LOWER LEVERAGE, HIGHER SCRUTINY

To offset low rates, lenders put equity requirements, tenants' creditworthiness under the microscope.

Compiled by Kristin Hiller

Borrowers have been quick to refinance commercial real estate properties due to historically low interest rates that have persisted during the COVID-19 pandemic and corresponding economic fallout. But these are much lower-leverage transactions than prior to the pandemic, say sources. *Heartland Real Estate Business* spoke with a few Midwest-based finance professionals to gain insight into the types of deals they're working on and to hear their predictions for the second half of the year.

Participants included Joshua Bernard and Dan Duggan, both vice presidents with Southfield, Michigan-based Bernard Financial Group; Igor Zhizhin, founder and principal of Chicago-based American Street Capital; and Marsha Goff, executive vice president and Fannie Mae and Freddie Mac chief underwriter with the St. Paul office of Merchants Capital. Goff focuses on the affordable housing sector. What follows are their edited responses.

Heartland Real Estate Business: What types of financing have you and your company been most active with recently in spite of COVID-19? Any examples you'd like to highlight?

Joshua Bernard and Dan Duggan: Right now, we're active with all types of financing. But that comes with a big asterisk. There's a post-COVID-19 playbook that everyone will need to get used to. Loans need to have lower leverage and tenants are getting heavier scrutiny than before the pandemic. And in many cases, lenders are requiring reserves of six to 12 months of mortgage payments.

Joshua Bernard
Bernard Financial Group

Well-located multifamily properties continue to do well as do diversified, multi-tenant industrial properties. Office properties are getting financed. However, there is an asterisk to that point. An office property that may have struggled to get financed in February — yet still got over the finish line — will likely not get financed today. But then again, post-COVID-19, they will likely be financed again.

Dan Duggan
Bernard Financial Group

Retail loans are getting done, but again, there is an asterisk there too. The property must have a consumer staple like a grocery store or drug store if the borrower is to have any hope of nonrecourse debt. The smaller properties with a lot of mom-and-pop restaurants are going to struggle.

Similarly, hospitality properties are still at a minimum six months away from having operating numbers that will get lenders comfortable with the property. Without a real crystal ball, it's tough to handicap just how, and in what form, hospitality performance returns.

Igor Zhizhin: The most competitive financing since COVID-19 started has been agency debt for housing assets — particularly smaller, lower-leverage loans. The combination of historically low Treasury yields, competitive spreads and limited COVID-19 reserves has offered reduced leverage rates and terms not available for multiple decades. [COVID-19 reserves are based on leverage for most securitized lenders. Lenders are requiring borrowers to prove mortgage payment reserves in case the pandemic disrupts future collections.]

The reality is that in a completely unpredictable leasing environment, the only marginally predictable source of income is from residential assets. That is why most bond investors are flocking to this asset class, creating a substantially more desirable product.

For a tertiary market property in Mississippi, we secured a refinancing loan below $1.5 million. The large cash-out, nonrecourse loan features a 12-year fixed term, five years of interest-only payments and a rate below 4.25 percent. Historically, loans of that size and with that type of structure have at least a 1 percent premium to what we were able to place in April during the most unpredictable period of the COVID-19 impact on lending.

Marsha Goff: Merchants Capital specializes in multifamily housing and healthcare facilities finance. Through our parent company, Merchants Bancorp, we are able to access Merchants Bank of Indiana and offer acquisition and short-term bridge loans and new construction loans.

Despite COVID-19, Merchants Capital's year-to-date business has remained strong, with the number of second-quarter loan closings surpassing the first-quarter loan closings. In addition, affordable housing loan applications for both Merchants Capital and Merchants Bank are going up.

Our financing products held strong in the second quarter. The product types that are most active include acquisition/bridge loans, 4 percent and 9 percent low-income housing tax credits (LIHTC), new construction, forward commitments and FHA 223(f) and 221(d)(4) loans. We have experienced the greatest increase in short-term bridge loans with the intent of a future takeout by HUD or the GSEs (government-sponsored enterprises).

HREB: To what extent have you seen demand for acquisition financing fall during the pandemic and how does that compare with demand for refinancing loans? What about construction loans?

Bernard and Duggan: Acquisition financing is almost unnecessary because arm's-length trades have been few and far between. Real estate investors are on the sidelines either waiting for the dust to settle or waiting for discount properties to hit the market.

