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Financing: Another year of slow rollers? Banks are competing for deals in an upbeat environment - by William Pastuszek Jr.

March 02, 2018 - Northern New England

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Financing drives real estate markets. Whether it’s 1-4 owner-occupied markets or investment markets, financing – its cost and availability – is crucial to the health of real estate and critically influences attitudes and activities in this economic sector. This is true even in markets where cash buyers predominate; for example, $5 million downtown condos, mixed use projects purchased by insurance companies.

One brokerage notes, writing about capital markets in 2018, “On the heels of tax reform, the outlook for 2018 looks positive. Strong domestic economic fundamentals have propelled consumer confidence and business optimism to levels not seen since before the financial crisis. A powerful combination of extremely tight labor markets, strong financial market returns, increasing housing values, and broadly improving access to credit are supporting both the consumer and business investment engines of economic growth.”

Some keen observers voice concerns that real estate markets are overleveraged and lenders are not exercising discipline. Notes of caution are sounded that ring notes of caution about the potentially destabilizing growth of non-traditional lender’s market share at the expense of more traditional lender’s share. Banks have been dealing with non-traditional competition for many years. Remember what happened to all those alternative lenders when commercial markets crashed in 2009? (They disappeared from view and cautiously reentered markets.) Is this time different?

The Federal Reserve conducted an opinion survey of senior lenders in January on bank lending practices for the last quarter of 2017. Answers indicated that, on balance, banks eased their standards and terms on commercial and industrial (C&I) loans while demand for such loans was basically unchanged. Meanwhile, bank’s standards on most categories of commercial real estate (CRE) loans tightened, while demand for CRE loans reportedly weakened. An interesting dichotomy: read further.

However, the threat and influence of non-bank lenders is present. The fed survey notes that “more aggressive competition from other banks or nonbank lenders was by far the most emphasized reason for easing." Further, there are plenty of banks out there willing to "roll the dice" in this upbeat environment.

Banks are clearly competing for deals, whether it's C&I or CRE. Banks interested in making money in a competitive environment will end up making aggressive deals. Risk taking looks good on the balance sheet until such time when risk comes home to roost.

So, the trend is worth watching. Especially with more years of advances in data mining, taking advantage of sophisticated social media, and use of cutting edge technology, this lending sector has the potential to disrupt regulated, heretofore reasonably decorous lending markets.

Are rising rates a concern? The 2018 outlook includes "positive news" for all asset classes. Rent growth and increased occupancy rates are anticipated. However, rising rates will be "bad news" for borrowers closing floating rate loans and purchasing caps. A flattening yield curve is not the best case in these markets. Let's hope the offset of anticipated rising NOIs will cover high debt loads.

Another broker notes, regarding capital markets, that the next "three years will likely see cap rates flat at best or rising, which we expect will outstrip property income growth. The economy's performance over the period will determine whether commercial real estate values continue to rise mildly, remain relatively flat or decline mildly or moderately." A note of caution here.

What are signs to watch? No one is quite sure what the effects of the tax overhaul will be. The last one put markets into the bust of the 1990s. Inflation is a concern that the Fed is watching carefully. The long-term supply/demand imbalances in real estate markets have the potential to erupt into dangerous price inflation. It pays to watch all these trends and probably others not mentioned. As was said earlier, it a "powerful combination." Markets have a way of dealing with these scenarios. More later.

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