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A Cloud Appears on the Real Estate Horizon

Problems in the real estate market played a major role in this country's 2008 financial meltdown. As the subprime mortgage market faltered because of borrowers' inability to make loan payments, the residential real estate market collapsed, resulting in a tremendous number of foreclosures and significant diminution in residential real estate values. As the financial giants teetered, commercial real estate also began to feel the impact. By the time the dust settled, commercial real estate values declined by an estimated 40%.

The problem in the commercial arena arose from the capital market drying up, taking with it the major source for financing commercial real estate. Real estate, whether residential or commercial, became anathema to banks and other financial institutions.

Commercial real estate values have made a significant comeback and investors have recouped much lost value. Nevertheless, the lack of new commercial projects, other than multi-family housing, continues to disappoint many developers. Their greatest concern, however, should not be the paucity of development, but rather refinancing their current loans. The 2008 meltdown resulted in the then-most popular source for commercial real estate financing, the commercial mortgage-backed security market (CMBS or conduit market), disappearing.

Wall Street created the CMBS market as a mechanism by which lenders could lend on commercial development and then sell those loans to large financial houses which would package the loans and sell investors pieces of the portfolio. Beginning in the late 1990s, conduit loans became an important source of commercial real estate financing. By 2003, and continuing on into the summer of 2008, most significant commercial financings were done via conduit loans, with approximately $615 billion being financed via conduits between 2005 and 2007 alone.

As compared to banks, conduit lenders could offer more favorable terms. Whereas banks did not want their loans to remain outstanding for more than three to five years due to interest rate risk, conduit lenders typically offered ten-year loans. The result is that many conduit loans will be coming due between now and 2017. With the conduit market having disappeared in 2008, how can we now finance those maturing loans, estimated at $1.8 trillion?

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Clearly, some of those loans cannot be refinanced and will fail. As the market heated up and became more competitive in the 2005 to 2007 period, lenders became too aggressive with their loans. Many conduit loans were offered on an interest-only period for a significant portion, if not all, of the loan term and many times at values equaling at least 80% of the property's appraised value. If the real estate has declined in value at all, and if the lender wrote the loan on an interest-only basis, the borrower will not have paid any principal on the loan. Without infusing capital, the property's economics will not justify refinancing.

Between 2005 and 2007, appraisers became more aggressive in their appraisals and lenders became more aggressive in how much they would lend on a property. With interest rates low and the ability to lock the interest rate for a ten-year period, many investors refinanced with conduit lenders, walking away with a nice check in their pocket.

Today, appraisers are far more cautious in appraising properties. Except for certain "trophy" properties, appraisers have difficulty finding (or if they find them, are sometimes unwilling to use) comparable properties at the same high prices as during the go-go years, with the result that many appraisals show little, if any increase, in value. Lenders, meanwhile, have lost their appetite for lending at the 80% level and are frequently now only willing to lend 70-75% of a property's appraised value.

Without a material increase in the appraised value and with a decrease in the amount lenders will now lend against a property, borrowers will not likely be able to refinance their loans without a significant cash influx. The current state of commercial lending causes additional concern. Banks are reluctant to lend on commercial real estate, not only because of their recent experience, but because of the constraints heaped on them by regulators. Life insurance companies, which, according to Murray Kornberg, a director of CBRE Markets' Minneapolis office, comprised the largest class of commercial lenders in 2011 with $66 billion lent, are more conservative. They will only lend on the best properties and even then at levels far below the 80% that was previously typical.

Because banks and life insurance companies do not have sufficient capacity to meet the burgeoning refinancing needs, the new CMBS products must take hold in a meaningful way. In 2011, for example, Kornberg stated that conduit loans were only responsible for a little over $33 billion of lending. While the Dodd-Frank legislation created new protections for the CMBS product, and while some conduit loans are being made, great concern exists as to whether there will be a sufficient market to refinance those loans that are creditworthy and whether, once rules and regulations are promulgated under Dodd-Frank, the CMBS product will still be attractive to originators and investors.

If the market cannot meet the refinancing demands, another major meltdown is likely. A new wave of commercial foreclosures will depress the value of those properties that would otherwise be solid performers. For example, if a lender forecloses on an office building and a new buyer purchases it at a foreclosure sale for 40 to 50 cents on the dollar, that new owner will be able to offer rents far cheaper than his neighbor down the block who had an otherwise successful investment. The vicious cycle will begin anew.

The good news is that the CMBS markets heated up in the last half of 2012 and are starting out strongly in 2013. A recent report from the Mortgage Bankers Association Commercial Real Estate Finance (MBA CREF) convention noted that "the CMBS conduit loan machine is cranking full tilt," although there is now concern that the market may overheat and we could begin again to start feeling overzealousness in the market. Even with the market "cranking full tilt," some optimistic attendees at MBA CREF predicted that CMBS loan originations could approach $90 billion, which could conceivably cover the CMBS loans coming due in 2013, estimated at $78.5 billion by commercialrealestate.com.

While the government should attempt to ensure that financial institutions do not make the same mistakes they made in the past, the government must also avoid over-regulating the banking and conduit industries. We must make sure that the capital markets can efficiently and successfully originate commercial real estate loans. A strong and healthy conduit market is critical in avoiding another real estate meltdown.

So, with the situation being so muddled, the following are the steps we recommend to clients:

- Start planning early and work with a lender or mortgage broker you trust to help determine the possible parameters of a refinancing loan. If you need to know who you might talk to, give us a call and we can provide some names.
- After determining the parameters, determine what additional equity you might need to bring to the table and where you might find it. You may need to consider finding partners if you don't have the liquidity to fund any shortfall.
- Come and talk to us as soon as you receive any commitment or term sheet. The

lending process is a completely different process than it was 10 years ago. Lenders are now looking at the borrower's global situation. Without noticing, your refinancing lender may be creating a situation that will cause problems with refinancing and/or sales of any of your other holdings.

- The final suggestion is the same as the first—START PLANNING EARLY! If you haven't done a refinancing in this lending environment, I guarantee that you will be amazed at how long and arduous the process is.

We at Reinhart are here to help. Please make sure, though, that you involve us early enough so that we can help steer you clear of pitfalls that could plague you for years.