And by the way, we're not totally convinced that the 25 cents on the dollar real estate owned (REO) acquisitions of 2011 and 2012 will be coming our way again, especially since there are so many well-capitalized buyers just waiting to pounce. The market has been to this rodeo before, and this time professional investors are lying in wait. But for the acquisitions that are happening, there are plenty of loan options to be found because fresh equity is being brought to the table.

Refinancing is a much different story. There is a deep market for refinancing stabilized properties. However, leverage has tamped down 5 to 15 basis points from February's mature market cycle highs. That said, interest rates on this financing are super low, historically speaking.

Construction financing is available, but mostly only for pre-leased projects with strong developers/guarantors. Pure speculative construction is not "in vogue" at this point. Part of this is real estate risk but an equally important part is the banking system. Between the banks fronting cash for the Paycheck Protection Program (PPP) loans as well as the write-downs on loan restructuring, there's a lot less bank liquidity out there. That's going to push what money is available toward the very strongest of loan requests and leave everything else on hold.

Zhizhin: Without a doubt, during February, March and April acquisitions were significantly impacted by COVID-19. Buyers are burdened with unpredictable collections, COVID-19 reserves, reduced leverage, a very limited pool of active lenders and a much more selective lender appetite for transactions. Sellers were generally forced to make large price concessions, especially if the transaction coincided with being under contract during either legislative or lending changes impacted by COVID-19.

With that said, we have seen a large uptick in the last few months because of a combination of tangible collection data, reduced restrictions for business operations giving the ability for commercial tenants to pay rent and their employees to pay their housing rent, and a more reasonable appetite for leverage and spreads with multiple successful securitizations.

Furthermore, there is the unfortunate reality that several operators have been challenged with maintaining positive cash flow and are divesting assets at discounted prices and attractive valuations. These are ideal opportunities for those willing to accept the reality that they need to make major assumptions regarding all aspects of future collections due to the lack of any clear evidence that COVID-19's impact on all aspects of society will materially improve in the short term.

What has been interesting to see is the growing appetite for suburban assets and affordable housing properties. The combination of a short-term flight to lower-density areas and the predictability of subsidy payments has directly impacted the appetite for these multifamily property types. Currently, roughly 65 percent of our engagements are purchases, which historically is the inverse of the industry standard where the vast majority of engagements is seeking to refinance existing debt.

The refinance market has materially suffered outside of lower-leverage transactions. The majority of asset classes, excluding rental housing, were deemed ineligible for several months at the early onset of COVID-19 restrictions. The temporary closing of retail, the mass transition to home offices and the historically low travel that virtually eliminated the need for hospitality made nearly 60 percent of commercial properties ineligible.

Second, the majority of all lending institutions either scaled back or completely stopped lending. The CBRE Lending Momentum Index documented a 12 percent drop in March, spreads that are 100 to 140 basis points wider than historically available for larger transactions, and there was a substantial liquidity issue with the majority of debt funds dependent on warehouse lines.

Third, those that were active typically either added a substantial COVID-19 reserve, scaled-back leverage or restricted cash-outs, with the most impacting being not giving credit to commercial tenant income unless the tenant was a credit tenant or an essential business.

Finally, for those with a defeasance or a maintenance prepayment, the historically low Treasury yields effectively eliminated their ability to pursue the attractive interest rate environment. In my opinion, this will create an irreversible trend of borrowers paying a large premium for prepayment flexibility.

On the other hand, the refinance demand was much stronger in the second quarter as several months of positive data of performing loans has tightened spreads much closer to historical levels, offering interest rates that have not been available for decades.

The CBRE report demonstrated an average 17-basis-point drop in agency rates in the first quarter for seven- and 10-year terms, and an astounding 85-basis-point drop year over year. In the first quarter, there was a 17 percent increase in the percentage of loans with a rate under 4 percent, and an unheard of 81 percent of loans with an origination balance over $10 million were at or below 4 percent.

Property owners that wanted a cash neutral refinance to greatly benefit from the rate difference, or opportunistic buyers wanting to cash out to acquire discounted properties, became much more active in the last three months. As economic and lending data reaches a critical mass to give lenders and bond investors comfort to make COVID-19's impact more predictable, we anticipate a continued growth in the demand to refinance debt.

Goff: In the early phase of the pandemic, interest and demand for acquisition bridge loans initially slowed down as buyers and sellers were on pause, waiting for any negative impacts on multifamily housing in terms of increased vacancy and delinquent rent payments. However, occupancy has remained strong, with overall rent collections generally stable and much less impacted than initially anticipated by many industry professionals.

