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Transaction volume declined, but creative solutions have allowed deals to close during pandemic - by Michael Chase

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On March 10th Mass. governor Baker gave the order to shut down all non-essential businesses in Massachusetts. The last 20 weeks have certainly presented unprecedented challenges, but also incredible responses in the face of many obstacles. Regulators for the banks, life insurance companies and multifamily housing acted quickly allowing lenders to work with borrowers on existing loans and provide guidelines for closing new loans. Transaction volume declined sharply during much of the second quarter, but creative solutions allowed deals to close even in the midst of the pandemic. Now we look forward to the challenges and opportunities that lie ahead.

Interest Rates

As the COVID-19 pandemic shut down economies around the globe, there was a natural flight to quality and de-risking in the capital markets. Instability in the oil markets exacerbated investor concerns. On March 8th the yield on the 10-year U.S. treasury touched an all-time low of 0.318% during overnight trading. The 10-year U.S. treasury holds great importance as a key benchmark for mortgage rates in the U.S.; however, corresponding volatility in corporate bonds forced many lenders out of the market. Borrowers had to wait until early April before being able to take advantage of a new lower-rate environment.

Commercial mortgage rates are once again near all-time lows. This is likely to be the case for at least the remainder of the year. Consider that a commercial mortgage rate of 3.5% represents a healthy spread of 285 basis points over the current yield on the 10-year U.S. treasury (0.65% as of July 10, 2020). This means there is plenty of room for the benchmark 10-year U.S. treasury yield to rise and for spreads to compress, keeping mortgage rates at their current historically low levels.

Of course we will have to continue to keep an eye on potential market disruptors such as U.S./China relations or a resurgence in COVID-19, which could bring volatility back to the corporate bond market. Borrowers may also want to consider acting sooner rather than later to lock in favorable rates before the November elections.

Preferred Asset Classes

Underwriting is generally more conservative in the current environment. Lenders are taking a close look at in-place rental income for any signs of distress while looking to avoid future disruptions.

Multifamily remains the asset of choice for most lenders. The agency lenders, Fannie Mae and Freddie Mac, continue to lead the way for multifamily financing. They are generally able to provide higher leverage on a non-recourse basis than most banks, and are currently providing borrowers with extremely competitive rates at all leverage points. The agencies are currently quoting 10-year fixed rate financing from around 2.5% to 3.3% with pricing incentives available for properties that qualify for their affordable or green programs. Another agency lender, FHA, is helping to provide liquidity for construction and cash-out financing requests. There is no equivalent capital source to the agency lenders when it comes to other commercial asset types. Their presence in the multifamily space keeps other lenders with their pencils sharpened. Borrowers should strongly consider taking advantage of refinance opportunities before the Agencies exhaust their lending limits, which were set at $100 billion each for the five quarters from the end of 2019 through 2020.

According to the National Multifamily Housing Council (NMHC) apartment rental collections have held up favorably so far through the pandemic. Some of this can be attributed to the enhanced federal unemployment benefit which was part of the CARES Act. This added an extra $600 per week to qualified individuals, but is currently set to expire at the end of July. Meanwhile, here in Boston, approximately 60% of the apartment units typically rollover on September 1st. Much of these units would normally be rented by students or others tied to the several area colleges and universities, many of whom have already made announcements regarding their fall programs. Local apartment landlords and lenders will be looking to see what impact these or other conditions may have on collections in August, September and beyond.

If multifamily assets are 1A, then industrial assets would be 1B when it comes to lender preference. Industrial properties have several advantages including lower tenant replacement costs and they are typically leased on a triple-net basis. The rise of e-commerce and a movement from just-in-time deliveries to just-in-case stockpiling continues to fuel demand in this space. Lenders will be critical of significant near-term roll over, the credit worthiness of major tenants and functional obsolescence. They will also take a conservative underwriting approach to characteristics such as a higher percentage of office build out, freezer cooler space or outside storage which maybe providing revenue that could be difficult to replace. While the industrial market in the Boston area is not to the same breadth and scale as other major distributions hubs the asset class continues to perform well in this region.

Outside of multifamily and industrial, other asset classes are finding more difficulty attracting capital in the current environment. Relationship lending is as important as ever with lenders showing a definite preference to work with existing borrowers. A well located asset with solid leasing, strong sponsorship and a stable track record should be able to attract favorable financing at historically low rates.

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