Illustration: retrorocket/Getty Images

Keeping the Capital Flowing

As interest rates are cut, commercial real estate pros expect stability in the capital markets.

By David Bodamer

Categorizing it as a "mid-cycle adjustment" meant to bulwark against "downside risks," Federal Reserve Chairman Jerome Powell announced the Federal Open Market Committee's decision to cut the benchmark federal funds rate a quarter point to a range of 2.00 percent to 2.25 percent. It was the first interest rate reduction in the U.S. since December 2008—the height of the financial crisis, when the target rate was lowered to a range of 0.00 percent to 0.25 percent. The fed funds rate had been on a long, slow march upwards starting in December 2015, moving up nine times since then at a clip of a quarter point at a time.

That gradual rise had caused little more than a ripple in commercial real estate financing circles as the long recovery has largely proceeded unabated since the financial crisis and the Great Recession gutted the sector more than a decade ago.

And although there has been consensus for some time that this commercial real estate cycle is long past due for a dip, the move to reduce rates now comes before any serious issues have set in. That's the context in which *NREI* conducted its latest survey on the state of commercial real estate financing. (The survey was completed shortly before the Fed officially cut rates, but many respondents indicated they were expecting such a move to occur.)

In all, respondents continue to have a favorable outlook, largely expecting stability when it comes to volumes and lending terms from all categories of commercial real estate lending sources.

In one sign of how good conditions remain, in answering what the biggest challenges were in financing commercial real estate properties, a respondent wrote, "One, making a choice between the 30 or so lenders fighting to the death over your $3 million deal. Two, deciding to close at your office or the attorney's. Three, deciding whether or not to order in coffee and donuts or just stop at Dunkin' on the way."

Another echoed that sentiment, if a bit less cheekily, "I don't think there will be many challenges. Based on what I'm seeing there is plenty of money in the marketplace that wants to be debt."

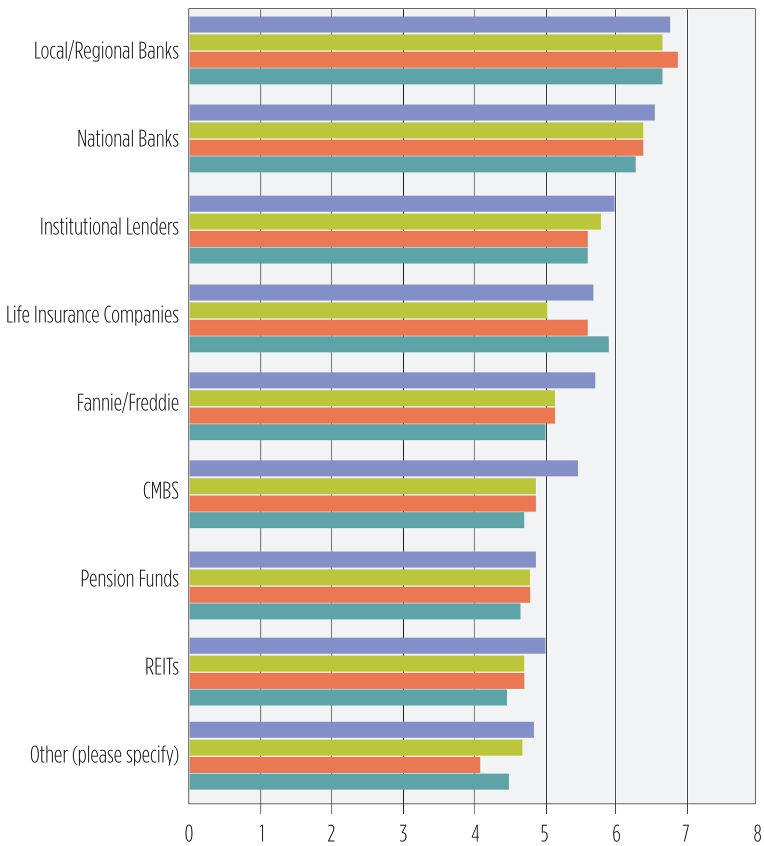
The state of play

On a scale of 1 to 10, respondents rated local and regional banks as the most significant source of capital for the commercial real estate sector at a 6.8—a place those institutions have held in every year of the survey. That segment was followed by national banks at 6.6 and institutional lenders at 6.0. The ratings for all three sectors were about 0.2 points greater than in last year's survey.

