



## The state of the commercial mortgage market - by Michael Zysman

February 28, 2023 - Spotlights



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The debt capital markets for commercial real estate are healthy, with the caveat that rates are much higher than they were in months prior. As of February 15, 2023 the 10 year treasury is 3.8% vs 2.0% a year ago or a 90% increase, the 5 year treasury is 4.04% vs 1.90% a year ago or a 113% increase, the 1 year treasury is 4.96% vs 1.11% a year ago or a 346% increase, and SOFR is 4.55% vs 0.05% a year ago or a 9,000% increase. Construction and bridge loans are generally more expensive due to the rise in SOFR and other short term rates but generally have similar proceeds to what was available this time last year. Stabilized property loans have higher interest

rates and less proceeds than what was available this time last year, unless the underlying property benefited from commensurate rent growth. Overall, there are great commercial real estate debt capital options available for desirable commercial real estate with moderate leverage.

The rates for short-term bank and CLO loans have increased dramatically due to the increase in SOFR and other short-term rates. Today, rates for short term loans from banks are generally equal to or slightly less than the cost of private capital, but with less proceeds. In recent history, banks have been the backbone of the short-term private debt markets by providing considerable leverage to private lenders, but today private lenders are utilizing bank leverage less due to the increase in cost. This is a result of the Federal Reserve's policy to control inflation by pulling excess liquidity out of the system through increasing short term interest rates and incentivizing banks not to their deposits by offering attractive risk free yields in the Federal Reserve's Reverse Repo Facility. The current Reverse Repo Facility yield is 4.55% and the balance of the facility is just over \$2 trillion. In general, private lenders that lend on HVCRE asset classes have not raised their rates much, or at all, over the past year due to substantial competition in the market and prime borrower's willingness to finance deals all cash once rates push above certain return thresholds.

The availability of loans for desirable stabilized properties is still strong, but with rates that are higher when compared to a year ago. Banks, agency lenders, insurance companies, and CMBS lenders are all still actively lending. Even though the Federal Reserve has stopped its bond purchasing program, there is significant private capital investment in long term real estate debt due to a shift in investors' appetite for debt investments now that interest rates have increased from historic lows to historical norms. Stabilized desirable assets with loans coming due that were originated 5+ years ago generally are not going to have issues refinancing due to increased rent growth and NOI over that period, amortization of their in-place debt, and they will most likely have in-place interest rates that are somewhat in-line with what is available today.

Borrowers with functionally obsolescent assets with declining revenues and occupancy and/or who took out aggressive short term loans are going to have a more difficult time refinancing their properties. Owners of these properties are most likely going to have to bring in new equity to refinance their deals, sell their properties, repurpose their properties, negotiate extensions or workout their loans with the lender. Desirable stabilized assets have maintained low cap rates and strong revenues during these early stages of the Federal Reserve's monetary tightening due the abundance of both equity and debt capital, which will help borrowers who took out aggressive loans sell or recapitalize their properties.

As the Federal Reserve continues to pull liquidity out of the system by raising short term interest rates, disincentivizing banks from lending deposits, and stopping bond purchases in the hopes of lowering inflation, commercial real estate capital markets should continue to stay resilient. The rent inflation and NOI growth that has occurred over the past few years for desirable assets will allow them to continue to absorb interest rate increases. An abundance of private equity and debt capital has kept real estate valuations strong during this period of quantitative tightening. There is a risk that the effects of the Federal Reserve's continued tightening can hurt the consumer economy and lead to decreased rents, but the Federal Reserve's policy of doing everything possible to navigate a

“soft landing” should be able to help mitigate that risk.

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