In regard to affordable housing, demand has remained strong so it continues to be a stable asset class. As such, acquisitions returned and brought about an increased demand for short-term acquisition bridge loans to accommodate a GSE or HUD permanent loan, which generally have a longer processing-to-close time.

Merchants Capital has experienced continued demand for construction financing for both market-rate, workforce and affordable housing multifamily projects. Some deals have been delayed or pushed back given items related to equity investors pulling back.

For affordable housing and workforce housing, a lack of available equity — whether in the form of equity investors, TIF/tax abatement, grants or soft subordinate debt — is the primary delay for new construction. However, demand for this product type remains very strong. Soft subordinate debt refers to a government debt (city, county, or state) that is subordinate to other positions and does not require hard, mandatory principal and interest payments.

HREB: To what extent has the Fed's lowering of short-term interest rates to stave off the severity of a recession helped keep deals moving forward?

Bernard and Duggan: This is an interesting topic right now. Historically, loans were tied directly to the pricing of the 10-year Treasury note, which is then tied in a roundabout way to the federal funds rate.

But when the 10-year Treasury yield reached such an absurdly low level, lenders had to begin instituting what's called a "floor rate" that's independent of Treasuries. Why? Lending is a business and lenders need to make a return on the money they've put out. And if they've determined that an all-in rate of say 2.5 or 3 percent is about the lowest they can go while still making a profit, then it's irrelevant what Treasuries do below that.

So, today you'll see lenders basing their pricing on the quality of the assets and pricing the loan somewhere between 3 and 5 percent.


Igor Zhizhin
American Street Capital

Zhizhin: The impact has been substantial. In an environment where everything has instantly become unpredictable and continues to be very fluid, keeping rates at historical lows was a fundamental driver in maintaining market and lending stability. Commercial lending does not exist in a vacuum, and never has that become more obvious than during the COVID-19 crisis.

Low interest rates have ensured residential tenants have enough money to pay rent and stay current with their consumer debt. Low rates have also allowed small business owners to receive critical loans to cover their expenses and make timely lease payments, and saved commercial real estate property owners that had a spike in collection loss or vacancies to maintain good standing on their obligations.

The reduction in rates allowed for loans to be closed that historically would have failed debt-service thresholds. The hope is that the interest rate environment stays relatively static as the economy, and the real estate sector in particular, is far from returning to the stability and predictability of the last few years.

Goff: The Fed's lowering of the interest rates has helped to keep deals moving forward. However, the majority of permanent loan pricing is based off the 10-year Treasury note, which has seen record lows. Because of the record low Treasury rates, investor spreads have either widened or floors have been put into place. As such, the rates, while at historical lows, are subject to factors other than the Fed's rate reductions.

New construction loans, which are generally floating over 30-day LIBOR, are experiencing the same, with either loans subject to LIBOR floors, increased spreads or both. The reasons for the interest rate floors is related to required investor returns and also loan exit analyses requirements.

HREB: How would you compare demand for floating-rate versus fixed-rate financing in the current environment?

Bernard and Duggan: Typically, floating-rate loans have been reserved for acquisitions and value-add properties. With buyers largely on the sidelines, it's eliminated some of the demand for a floating rate. Also, many of the bridge lenders are still on the sidelines as well.

Now one could argue that this is the chicken versus the egg in that buyers are on the sidelines because there is limited cheap, nonrecourse floating-rate money available without the debt funds being in the market. It cuts both ways. The key is understanding that debt funds are levered vehicles by nature. When their back-leverage through the overnight repurchase, note sale and collateralized loan obligation (CLO) market dries up, they too no longer have the right type of leverage to acquire their assets (for example, new loans).

Floating-rate loans are going to be more expensive than fixed-rate loans right now though.

Zhizhin: Like everything else during the COVID-19 crisis, opinions on the value of floating-rate versus fixed-rate financing could not be more divergent. The fundamental difference lies in the motivation of the borrower to put a premium on flexibility or the elimination of refinancing and interest rate risk. For the large pool of owners that are either in the middle of or completing a value-add project, the floating-rate product is an ideal tool to effectively buy time until a normal lending environment returns as defined by loan proceeds and leverage.

The global view is that in the near term, rates will stay stable and that some medical solution to at least curb new cases of COVID-19 and control the mortality rate has a high probability of becoming readily available within the next year. We have also experienced for the first time a substantial number of lenders offering floating-rate products without interest rate cap requirements while offering two- to three-year loans.