For nearly every category of lender, ratings were the highest in the four years of conducting the research. The most significant year-over-year jumps in this year's edition came for Fannie Mae/Freddie Mac and for CMBS, which each leaped 0.5 points (to 5.7 and 5.5, respectively.)

Looking ahead, respondents expect production in the next 12 months to be stable for all financing sources. For all sources, between 45 percent and 60

Figure 1: Respondents were asked to rate sources of capital. Local & and regional banks topped the list for the fourth straight year.



percent of respondents said the volume of debt capital would be flat.

The lenders respondents expect might grow volumes the most are institutional lenders. In all, 37.0 percent of respondents said institutional lenders would grow volume "somewhat" (31.8 percent) or "significantly" (5.2 percent). Life insurance companies (29.5 percent) and REITs (29.0 percent) were also identified as lenders that might grow volumes. On the flip side, national banks (28.7 percent), CMBS lenders (25.7 percent) and local/regional banks (25.5 percent) were most frequently named as likely to provide less capital in the next 12 months.

But some recent data suggested that the system may be more exposed to commercial real estate risk than it seems. CrediFi published a report in June that pointed to high levels of lending to "more opaque" property sectors, including retail and industrial. In addition, the report noted potential risks from out-of-norm lending by banks that occasionally take on loans that are outsized or out-of-character for them.

CrediFi CEO Ely Razin told *NREI* in June, "We did not issue this report to say all bank lending is problematic. It's absolutely not. However, certain areas of lending, and certain institutions, are taking on more risk and we are simply calling this out."

In a response to open-ended questions about concerns in the sector, one reader added, "The increasing capital available from alternative lenders may erode lending standards for borrowers willing to take on excess leverage to juice returns."

The Trump effect

As part of the survey, *NREI* asked readers what impact Donald Trump's presidency has had on commercial real estate financing, which generated both very positive and negative reactions.

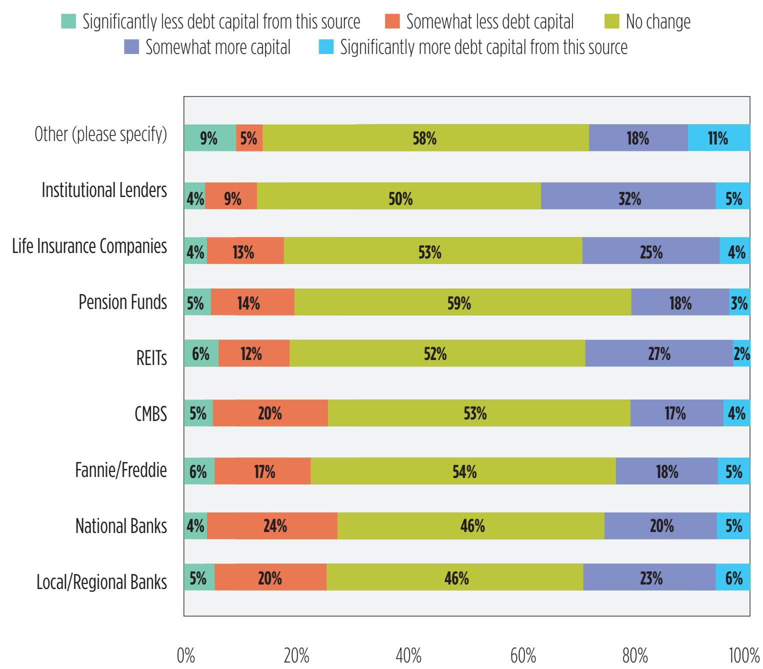
Many respondents applauded the presidents' broader handling of the economy and its continued expansion, which they say has redounded to the commercial real estate sector. Others added that cuts in regulation were good for commercial real estate.

"His policies have led to economic prosperity across the board," one respondent wrote. Another echoed that sentiment, writing, "Donald Trump has had a large positive effect on the economy in general, with commercial real estate rising with the economic tide."

One respondent expressed a more mixed sentiment, saying, "He has had a lot of success, but has also created a lot of instability and the market doesn't like instability."

On the negative side, some pointed to the overall volatility in Washington, increasing deficit and unclear benefits

Figure 2: Respondents expect most capital sources will remain stable in the coming 12 months.



from his signature tax cut as negatives. As one reader wrote, "An idiot surrounded by incompetents does no one any good. (We have a) $1 trillion deficit and growing from the party that screws it up every time." Another added, "He has not provided the fundamental support for the middle and lower classes."

