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REPORT

DEBT FINANCE

The real estate market continues to work its way out of the most recent slump, and many traditional forms of financing for projects are in short supply. But, as the author points out here, real estate ventures that choose the right projects and know where to access the most appropriate forms of finance will be able to stay in the game until credit conditions ease further.

Despite Sagging Economy, Financing Is Available for Viable Real Estate Projects

BY BEAU BYRD

The overheated commercial real estate market melted down in 2008 after years of incredible and unprecedented growth. Prior to the meltdown in commercial real estate, financing was readily available from multiple sources: commercial mortgage-backed securities, life insurance companies, Fannie Mae, Freddie Mac, banks, and other sources.

In 2009, we experienced very low levels in commercial real estate activity, and 2010 has shown some signs of improvement but nothing like the activity levels prior to the downturn. Overall demand for commercial loans remains low, as businesses stay conservative in their spending and in their appetite for debt. The factors affecting commercial real estate are unemployment, devaluation maturities, and lack of debt/credit. The national unemployment rate peaked in January of this year at 10.6 percent and has improved to 9.6 percent as of October of this year. The decline in unemployment rate is a positive for commercial real estate.

As of the early part of 2010, valuations for commercial real estate had declined 40 percent to 50 percent from their highs in October of 2007. Some of the property classes, such as multi-family housing, have stabilized and these property types appear to be rebounding. However, other property classes are still testing the bottom.

The Mortgage Bankers Association estimates that approximately $500 billion of commercial real estate debt will mature this year and in 2011. More than 80 percent of this debt is held by commercial banks. On Feb. 20, 2010, Elizabeth Warren, chairman of the Congressional Oversight Panel of The Troubled Asset Relief Program, stated that between 2010 and 2014 approximately $1.4 trillion in commercial real estate loans will mature and nearly half of those loans are underwater.

The last and most important factor affecting commercial real estate is the lack of debt/credit. In 2010, we have seen some thawing of the credit freeze, and these options warrant further discussion.

Viable Project. In today's current environment, real estate developers and owners need to reassess which projects are viable. For instance, office and retail are generally in low demand. Additionally, lenders are avoiding financing raw land and do not have an appetite for speculative construction projects. However, construction projects for a specific use with solid tenants should be viable transactions. Multi-family rental properties will continue to be strong as there should be more hurdles to home ownership. Additionally, medical facilities projects are seen in a favorable light. In today's market, real estate developers/owners will have to reassess and evaluate what projects are viable and able to secure financing.

What Financing Is Available? Active lenders today include banks, life insurers, government-sponsored enterprises Freddie Mac and Fannie Mae (the GSEs), the Small Business Administration (SBA), and some forms of specialty financing. Banks are not very active in commercial real estate lending now and when they do lend, they have a preference for owner-occupied projects rather than income-producing projects. Additionally, banks are requiring more equity in the deals today than they did before the recession. GSE lending is focused on multi-family type projects and activity in this area remains strong. The commercial mortgage-backed securities (CMBS) lending has shown some signs of coming back to life but it is far from the 2007 levels. SBA financing is a good financing option but it also is focused on owner-occupied real estate.

In the past, developers avoided Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA) financing due to the length of time required to obtain these loans and the amount of due diligence involved. Since it is one of the few options presently available for construction financing, multifamily housing developers have sought HUD/FHA support. HUD offices around the country have been inundated with requests for this type of financing. However, this financing option may have hit its saturation point and HUD is being extremely selective.

Life insurers are definitely back in the lending game. Due to life insurance companies' conservative underwriting criteria, the losses suffered by life insurance companies are seen as insignificant. According to Tony Carlson of Grandbridge Real Estate Capital, life insurance companies have a renewed desire for commercial real estate since corporate bonds do not have the same return and the European sovereign debt crisis has shaken confidence in developing nations.

Alternative financing options that purchasers/developers may consider include seller financing and tax increment financing (TIF) and other state and local incentive options. These options could help close the equity gap that developers/purchasers encounter and make these transactions viable.

Conclusion. Although things are brighter in 2010 than in 2009 and there are more financing options available, we are not back to the multitude of options that were available in 2007 and probably won't be to that level for some time. Most experts agree that a commercial real estate recovery will take years due to a backlog of maturing commercial real estate loans and limited financing options. In the meantime, understanding the current market and pursuing transactions that are viable and financeable in the current commercial real estate market is the best course of action for commercial real estate owners and developers.

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