For the seasoned investor who is actively aware and follows the capital markets, this is the perfect time to take advantage of limited upside rate risk with maximum flexibility. This is also the preferred product for borrowers with a shorter investment horizon, who are waiting for the commercial lending environment to improve and the overall appetite of buyers to increase while maintaining the least exposure to prepayments once things return to normal.

The fixed-rate financing product is the preferred tool for long-term and small balance investors that have access to rates and terms that have not been available for nearly 50 years. The current fixed-rate interest environment is so attractive that an agency 30-year fixed loan is still below 4 percent, while historically 10-year loans were in the 5.25 to 5.5 percent range.

The ability to lock in a rate that is at least 100 basis points better than just a year ago for an extended period of time and remove interest rate risk, underwriting risk and all the closing costs associated with the refinancing process is incredibly appealing to borrowers that have a much longer time horizon.

Furthermore, small business owners who are not interested in following the bond market and are generally concerned about the macroeconomic impact, combined with an election during a once-in-a-century pandemic, are very aggressively pursuing fixed-rate financing. If you have the ability to get a rate below 3.5 percent with interest-only payments, then this is the greatest tool to hedge any future volatility that may occur at the property.

Finally, we are seeing a lot of clients try to take advantage of the fixed-rate environment as a selling tool in the future. The interest rate environment is so competitive that even the most flexible loans are priced at historical lows. A five-, seven- or 10-year fixed-rate loan with only a half-term prepayment is generally under 4 percent. This is at least 25 basis points better for a comparable term loan with defeasance or yield maintenance than a year ago.

Furthermore, taking a longer-term loan, specifically 10, 12 or 15 years, and combining it with several years of interest-only payments, creates a uniquely compelling assumption in several years that most likely will increase the sales price when the current market rates are no longer available.

The benefit of this environment is that regardless of any investor's critical factors in choosing a loan product, every option is priced at once-in-a-lifetime lows.

Goff: Short-term bridge and construction loans are generally originated using a floating rate, with few options or requests for fixed-rate financing. Conversely, permanent loans are originated at a fixed rate, with nominal, if any interest for variable floating-rate debt given the historical low interest rates.

HREB: What are your expectations for deal volume and velocity in the second half of 2020 as the economy reopens, for both your firm and the primary market(s) in which you're active?

Bernard and Duggan: While March and April were slow, we saw a big boost in May and an even bigger boost in June. Our firm is currently very active placing loans, and we're all looking at a second half of the year that's going to make up a lot of the ground that was lost in the first half.

So, for our firm, we're forecasting a year that's down only slightly from the roughly $1.3 billion we had in production for 2019. We've got a vibrant pipeline of loans in the works. We consider ourselves fortunate to be working almost exclusively with the strongest investors in the market, the kind of professionals who are prepared to weather short-term problems in the market and make sound decisions. As a firm for professional real estate investors, we are seeing and expecting a lot of activity in the third and fourth quarters.

Zhizhin: Our expectations are for deal volume to pick up, but most importantly for deal size to increase. The reality is that several lenders and mortgage banking firms, due to the source of capital or asset focus, will not return. Our firm was very adamant to stay open and active the entire year with the ability to be flexible and creative to help our clients achieve their immediate and long-term goals. This opened up new markets for us and continues to provide customized solutions, even during these difficult times.

As it relates to the real estate industry as a whole, I am extremely bullish in believing that the industry will bounce back and continue to grow. The real estate sector is a very resilient and stable sector, particularly during times of unpredictable volatility. I envision a large pool of first-time investors aggressively entering the real estate market looking for stability after experiencing large losses or reduced cash flow in their businesses due to COVID-19.

I also believe that lending, while more selective than last year, will again start to open up, especially if we marginalize the risk of mortality from COVID-19. The entire COVID-19 experience has put a premium on predictability, and no industry is historically more predictable than real estate.

Goff: We expect demand and velocity for the third and fourth quarters to remain strong given that investors, owners and buyers of multifamily properties have adjusted to COVID-19. Affordable housing remains strong with continued high occupancy levels, stable rent collections and overall strong demand.

Marsha Goff
Merchants Capital

We anticipate that 9 percent LIHTC financings will increase in all markets as the state allocation of tax credits occurs. We also anticipate continued financing demand for the new construction of workforce housing and for affordable housing preservation as those loans mature. And refinance opportunities remain strong given the current low interest rate environment.

HREB: In your view, what are the opportunities and challenges going forward?

Bernard and Duggan: The challenge in Michigan, and frankly the rest of the Midwest for top mortgage bankers like our firm, is to get more of the amateurs out of the way and make room for the professionals. That extends to lenders and borrowers. The last 120 days have been a wake-up call to always operate as if there's a problem around the corner and plan accordingly.

