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Current and future issues affecting liquidity in the commercial real estate capital markets

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It is clear that the New England real estate market, long stagnant, is not improving much in the short term. How about the long term view? Although developers are always optimists by nature, the following factors should be considered before you next put a shovel in the ground.

All indications are that demand is shrinking for office and retail space in New England. Many offices are shrinking due to both increased use of technology and increased acceptance of alternative work systems such as home offices or "hoteling" employees into first-come-first-served work environments. Retail changes are still evolving as internet buying presents retailers with the challenge of keeping physical storefronts from becoming little more than showrooms for customers who want their purchases delivered to their front door. A developer must be sharper than ever to determine whether a tenant will be a winner or a loser in today's uncertain economy when making decisions about what and where to build, and whether the tenant will remain solvent long enough to make constructing a new building or tenant improvements in an existing building economically worthwhile.

We are constantly told that liquidity in the real estate capital markets is coming just around the corner. However, several factors will combine to keep real estate lending reserved only for the very best and most solvent developers. First, new capital limitations imposed on banks by the infamous Dodd Frank Act, as well as by the Basel III requirements which begin implementation in 2013, should keep many lenders on the sidelines. The Organization for Economic Co-operation and Development estimates that implementing Basel III will decrease annual GDP growth. The long term loan favored by many developers will not be available from a lender whose capital needs override its income needs.

A second factor in the slow return of liquidity to the real estate lending community is the existing over-allocation to real estate loans many lenders currently carry in their loan portfolios. Many banks are looking to cut their exposure to real estate loans, which obviously makes getting a new loan from such a lender quite difficult.

There are hundreds of billions of existing real estate loans which must be refinanced over the next three-to-five years; thus, the third factor inhibiting the availability of liquidity in the real estate capital markets is this flood of forthcoming refinancing, which involves loans to property that have a loan-to-value ratio in excess of 1.00 to 1.00. Many lenders fear their existing portfolios contain ticking time bombs that will result in write-offs and diminished earnings for years to come. The typical cautious lender will not be looking to make new loans in that environment.

A related issue is the incredible shrinking cap rates being experienced in New England. By all accounts, cap rates are returning to levels not seen since 2007. What will result when interest rates finally start to increase and cap rates decompress? We may be heading for another round of

declining valuations that will further depress the current real estate market.

It seems clear that commercial real estate is in a decline that will continue until excess capacity and risk have been wrung from the market. In the meantime, if you are a developer or own a small property or a property in a secondary or less desirable market, or have been historically a weak borrower whose properties suffer either substantial vacancies or high turnover in tenants, then you will find great difficulty obtaining financing from traditional banks in today's challenging real estate capital markets. However, non-bank lenders are including real estate loans in their portfolios. The message to developers is don't despair, there is money out there for your project but you may have to look beyond your bank to obtain funding.

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