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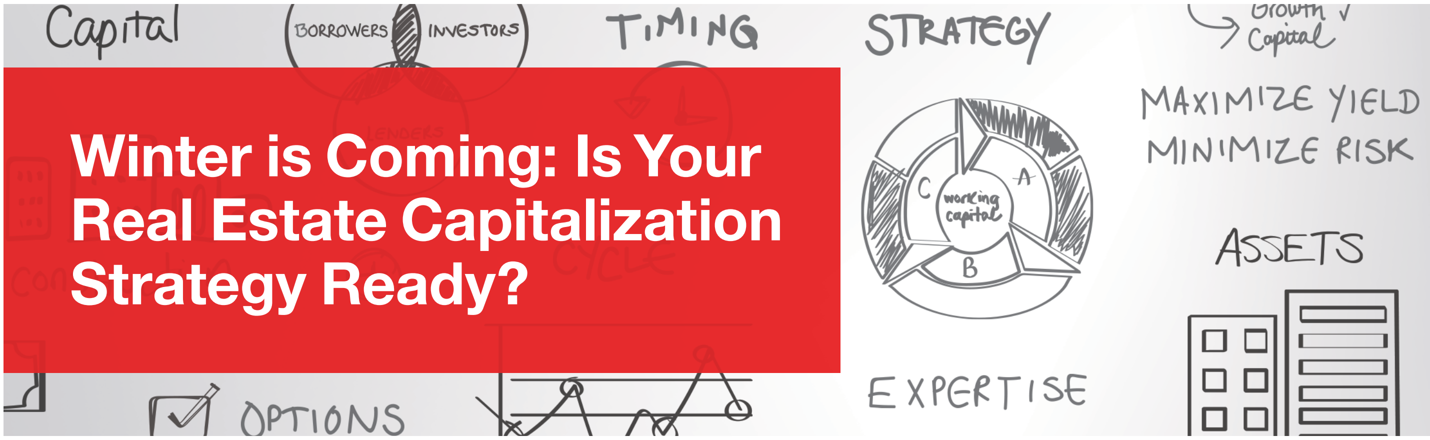

Winter is Coming: Is Your Real Estate Capitalization Strategy Ready?

By Andrew Lucca, Senior Vice President, KeyBank Real Estate Capital®

Real estate capital markets have been as healthy as ever, with debt and equity capital flowing freely at historically low interest rates. Even many properties that were financially under water for most of the past decade have been able to cure their ills with a dose of new capital. Despite the free-flowing debt and equity capital, however, many borrowers are concerned that the market could take a turn for the worse—as it has in the past.

We say enjoy the market as it is, but plan ahead.

Given the cyclical nature of real estate markets, it's certainly wise to consider the possibility of a market adjustment in the coming years. No one can say for certain when capital markets might tighten up or what the market impact might be. But with the right advisor, you can structure today's capital strategies to minimize the impact of market gyrations down the road.

Going with the (capital) flow

The river of capital has been practically overflowing its banks. Cap rates on investment properties are as low as they've ever been and interest rates remain low. In an environment like this, borrowers can't be faulted for taking advantage of the highest leverage at the lowest interest rate achievable.

But isn't high leverage what got us into the financial crisis "mess" last time around?

Indeed, too much leverage can be a problem. Experienced owners remember that the last easy-money market ended abruptly with many over-leveraged borrowers struggling to hang on to their properties. Because history tends to repeat itself, questions on the minds of many investors and developers include "Does today's momentum mean we're in a bubble?" and "How can I protect the investments I'm making today against a future downturn?" It's logical to be asking these questions, given the continued strength of the commercial real estate market over the past several years.

Key Takeaways

- Manage your assets with a long-term view regardless of market cycles.
- Keeping leverage moderate is one defensive strategy to help prepare for a downturn.
- Manage your debt maturities to avoid concentrations at any individual point in time and with a longer-term bias if possible.
- Multiple financing options can help mitigate risks and seize opportunities, regardless of market cycles.

With cap rates at current low levels, if property values were to fall significantly, assets with high leverage could be under water. That said, there are also important differences between the market of today and a decade ago, including better controls on underwriting and rising real estate fundamentals that justify the high prices investors are paying.

In our view, the aggressive capital markets today bear little resemblance to a bubble economy on the verge of bursting. But no one can see the future and any "black swan" event could prove to be disruptive to the commercial real estate market. Investors and developers who feel the need to protect their investments in the event of a credit crunch can work with an experienced advisor to find solutions that bring the best risk-adjusted yields in line with borrower goals.