The interest rate shift

The most significant change from previous surveys pertains to expectations on interest rates. After a period of rate increases, the Fed reversed course in late July and lowered rates for the first time in more than a decade. So, it's no surprise that after a clear majority expected rate increases in previous surveys, this year only 20.5 percent expect rate increases in the year ahead, while 43.6 percent expect rates to remain flat and 35.9 percent expect them to fall.

In terms of predicting the Fed's course of action, responses were fairly evenly split. The most popular response was that the Fed will decrease rates once (32.0 percent), while 25.5 percent expect two decreases and 3.9 percent expect three or more decreases. In addition, 14.2 percent said rates would be flat, while 14.7 percent said the Fed would raise rates once, 8.7 percent said there would be two rate increases and 1.1 percent said there would be three or more rate increases.

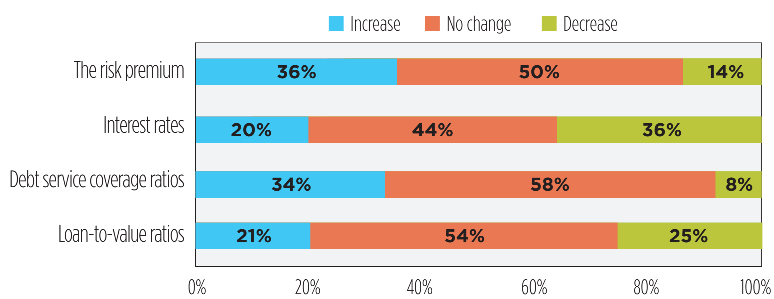
The common mantra throughout this cycle is that underwriting has remained disciplined. Yet respondents were split on whether commercial real estate lending is repeating patterns from the last cycle, with 27.9 percent who said "yes," 39.3 percent who said "no," and 32.8 percent who were not sure.

And while some respondents wrote in answers to open-ended questions that they had concerns about loosening standards, a plurality of respondents (45.3 percent) said underwriting standards will remain the same in the next 12 months, which matched last year's results. Another, 42.4 percent said underwriting will tighten over the next 12 months (up slightly from the 39.4 percent who answered that way in 2018), and those who think underwriting will loosen fell to 12.3 percent from 15.6 percent last year.

One respondent wrote, "Lending standards continue to be extremely strict and aimed at entrenched developers."

Another respondent argued, in fact, that lenders may be too cautious. "Lenders are too conservative in order to avoid potential entanglements with regulators. This is choking off new lending and creating bar-

Figure 3: On most financing factors, respondents expect no change in the next 12 months.

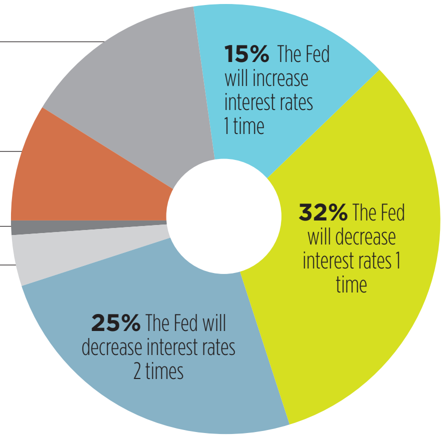


riers to financing otherwise worthy projects."

More than half of respondents anticipate that loan-to-value (LTV) and debt service coverage (DSC) ratios will remain the same in the coming year, at 54.3 percent and 58.5 percent respectively. A roughly equal amount of respondents believes LTV ratios could increase (20.7 percent) or decrease (25.0 percent). On DSC ratios, more respondents thought they were likely to increase (33.8 percent) than decrease (7.8 percent). Those numbers were largely in line with the responses in previous surveys.

Lastly, when it comes to the risk premium (the spread between the 10-year Treasury and cap rates), just over half expect the premium to remain flat (50.1 percent), while another 35.9 percent expect it could increase. That's a shift from last year, when a majority (51.7 percent) said it would increase vs. 33.1 percent who said it would remain flat.

Figure 4: After years of rising interest rates, some respondents now expect one or more rate decreases in the next 12 months.



Survey methodology: *In July, NREI emailed commercial real estate professionals requesting participation in an online survey about financing. Overall, the survey received 407 responses, half of whom identified as Owner/Partner/President/Chairman/CEO/CFO.*