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Debt capital availability increases for multifamily acquisitions

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Debt availability has increased dramatically from the trough two years ago, but the overall supply remains limited and selective. Institutional debt sources share a preference for low-risk, higher-quality assets in top-tier markets with strong sponsors. This mandate leaves the majority of the transaction bell-curve, which includes sales of $5 million to $20 million in the B-minus to C-quality range, with fewer financing options. Transactions of this type can get funding, but the process and qualifications are more challenging, with a significant focus on sponsorship. A large number of properties remain in limbo with respect to refinancing without recapitalization or lender write downs. An estimated $77 billion of maturing multifamily mortgages will weigh on the market in 2011 as reduced market values in the B- to C- categories and higher loan-to-values (LTVs) create shortfalls for owners in need of refinancing. This may result in more acquisition opportunities as many owners opt for a quick sale over additional equity contributions.

As the future of the GSEs Fannie Mae and Freddie Mac hang in the balance, commercial banks and life insurance companies are stepping up with competitive terms. Lending by life insurance companies increased nearly 150% last year, while GSE volume declined 55%. In perspective, the GSEs currently hold 37% of the $843 billion in total multifamily mortgage debt outstanding, while life companies account for 6%. Multifamily delinquencies held in the GSEs' portfolios remain below 1%, supporting expectations for the agencies to remain active, despite talk of reform in Washington, D.C. CMBS apartment loans continue to post high levels of distress, with delinquency in this sector hovering around 8.5%. Economic growth and increases in apartment property values, particularly for high-quality assets, will relieve some pressure and lead to more sales and refinancing. Some level of distress at the local- and regional-bank level with high exposure to lower-quality assets and construction loans will persist into 2013.

Nonetheless, the CMBS market has started to recover. Total issuance in 2010 for all property types was expected to be just shy of $13 billion, roughly four times the volume in 2009 but still a fraction of the $234 billion peak in 2007. Even prior to the market froth of 2005-2007, CMBS issuance averaged $85 billion per year from 2002 through 2004, providing a critical source of financing to the commercial real estate market. The recovery should gain momentum as the secondary market continues to expand thanks to improved confidence and better underwriting. Approximately $8 billion of issuance is expected for Q1 2011 alone, and we agree with Standard & Poor's forecast of total volume of $35 to $40 billion for 2011.

The primary factors driving this recovery are slowing pace in the growth rate of CMBS delinquencies (including a growing number of successful loan modifications), improving CRE market fundamentals and increasing demand from CRE investors. The large spread between CMBS returns and alternative investments also helps. CMBS delinquency rates are the highest in the industry, but investors are distinguishing the new round of deals from the underperforming pools of the past,

particularly 2005-2007 vintage loans.
Growth in CMBS activity will help fill a hole that traditional lenders - in particular commercial banks and life insurance companies - may not be able or willing to fill in earnest for some time. Although banks' improved financial position, clarity on higher reserve requirements and lower losses bode well for increasing commercial lending, their allocation will likely fall short of increasing demand until improved valuations and property fundamentals provide a safety net to the next wave of loan maturities. In the next three years an estimated $1.4 trillion in commercial loans will mature in addition to re-maturing loans that were extended during the crisis, according to Foresight Analytics. Approximately half of this debt is considered under water based on current valuations, according to Trepp LLC.
The bottom line is that the availability of debt capital to gradually increase, with much of the growth taking place via CMBS issuances. However, apartment borrowers will continue to be forced to contribute significant equity, and underwriting criteria will be conservative. This will limit the rise in investment activity and keep the volume of seller financing and loan assumptions higher than usual. It also gives cash-rich and low-leverage investors - high net-worth individuals, REITs and pension funds - in strong positions, especially as they become more willing to acquire Class B assets.

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