Maximizing yield, minimizing risk

Lenders that focus on one type of execution—such as CMBS conduit loans—may tend to take a one-size-fits-all strategy. The assumption is that all borrowers want the highest proceeds at the lowest rate possible, to the exclusion of all other considerations.

Your capital provider should offer a much wider range of options, including CMBS loans as well as relationships with life companies, Agency lenders, and other avenues. Most important is the expertise and time to work with each borrower to find the best financial solution to ensure your goals are met.

Seeking opportunity? Ask the right questions.

The first step to getting the best financial structure is to understand your risk tolerance and return goals. Perhaps the most common mistake borrowers make is to pursue financing that brings the highest current yield without considering the downside risk. If you decide to maximize returns after concluding that the risks are negligible, that's still better than going into a deal with your eyes half-closed.

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Questions to Ask When You're Concerned About a Slowdown

- [ ] Are we over-leveraged?
- [ ] What would a downturn mean to individual assets?
- [ ] What investments can be made now that will deliver ROI throughout up and down cycles?
- [ ] How can investors continue to work toward long-term ROI targets?

Here are some strategies and considerations that we use to help our clients think through their options:

Seek strategic long-term plays that will make sense regardless of market cycle. Some asset pricing is more stable than others. If you must acquire assets to meet investment allocations, look for evergreen transactions that will make sense long-term. Regardless of property type, look for buildings that are high quality, low-risk, and considered "core."

Think long-term regarding asset sales and subsequent acquisitions. Even a seller's market poses challenges for sellers. Once the deal is done, the next step is to find ways to reinvest the money. Typically, reinvestment needs to happen quickly to keep your money working for you, but if you expect values to drop in the near term, you can sell high now and hold the cash to buy assets after value declines have taken their toll.

Consider the status of each individual asset. There may be assets in your portfolio that you should sell now, even if you aren't quite ready—if you believe tomorrow's pricing is likely to take a turn for the worse.

Temper your leverage. During the last downturn, many companies found their hands tied because they were over-leveraged and lacked working capital. Some even found it difficult to fund operating expenses. Borrowing less than the maximum achievable leverage will give you more flexibility and cushion, and may position you to make opportunistic acquisitions if and when the market bottoms out.

Manage your maturities. One of the issues that caused many real estate owners severe pain in the downturn was an overconcentration in short-term debt. When the downturn hit, borrowers who had all of their debt maturing over a short period of time could not refinance the bulk of that debt while the debt markets were locked up. While longer-term debt is typically priced higher then shorter-term debt, having your debt maturities staggered over time with a bias towards longer-term maturities can allow you to ride out shocks in the debt markets.

Understand the risk and variability relating to floating-rate financing. LIBOR remains at historic lows, prompting ROI-conscious borrowers to consider variable-rate financing as a lower-cost alternative to fixed-rate debt. Make sure your team can help you determine the best mix of variable- and fixed-rate debt to manage risk and return in line with your goals.

Understand the effects of regulation. Partner with experts who stay abreast of evolving regulatory regimes and can help you understand the potential impact on your strategy, such as the Basel III leverage ratio framework and reporting requirements. The new regulations are already affecting how banks approach the construction lending business.

Winter is coming

Market cycles are moving more rapidly today than at any time in history. Presumably there will be peaks and valleys in the coming years, and while we can hope any market correction is mild, we can't know that for sure. A "Winter" cycle—or a downturn—is bound to occur. Opportunities come to those who keep their eyes peeled for signs of a slowdown, and plan ahead accordingly.

To learn more, contact:

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Andrew Lucca has been with KeyBank since 2005 and brings more than 18 years of banking experience to his clients. Based in Phoenix, Arizona, he manages two sales teams that provide a full range of financial services and products for commercial real estate owners based in Alaska, Washington, Oregon, California, and Arizona, including balance sheet lending, permanent loan placements (CMBS, Fannie Mae, Freddie Mac, FHA, Life Company), treasury services, loan syndications, investment banking, and interest rate derivatives.

Andrew holds a Bachelor of Science in Finance from the University of Arizona, and has completed Cornell University's "Managing for Execution" certification and the Mortgage Bankers Association Leaders Program. Andrew and his teams have originated more than $2.9 billion in balance sheet and permanent loans.

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