And there's plenty of opportunity ahead for Detroit and the rest of the country. We're about to see a resurgence in manufacturing and demand for industrial real estate. We'll see the smart real estate operators adapt to the post-COVID-19 environment and hopefully show some innovation to do things a little outside the boundaries of what we've seen before.

Expect an interesting next 12 months. But hopefully the interesting part will be opportunities more so than the recent challenges.

Zhizhin: This year has definitively been the greatest example that nothing is a given and every fundamental rule of real estate must be reevaluated. While this appears frightening and daunting, volatility is the greatest catalyst for opportunity.

The unfortunate reality is that many businesses and real estate property owners will reach a point where they no longer can continue operating. Many of these properties, which are cornerstones and have historically been unavailable, offer an opportunistic and aggressive buyer the ability to achieve long-term returns rarely seen in the industry. These opportunistic buyers have access to historically low interest rates that are unmatched.

However, all of that is predicated on being able to sustain extensive challenges — and within a relatively short period of time — or reach a viable end or ability to greatly marginalize the health impact of COVID-19. If COVID-19 continues to decimate the economy, if people's ability to earn enough money to pay their basic obligations continues to be a challenge, and if the government is unable to continue supporting the economy with stimulus packages and other subsidies, then any growth strategy will be counterproductive and potentially dangerous.

Although I strongly believe in the fortitude and vigilance of America to find a solution to this terrible pandemic and resurrect our economy, the reality is that astute investors must be committed to establishing a strong cash reserve and be calculating in their real estate decisions.

The current global pandemic created a series of unprecedented events: a double-digit U.S. unemployment rate within one month; a complete moratorium on evictions; extreme political unrest; and the legal shuttering of businesses due to the pandemic. These events occurred simultaneously without a definitive timeline for returning to historic norms.

This environment requires a shrewd and calculating approach to every aspect of the real estate sector to ensure that purchases, increases in leverage, value-add opportunities, new construction and general operations are highly stress tested for economic and financing challenges.

For those of us who are seasoned members of the real estate community that have experienced value erosion, recessions, illiquid capital markets and operational challenges, this time offers the greatest opportunity to use all that knowledge and experience to thrive.

Having the support of a good operational team, nonrecourse debt with the lowest possible interest rate and the longest term of interest-only payments and multiple exit strategies will help many real estate investors look back at this awful time as one of the highlights of their real estate career. Strategic aggressiveness will help the sector survive and use the lessons of this pandemic to hopefully eliminate the concept of unexpected events and continue the real estate industry's decade of a positive trajectory of growth.

Goff: Opportunities will continue to exist for short-term acquisition bridge financing, which will allow buyers to quickly close on a property and then reposition it for long-term permanent debt, via a GSE or HUD execution. Additionally, given the increased awareness for affordable and workforce housing, we expect continued opportunities for creative financing structures designed to cover equity gaps needed for continued new development and substantial rehab.

Challenges going forward include the continued pressure for gap financing on affordable and workforce housing needs, with much demand on limited resources. The limited resources will continue to present a challenge to developers and owners to meet financing needs. Construction costs continue to remain high, especially when factoring in COVID-19-related items.

As such, while overall construction activity may decline, construction costs may remain stable, which puts pressure on the overall new construction and substantial rehab transaction. We see challenges with tenant-in-place rehabs, given COVID-19 issues and risks.

Lastly, there is no "limited pool" for the 4 percent LIHTC tax credits as there is for the 9 percent credits. To obtain 4 percent tax credits, the property owner must first apply for an allocation of private activity bonds. This allocation can be an issue in many states, as the bond volume cap is limited with demand exceeding supply.

Overall, the pandemic has exposed America's affordable housing market crisis — a crisis that has always loomed. Even before the pandemic, renters tended to be lower-income and spent a greater share of their income on housing costs compared with homeowners.

A June 15 report from the Urban Institute — a Washington, D.C.- based think tank that provides economic and social policy research — estimated that approximately 20 percent of all renter households have at least one member who lost a job between February and April. This has left many lower-income individuals and families unsure how they'll meet expenses — including rent, which is one of the biggest expenses.

As a provider of financing for affordable housing in this country, we're trying to navigate through this crisis and keep our clients updated on their product options as the situation evolves and market opportunities shift state by state. ■

Merchants Capital recently secured a $57 million HUD 221(d)(4) loan for 4th & Race, a 264-unit apartment community currently under development in downtown Cincinnati.