real estate investment times
The primary source of global real estate investment news and analysis
ISSUE10 24 January 2017
realestateinvestmentimes.com

January 24, 2017

2017 Outlook

Through the looking glass

How will interest rate hikes and Dodd-Frank affect commercial real estate in 2017? Mitch Paskover, president of Continental Partners, takes a look ahead

Last year was one of tremendous growth and transition. This past year, we saw the market react to the newly elected president of the US, and experienced a period of post-election uncertainty regarding the impact of the new administration on the commercial real estate sector.

With the US Federal Reserve raising interest rates and additional Dodd-Frank Act regulations taking effect, many are wondering what the future has in store for commercial financing and investments. Will we continue to see healthy lending activity for commercial assets, or will the interest rate hikes and new risk retention rules create turbulence and uncertainty in the financial market?

Here is what real estate investors should expect in regards to financing their assets in 2017.

Slightly higher cost of capital

After nearly a decade of historically low interest rates, the Federal Reserve has raised rates by a quarter of a percentage point.

While some have expressed concerns about the increased cost of capital, the reality is that many lenders saw this coming and have already priced in the hikes in their underwriting and loan originations.

The effect of this rise in interest rates is two-fold. Lenders are exercising caution and lowering their loan proceeds, which in turn means that investors will require more equity to finance their acquisitions or development projects.

At the same time, borrowers will now be incentivised to refinance and will pursue long-term loans to lock in lower rates.

With this in mind, many borrowers are requesting fixed-rate loans to eliminate the interest rate risk over the next several years.

The implication is that any additional rate hikes will only affect floating rate loans and will not affect borrowers that refinance with a fixed-rate structure.

Ultimately, these interest rate hikes will not significantly affect lending activity. Interest rates still remain close to historic lows, relative to the double-digit rates we saw in the 1980s, and this could result in favourable conditions for financing and investing in real estate.

Cautionary approach to CMBS lending

In December 2016, a new commercial mortgage-backed securities (CMBS) bill under Dodd-Frank was passed, requiring lenders to hold onto 5 percent of the loans they issue, as opposed to selling them off as bonds.

Originally designed to protect issuers against risky lending, these risk retention rules may have far-reaching implications that could potentially impact CMBS lending.

By requiring lenders to utilise more of their own capital, the new CMBS bill may drive down their profit margins, pricing many of the smaller lenders out of the market.

The larger lenders that remain may scale back on the number of loans they originate due to the increasing cost of capital. CMBS lenders in general are being more conservative when it comes to financing assets, especially for high loan-to-value lending.

In the past, CMBS was the go-to source for class B and C assets in secondary and tertiary markets. Now, borrowers are looking to other capital sources to fill the gap in CMBS lending. Therefore, while CMBS lenders will still originate loans, they will simply be more selective in the deals they finance and more cautious in their underwriting standards.

It's also important to note that President Donald Trump has discussed potentially reversing the Dodd-Frank risk retention rules. Under Trump's administration, many industry leaders anticipate a loosening of regulations, which would spur financing and investment activity. That said, it still remains unknown as to whether a repeal of this law would take effect.

Availability of capital

While the CMBS market may experience some volatility, the overall availability of capital will remain the same in 2017. As such, there will continue to be a rush for capital, and borrowers will be more aggressive with their terms.

Borrowers are seeking out the most competitive debt financing available, especially fixed-rate loans to mitigate the uncertainty surrounding future interest rate hikes.

For example, we recently refinanced a 152,719-square foot shopping centre in Sacramento, California. The sponsor, a private equity real estate investor that specialises in value-add investments, needed to refinance the property to cash out the proceeds to invest in other assets.

We sourced a number of lenders and structured a competitive fixed-rate swap product that would allow the sponsor to generate additional yield should the prime index increase. This essentially enables the sponsor to benefit from the security of a fixed-rate loan while also making money through the swap exchange.

Overall, we anticipate healthy lender competition given the wide availability of capital in today's market. This is especially the case for asset classes such as multifamily and industrial, which are seeing heavy lender appetite based on strong fundamentals.

Looking ahead, the financial landscape in 2017 will remain strong. Despite the uptick in interest rates and new CMBS legislation, we will continue to see healthy lending activity and ample sources of capital in the year ahead. REIT