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CELEBRATING 55 YEARS

Fall 2018 commercial mortgage outlook: Get ‘em while they’re hot! - by Michael Chase

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The tax reform package passed at the end of 2017 helped to continue an economic expansion now over nine years in the making. So far, it is the second longest in U.S. history, trailing only the ten-year period between 1991 and 2001. The strong economy has continued to support a strong commercial real estate market, which has in turn led to a strong commercial mortgage industry. While some lenders have hit their targets for 2018, there is still plenty of capital available for borrowers with no signs of reduced lender appetite heading into 2019.

Speaking with several industry colleagues, it was a common refrain to hear this year lacked the typical summer slowdown. Whether the U.S. economy is still in the “seventh inning” or “extra innings” or no matter how much “runway” is left, the general mood is investors are not entirely certain when the next downturn will happen, only that it will happen eventually. Therefore, while signs still point to continued growth out to at least 2020, it only makes sense to get deals done sooner rather than later.

The Yield Curve

One of the most significant trends in 2018 has been the movement of the flattening yield curve. The Fed continued to raise their benchmark rate following three increases in 2017 with three additional bumps so far in 2018. A likely fourth increase is expected in December. While short-term rates have moved up steadily, the impact of Fed rate movements has not translated evenly along the yield curve. Long-term rates continue to feel downward pressure, particularly from global economic forces. Much of the summer was spent debating whether the Fed would ultimately push towards an inverted yield curve and would that be a harbinger for an upcoming recession.

The spread between the two-year and ten-year U.S. Treasuries started the year at 54 basis points and shrunk to as little as 21 basis points over the summer. Only recently has the spread started to widen again, but as of this writing, it is still just 30 basis points.

For much of the year, the flattened yield curve provided an opportunity for long-term investors. Many borrowers have been able to lock in long-term fixed rate financing of 10, 15 or even 20 years or longer for only a small premium over shorter-term loans. In addition, rising short-term rates have helped some borrowers get out of their current loans with reduced prepayment penalties. In particular, borrowers who previously fixed their mortgage rates using SWAPS are finding their derivative contracts are now “in the money.” This allows them to sell or refinance to pull out additional equity while receiving a prepayment benefit instead of a penalty.

Alternative Debt Sources

While traditional commercial mortgage capital sources are generally enjoying another strong year, the universe of alternative balance sheet, bridge, mezzanine and hard money lenders continues to exhibit distinctive growth. It seems as if each week there is news of another Mortgage REIT, private wealth fund, crowd-sourcing platform or even institutional lender announcing an alternative debt platform.

These debt sources are helping to fill the gaps not being met by traditional capital sources. For example, even though a reform of Dodd-Frank was passed earlier this summer, banks are still awaiting guidance from the OCC, the FDIC and the Fed. Meanwhile construction financing remains relatively tight from banks, so some developers have turned to the alternative debt platforms who are not subject to the same regulatory environment.

The level of competition has helped to further compress spreads, particularly in the bridge loan space. Loans starting as low as 250 basis points over LIBOR are available from some institutional lenders looking to supplement the yields they are getting on their typical long-term debt.

Overall Commercial Mortgage Market

As of the end of the second quarter, the Mortgage Bankers Association (MBA) reported total commercial and multifamily mortgage debt outstanding increased $90 billion over year-end 2017.

Jamie Woodwell, MBA’s vice president of commercial real estate research said, “… 2017 marked the strongest year for mortgage debt growth since 2007.” This is not unexpected given the dearth of available long-term debt maturities from the lean years of 2008 and 2009 during the heart of the last recession. Without having to replace a large volume of maturing loans rolling off their books, lenders were able to make significant gains in their mortgage portfolios. 2019 will provide another opportunity for portfolio lenders who are looking to grow.

Borrowers hoping to close loans in 2018 still have a little time remaining to get their deals into the pipeline. Meanwhile, borrowers looking to target closing dates in 2019 may benefit from looking into opportunities to lock their rates now with lenders who can offer forward commitments for up to twelve months. Either way, the commercial mortgage industry shows few signs of slowing down for the remainder of 2018 and into 2019. For borrowers, there is still time to “Get ‘em While They’re Hot!”

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