating as many loans to the CMBS market, which has seen volume cut in half this year as new risk retention rules require issuers to retain a portion of the securities issued.

For banks, however, the HVCRE rules have the greatest impact on construction loans, which are considered more volatile than permanent deals because there is no income stream, Williams said. The result is not only more cash demanded from developers but also higher spreads to cover the bank's higher cost of capital. Panelists agreed that merchant builders are finding it difficult to remain active in the risk-averse lending climate. Large-scale apartment owners have the field to themselves, although their profit margins are reduced by higher pricing and the need to put more equity at risk.

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>
> **Charlie Williams, KeyBank Real Estate Capital**

Relationships matter

While some banks may be curtailing their construction loan programs altogether, others continue to be there for their best customers. This is the point in the cycle where borrowers may benefit from having longstanding relationships with banks that value their business throughout the cycle.

“At Key, we have not shut off the construction spigot, because our model is different from many banks,” Williams said. “We typically finance holders of real estate—people with cash flow from existing properties to weather any economic downturns, rather than builders who will go away when the music stops.”

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