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Commercial real estate lending in 2012: A new optimism

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As Winston Churchill once said, "A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty."

The real estate industry is a business where the great optimism of rising markets can be quickly replaced by the pessimism of contracting markets. I have been a commercial real estate lending professional for over 30 years and have been witness to multiple cycles. My experiences have shown that when commercial property markets recover they are stronger and more dynamic than the previous cycle and much different. This latest recovery is no exception.

There are several takeaways from year-to-date 2012 which support my premise:

The recovery in the commercial real estate lending markets that began in 2010 is finally taking hold nationally. In the later part of 2011, we began to see increased production volumes in several areas of the country where the economic downturn had been more severe. NorthMarq offices located in states like Florida, Arizona, and Georgia are producing loan volumes not seen from these places in several years.

The market for commercial property sales appears to be strengthening as we are seeing more investment sales of office, retail, and industrial properties trading hands. This results in increased lending opportunities. According to CoStar, sales volume for 2011 was \$291.6 billion, a 32% increase over 2010.

When the CMBS market and lending in general began contracting 5 years ago, lenders of varying types either changed their product focus or slowly entered the market in order to fill the lending void that was created as capital contracted. For example, Insurance company lenders moved to higher loan dollar, lower-leveraged, higher-quality, best-of-class mortgage loans, eschewing risk for safety. In contrast, regional banks and credit unions, who were not large commercial real estate lenders in the past, now dominate lending for loans of less than \$10 million. That space was dominated by the insurance company lenders since the 1970s.

Other capital sources providing fuel to the lending market are Freddie Mac, Fannie Mae, and FHA, making multifamily loan production extremely active this year. In fact, with the recovery of non-multifamily lending adding to our multi-family lending platform NorthMarq will produce overall production volume similar to 2006.

Lending and sales volume did not take a summer vacation. Second-quarter Commercial Real Estate mortgage production increased 39% from the first to second quarters 2012. It was the highest lending level on record since the fourth quarter 2007 (source: Mortgagedaily.com). Preliminary indicators show that the third quarter 2012 should be just as strong.

Underwriting parameters have remained relatively constant throughout 2012 as lenders have maintained discipline with respect loan underwriting metrics. As capital continues to chase the best deals, lenders are holding to debt yield, LTV and debt service constraints, and are insisting on

getting paid for risk. The days of reaching to make deals based on rosy economic projections have not yet returned.

With the fourth quarter about to commence, the optimism that we have seen through September should continue through the balance of the year. Lenders have continued to emphasize multi-family loans as 75% sub 4.0%, 10 year-loans are readily available from both the GSEs and insurance companies. For the balance of the commercial sector, middle market lending continues to expand as CMBS and bank loans are readily available for requests of less than \$10 million.

Also expected to continue for the foreseeable future, is the conservative underwriting reflecting the deleveraging of the economy that began four years ago. Life companies generally will provide leverage of up to 70% with generic pricing for 5-10 year term mortgages ranging from 3.5% to 4.5% with amortization of 25 years and in some cases 30 years for newer product. CMBS pricing is generally 50 basis points higher, though more leverage is available with structure. Values this year have been generally determined using direct capitalization with capitalization rates of 7.5% to 8.0% or greater for most non-multifamily, non-CBD properties. There is a general sense that even though capitalization rates have compressed below 7% banks and insurance companies are reluctant to value properties beneath that except for core locations such as mid-town Manhattan and Washington D.C. Banks will continue to provide greater leverage though they still often insist on some percentage of recourse.

Investors with financing needs will have to meet these challenges head-on in order to achieve desired financing levels. NorthMarq Capital, Inc., and its network of 32 offices, have the lending resources to help our clients meet these challenges daily.

Ernest DesRochers is senior vice president and managing director of the New York Metro office of NorthMarq Capital.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540