Has commercial real estate lending turned the corner in 2010?

November 22, 2010 - Upstate New York

Recently a reporter for the CoStar Group reported that there was little to cheer about in the second quarter numbers for commercial real estate lending. Mark Heschmeyer reported that although loan demand remained light but steady, underwriting guidelines remained tight. Asset values for office, retail and industrial properties appeared to have declined in many parts of the country, with strength being shown only in institutional quality multifamily properties. According to one upstate New York multifamily investor, capitalization rates have decreased from 7.0% to 6.5% over the past year, and in some east coast marketplaces, below 6%.

Several banks are reporting that loan demand remains low in spite of near all time low interest rates. Ohio-based Fifth Third Bancorp reported to the US Treasury that they are "...continuing to monitor their Commercial Real Estate portfolios and have suspended lending on new non-owner occupied and on new home builder and developer projects in order to manage existing portfolio positions." Regions Financial also reported that activities primarily revolved around loan restructuring, re-managing and re-pricing to reflect the current credit quality of the sponsor, the project and the current market.

The bright spot in commercial real estate lending has and continues to be agency lending for multifamily assets. Now that the financial reform bill has been signed into law, Washington will shift its focus on both Freddie Mac and Fannie Mae. Where this will lead with respect to multifamily lending, is anyone's guess. Several things appear certain, the first being that the multifamily segments of these agencies are a fraction of their single family home segments. In addition, the multifamily segments continue to be profitable, unlike the single family side of the business. Finally, whatever Washington does, it will probably take years to reach an agreement on the roles agencies play.

According to Freddie Mac's Multifamily Developments Newsletter, total originations for the first half of 2010 totaled $4.4 billion. This included $3 billion in the second quarter aloneâ€”not nearly the amount closed by the second quarter of 2009. This parallels a reported 40% decrease in originations for FNMA.

In order to generate more demand and fill a niche in the market, both Freddie Mac and FNMA have established new mezzanine programs. Even though institutional quality cap rates have decreased in the past year, this is not true for all multifamily properties over the longer term. For example, a multifamily property financed with a valuation established using a 6% capitalization rate a few years ago may be underwater today using a 7% cap. Both Freddie Mac and FNMA have devised mezzanine programs to help bridge this deficiency gap. The new mezzanine programs will bring loan to values up to the 85-90% range.

An interesting unintended consequence of the current economic slow-down is the increase in demand for multifamily housing. As more consumers choose not to buy their primary residences,

increased demand for rental units has resulted in lower vacancies and rental rate increases. National Multi Housing Council economist, Mark Obrinsky, noted, "Demand for apartment residences has substantially increased thanks to a modest improvement in the jobs market and the continuing decline in homeownership rates." It was recently announced that US new home sales have sunk to their lowest level since tracking began in 1963, which confirms this trend.

So what do all these national facts, sentiments and trends mean to the average real estate developer and investor in the Upstate New York market? It is NorthMarq Capital's opinion that commercial construction lending from our national and regional banks will remain very conservative. We expect loan to values to mirror loan to costs with maximum ratios below 70%. NorthMarq continues to see pockets of lending strength from smaller, local community banks and surprisingly, from several Federal Credit Unions. NorthMarq has seen some loan to value ratios in the 75% range, but loan amounts tend to be on the small side. Continued market strength will be found for multifamily financing with low rates and 30 year amortizations. Loan to values for better properties utilizing agency mezzanine debt may approach 90%.

NorthMarq, headquartered in Minneapolis, offers commercial real estate services for investors, developers, corporations and tenants. The company provides mortgage banking and commercial loan servicing in 32 offices coast-to-coast, with an average of $7 billion in annual production volume and services a loan portfolio of nearly $40 billion. NorthMarq manages more than 60 million sq. ft. of retail, industrial and office space in 22 markets around the country and handles more than 7,500 leasing, sales and mortgage banking transactions annually. For more information, please visit www.northmarq.com.

Sam Berns is a managing director at NorthMarq Capital, Rochester, N.Y.