FANTINI & GORGA

Skillfully Linking Borrowers and Lenders

Observations

Capital Market Perspectives from the 2017 MBA CREF Conference

The annual Commercial Real Estate Conference of the Mortgage Bankers Association was held February 19-22 in San Diego, with some 3,200 industry professionals registered and many more in town to attend meetings. All the national capital sources – insurance companies, CMBS/ conduit lenders, Agency sources (Fannie/ Freddie), FHA lenders, and specialty lenders offering bridge and mezzanine products – were there to roll out program details and production goals for 2017. Bank lenders, most of which have a more regional focus, were only sparsely represented.

As always, the Fantini & Gorga team was there in force, identifying the competitive edge of particular lenders and sectors as well as broader trends, in a schedule packed with dozens of one on one meetings. Here's the gist of what we learned.

Overall

We found cautious optimism about the health of real estate markets and expected transaction volume, specifically:

- Real estate fundamentals remain in balance overall, and capital sources are bullish about investing and lending in New England. Concerns were raised about some other regions of the country, and about luxury apartment development generally, which many see as becoming excessive. Lenders also expressed caution about retail, impacted by internet shopping, and about older suburban office assets, given the increasing bias toward urban and "24-hour" work environments. (Generally, the core markets in New England are unusually resilient in the face of these trends.)
- Lenders are setting high production goals, somewhat more than 2016, based on the underlying real estate basics and a large volume of loans that will need to be refinanced this year – including some of the $100 billion of 10-year CMBS loans originated in 2007, the peak year of the pre-recession market. Most of these loans underwrite for a conventional refinance, but others will be a challenge – and an opportunity for the specialty lenders.
- Many lenders noted the uncertainty about the economic effects – intended or unintended – of policies that may come out of the new administration and Congress. This relates to tax rates as well as business and financial regulation. Thus far, most of the lenders have implemented the Dodd-Frank and Consumer Protection Act risk-based capital retention rules successfully.

Insurance Companies

These remain poised to increase overall loan volume production in 2017 and have set their sights on New England where they remain underweighted due to competition from regional banks. Now the insurance companies see conditions changing in their favor as banks move to restrict volume and impose more conservative underwriting because:

- Regulators are putting pressure on banks to reduce their book of real estate loans, including fixed-rate non-recourse loans – the sector where insurance companies are most active.

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Capital Market Perspectives from the 2017 MBA CREF Conference – Cont.

- Accordingly, banks are pulling back on construction lending, and when current loans mature, more of them will need to be repaid by non-bank lenders.
- Fewer banks are fixing rates for even as long as 7-10 years, as bankers consider how long the current economic expansion has already lasted. (Insurance companies continue to have large amounts of money to lend for 10+ years – out to 30 or even 35 years.)

Seeing opportunity, insurance companies have revamped their programs to increase market share, offering:

- Best pricing: low to mid 100s – low 200s over the average life Treasury, .50% below typical bank pricing for permanent loans, and well below CMBS offerings.
- Lower minimum loan amounts from a number of lenders – down from $10M to $5M – to compete better for the middle market.
- New or expanded construction lending programs.

CMBS Lenders

The CMBS industry experienced a 20% drop in production year over year in 2016. A number of lenders closed their CMBS operations. However, CMBS still represents one-eighth of all originations and remains a vital part of the financial ecosystem. We see the following trends:

- The consensus prediction was that 2017 loan volumes would remain flat compared with 2016.
- Of the remaining 29 CMBS lenders, some will close shop in 2017, and the more successful lenders will increase market share. So it will be more important than ever to choose a CMBS lender with the market strength and expertise to quote aggressively – and close reliably.

The dominant CMBS loan structure continues to be the 10-year fixed rate non-recourse loan, most competitive for full loans, often in secondary markets. Specifically:

- Up to 75% loan-to-value (LTV) ratio
- Interest rates at spreads starting in the 2.20% range over 10 year swap rates for "average" quality loans.
- For 60%-65% LTV loans, spreads are starting in the 1.70's% + range.

Some CMBS lenders also have active "balance sheet" programs that are not securitized, although the lenders do hope to refinance some of these loans later with CMBS. These programs offer:

- 2-7 year terms, non-recourse, loan amounts $5M and up
- Floating rate over 30-day LIBOR, starting at LIBOR + 2.00%
- Maximum 65% - 70% LTV.

Capital Market Perspectives from the 2017 MBA CREF Conference – Cont.

Agencies (Fannie and Freddie)

The continued debate about privatizing the multifamily arms of Fannie Mae and Freddie Mac creates some medium-term uncertainty for this sector, but the agency lenders are very optimistic about multifamily production 2017.

- There were no announcements of major program changes.
- Freddie Mac particularly is trying to grow market share in what would be traditionally considered small to mid-market size loans and are trying to push lenders to originate loans of less than $8M and even down to $1M with a competitive "small balance" loan program that took off in 2016.
- Both agencies are bullish about the New England market – the large urban areas and also the second-tier locations. In the multifamily sector, we see them in a position to gain market share in permanent lending from the banks on 2017.

FHA

FHA had rolled out significant program improvements in the Spring of 2016, especially lower Mortgage Insurance Premiums (MIP) for construction loans with affordable or "green" characteristics and a less onerous method of calculating replacement reserves. In addition, the reorganization of work flow in the HUD offices, implemented over several years, leading to uniformly faster processing, was largely complete in 2016.

With these changes still recent, there were no major program announcements at this year's CREF convention. However,

- The 221(d)4 apartment construction program, providing non-recourse construction/ permanent loans with fixed rates out to 40 years and loans of up to 83% loan-to-cost or more, continues to gain market share, particularly as bank underwriting becomes more conservative.
- FHA lenders noted that their 35-year fixed rate, at 0.55% over the 10 year Treasury (plus 0.60% MIP, 0.45% for affordable properties) is highly competitive against 10 year fixed rated from agencies and banks.

Non-Regulated Specialty Lenders

Non-regulated lenders continue to grow as a sector, and were somewhat more in evidence to the CREF convention than in earlier years. These lenders are generally backed by private equity firms, hedge funds, family offices and other opportunistic capital. They primarily look for situations able to deliver higher yield returns, and reported:

- Bridge and mezzanine loans will continue to be the focus.
- Expect to see some increase in construction financing, particularly as banks become more conservative.
- They are willing to quote smaller loans than previously – down to $5M or even lower – in an attempt to generate middle market business.

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Some Takeaways

- Despite the consensus expectation of an increase in interest rates during 2017, the national lenders are planning to put out more money than in 2016.
- National lenders are bullish about New England and look to gain market share from the regional banks this year.
- We've identified a number of insurance companies, specialty lenders, and agencies that have lowered loan amounts down to $5M and even $1M – seeking to compete for a broader swath of business.
- We have also identified a select group of insurance companies and specialty lenders that are expanding construction lending, looking to pick up where the banks have reined in.
- It's still a great time to be a borrower – rates remain low in historical perspective, and lenders are competing fiercely for business.