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The current shifting lending landscape: Deals and opportunities are still out there

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Saying the commercial real estate market is in a state of turmoil is an understatement. Workouts, foreclosures and bankruptcy filings are all on the rise, and the worst of the commercial paper market is likely in front of us due to a vast number of loans coming due between 2010 and 2014. The silver lining is that there are opportunities to be had for the savvy investor and banks now have money to lend. Two senior lenders recently interviewed reiterated the fact that liquidity at their respective banks is not an issue. Instead, they explained that as a result of more stringent lending guidelines, it will take a very commercially sound deal to obtain financing.

The decline in the transactional volume and prices in the commercial real estate market cannot be attributed to any one factor. However, there are two recurring themes mentioned by each loan officer interviewed. The first issue concerns the significant discrepancy in property valuations existing between buyers and sellers. Unless a seller is under pressure from a lender to sell as a result of a failing loan, there is nothing to force the sale of a parcel of real estate at a discount. On the flip side, buyers who are unwilling to meet high asking prices are instead sitting back and waiting for prices to continue to decline. The combination of the two events has caused the market to become stagnant, and is a proximate cause of the second major issue affecting the commercial real estate market: appraisals.

Due to the lack of sales, commercial appraisers are having an extremely difficult time appraising property based on "comparable" sales prices. While it is evident that property values are dropping, without comparable sales, determining the precise extent of the decline has become problematic. As a result, appraisers are being conservative in assigning valuations, particularly for "single purpose" buildings. When an appraisal comes back lower than anticipated, lenders may revoke their loan commitment, request additional collateral or require the borrower to come up with more money than expected. This last aspect has proved to be the most challenging, as the additional funds will either come from the borrower's pocket or through a bridge loan, which bridge loans have become increasingly difficult to obtain. Additionally, lenders are now looking more closely at capitalization rates (defined as the annual net operating income of a property divided by its acquisition cost). As a result of decreasing rents and increasing vacancy rates, appraisers are having difficulty coming up with appropriate cap rates. "It's all based on cash flow," said a senior loan officer at a Boston-based cooperative bank. If the cash flow is not there, the loan is dead in the water.

In the past, fund investors and insurance companies acted as sources of conduit financing or purchasers of commercial paper. With these types of lenders now pulling out of the market, and larger banks being strictly regulated, smaller cooperative and community banks are poised to be more significant players in the commercial lending industry. The criteria for making new loans has become more strict, with a seventy percent loan-to-value ratio generally being the new standard for

commercial real estate. The majority of the aforementioned smaller banks, even though they were not as greatly affected by the collapse of the commercial mortgage backed securities market as some of the larger banks and fund investors, have nonetheless become more risk averse. These smaller banks offer familiarity with the market and typically have a quick turnaround after a prospective borrower has made application. The downside to this type of institution is lower lending limits, which could preclude the lender from certain deals without the assistance of an additional participant.

At a recent real estate finance seminar held in Boston, a senior official from Key Bank stated that, in comparison to the rest of the country, the Northeast has been the most resistant to the downturn in the commercial real estate market. The majority of cooperative and community banks are adequately capitalized, and many loan officers find themselves busier than a year ago at the same time. However, with more real estate related problems anticipated in the coming years, deals will be closely scrutinized and conservative lending trends will likely extend into 2011 and beyond. As a result, the current turmoil in the commercial real estate market will likely continue for some time.

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