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Weighing the options: Short term versus long term borrowing in today's market

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As we enter the second year of the credit slowdown that began in August 2007, borrowers who need to raise capital must understand which lenders are still active in the market. In addition, it is helpful to realize the relative benefits and potential detriments related to securing short-term floating rate loans versus long-term fixed rate loans. Many believe that property and credit markets will improve in the near future, making short-term loans an attractive alternative to long-term loans, which may limit future options.

Borrowers in the market for ten-year fixed rate deals will find very few lenders willing to make these kinds of loans. Insurance companies, who have traditionally been very active with these loans, have mostly pulled out of the market because of filled yearly allocations. As a result, these insurance companies are now extremely selective and will only lend on high-quality, low-leverage deals. If you can find a CMBS lender in the market they are offering loans with spreads greater than 4.5% over the ten-year treasury, yielding a rate of 8.5%. Given the uncertainty surrounding their ability to close, many borrowers are currently reluctant to commit to these CMBS deals.

For fixed-rate deals, property location and sponsorship will become even more significant as new underwriting requirements make committing to a ten-year fixed rate deal unattractive to many borrowers. Leverage will most likely max out at 70%, compared to 80% at the height of the market. A year ago, we were seeing DCSRs of 1.2 or lower on pro forma cash flows, today, the DSCR for in-place cash flow is closer to 1.25. Also, amortization for newer properties has reached 30 years, with older properties still at 25-year amortization.

Borrowers interested in securing loans for the long term are facing an interesting dilemma. Because the proceeds and the structure of fixed-rate loans are so unfavorable at the moment, they must consider borrowing for the short term until the market improves. The dramatic drop in the London Interbank Offered Rate (LIBOR), a common index for pricing floating loans, has also made these short-term loans even more attractive. As of August 5, one-month LIBOR hit 2.46%, compared to 5.33% one year ago.

The term for LIBOR loans can be as long as five years, but because the rates reset each month, the borrower is exposed to interest rate risk. Most lenders actually require borrowers to buy interest rate caps to limit rates. A five-year interest rate cap of 5% means the borrower would not be responsible for any increase of LIBOR over 5%, and it requires a one-time, upfront payment of 1.72% of the loan amount. Capping LIBOR at 4% for five years would require a one-time upfront payment of 3.35%.

By securing a short term loan, the borrower is making a bet on credit and interest rates. While many borrowers prefer not to expose themselves to market and interest risk, others feel the risk is acceptable due to the limited availability of ten-year fixed-rate deals and their onerous prepayment restrictions that may limit the borrower's options when the market turns. While this is the standard fixed vs. floating dilemma, there is one option that provides a compromise between them: a five-year fixed rate loan. It is more available than a 10-year loan and carries less onerous prepayment restrictions.

With the upheaval in the capital markets, lenders moving in and out of active lending, and spreads and underwriting constantly changing, borrowers are often overwhelmed by current market conditions. That makes seasoned mortgage advisors absolutely invaluable. Johnson Capital has remained active throughout this current period, helping clients understand current market conditions so they can make informed decisions and secure the best possible financing.

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