REAL ESTATE

The Real Estate Quarterly – Financing Slowdown

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MJW Investments' Mark Weinstein at his Brentwood office.

Interest rates have been on an upward trajectory since last summer, which has hurt commercial real estate financing, according to lenders and investment firms.

Interest rates climbed from 1% in May of last year to 5% in April.

Higher interest rates continued to slow borrowing activity as the CBRE Group Inc. Lending Momentum Index fell nationwide by 15% quarter-over-quarter and 27% year-over-year in the fourth quarter of last year.

Local lenders appear to be adjusting their underwriting in alignment with these statistics. Paul Rahimian, chief executive of Brentwood-based private construction lender Parkview Financial, said it has become more difficult to secure a construction loan because of the uncertainty in the marketplace.

"It started when rates started going up and commercial real estate took a hit because nobody could understand where the terminal rate is with the Federal Reserve, what are cap rates going to lie at and what are valuations going to look like in a year," Rahimian said. "Everyone's taking a step back saying, 'I don't want to close a construction loan today based on a 4% cap when it might be a 6% cap in two years.'"

A cap rate, or capitalization rate, indicates the expected rate of return.

Lenders are currently looking for a bit less leverage than before.

"Most construction lenders, their goal is just to get paid off," Rahimian said. "They don't want the asset. They just want to get paid off and move on. The lower the leverage is, the more solid it is and that gives them the assurance that they're not going to get stuck taking back the property, which is what they're going to avoid."

Rahimian said another lending difficulty is that developers have less money than before.

"Their equity partners are not stepping up as much," he said. "So there's this gap now where construction lenders have scaled back, and you compound all of that with interest rates going up. At Parkview, we used to write loans last year at 9%. Now our loans are at 13% or 14%. That makes a huge impact on the feasibility of the project."

‘Liquidity is tough’

Jay Maddox, principal at Avison Young, believes the commercial real estate industry is in the midst of a bad financing market.

“Liquidity is tough,” Maddox said.

Rahimian said Parkview Financial has become more conservative.

“We’re being more selective and more cautious and just trying to make sure we’re picking the right deals with the right developers,” Rahimian said. “We’ve tightened it up significantly. Frankly, the money is not moving in the marketplace the way it used to.

“We raise money two ways: we get investor money and then we get paid off on a deal that was complete. Those payoffs are not coming the way they used to,” he added. “So it creates a liquidity crunch where you say, I’ve got to be a little more selective of which I’m going to close because the money is not moving the way it used to.”

Jonathan Fhima, chief executive of Beverly Hills-based lender F2, which has originated $100 million in loans since its June 2021 founding, agreed that things are tighter now.

“You have to be a lot more cautious,” Fhima said. “A lot of lenders are on asset management mode, not originations mode. They’re trying to stabilize their portfolio and get back on track.”

Some benefit

Fhima said lenders such as F2 are going to be more cautious in this current economic environment which could create an opening.

“There’s going to be lenders that will become a lot tighter, close their doors,” Fhima said. “That provides a lot of opportunities for private bridge lenders and smaller bridge lenders who are more aggressive.”

Vicky Schiff of Avrio, a recently formed lender based in Denver and downtown, said the current atmosphere is advantageous for her.

“We have pretty good timing right now,” Schiff said. “We feel that we could do better quality transactions to better borrowers in better markets because there’s less competition.”

Shlomi Ronen at Century City-based lender Dekel Capital said that many of the loans his firm is underwriting are debt service constraints because the cost of borrowing has gone up so significantly.

And borrowers are getting less loan proceeds than they originally hoped for.

“It’s caused a lot of borrowers to take on either mezzanine or preferred equity to be able to lever up to the levels that they need to refinance their existing debt or get to the leverage point that they want on an acquisition,” Ronen said. “For us, what that means is that we’ve been actively providing mezzanine in those situations.”

Disconnect

Mark Weinstein, principal of Brentwood-based MJW Investments, said the current economic climate has put a strain on borrowing for projects.

Weinstein has seen lenders become more strict regarding who they lend to.

“The rates were changing so quickly, the agencies were having second thoughts about lending as much,” Weinstein said. “Some of the banks are pulling back. We’ve been able to get loans when we need them, it’s just that the interest rates are too high.”

The change has forced a different formula on loans.

“Whereas before you could get a certain interest rate and you could get a certain leverage loan to value, now you’re borrowing less at a higher rate,” Weinstein said.

Weinstein said the current market has caused MJW Investments to slow down its investment strategy.

“We haven’t had to borrow a lot of money because there’s not really great deals right now,” Weinstein said. “There’s a disconnect between buyers and sellers. Because the financing rates are higher, you have to buy a property at a certain value for it to make sense. Most sellers haven’t adjusted their prices to meet the interest rate raises. So that’s why you’re not seeing as much activity.”

The economic climate is affecting the way other borrowers are approaching loans, he added.

“Most people who are looking for financing right now have to deal with variable rate debt or debt that’s come due so they’re being defensive not offensive,” Weinstein said. “You’re only financing right now if you have to. If you have a variable rate you want to get rid of it and get a fixed rate because fixed rates are high but they’re not ridiculous. If you have a loan that’s due, you need to get something and you probably don’t want to lock in 10 years because hopefully in a couple years, rates are going to go down.”

Construction lending

The interest rate on loans to build new projects have gone up.

“Construction financing is expensive,” Maddox said. “Is it going to get cheaper? In my view, not in the next 12 to 18 months. What happened is that index that the loans are priced off of went from practically zero (interest rate) to 4%. And then what lenders charge on top of the risk-free rate – the spread – even if it stayed the same, at 4.5% or 5%, you’re paying 9% for your construction loan when you were paying 5.5% a year ago. It’s just gone way up. So naturally that has an impact on whether you can build a project that makes sense economically.”

Maddox has seen banks retracting as a source of capital.

“A lot of the banks are pencils down on construction lending right now unless it’s something very compelling for an existing client,” Maddox said. “A lot of the banks are requiring the borrower to establish a deposit relationship. Maybe to be 10% of the loan amount.

“People who will come out ahead are the ones who are building something they’re going to hold onto,” Maddox continued. “There are groups out there who are merchant builders. They build something to get it stabilized and then they want to sell it and recycle their profits. And it’s just going to be tougher for those projects to pencil because it costs more to build it and you’ve got to be more patient and stay with the asset longer.”

Still investing

Construction costs have also skyrocketed because of inflation and supply chain issues and a rise in labor costs. Nevertheless, construction will continue despite the difficult financial picture.

“Construction financing is still there,” Maddox said. “There’s definitely an appetite for multifamily and self-storage. Industrial continues to be popular, especially distribution centers. There’s

even some money for hospitality. It's not completely impossible, you have to adjust your cost structure based on what financing is truly going to cost."

Laura Clark, chief financial officer of Brentwood-based Rexford Industrial Realty, said her firm won't be discouraged from investing and developing by current economic forces.

"We're the largest industrial REIT in the country and we also have an entity value of over $15 billion so Rexford is in a very favorable position in the current market," Clark said.

"We have favorable access to capital in many forms that includes equity as a publicly traded company. We also have ample access to the public and private debt markets as an investment grade issuer," she added. "Today we're sitting with over $1 billion of liquidity. In this market, we're very well positioned to continue acquiring industrial properties within in-fill Southern California."

Clark believes that there is plenty of growth runway for Rexford.

"Rexford only has 2% of the infill Southern California market," Clark said. "We believe that we're in a position to continue to grow that market position substantially over time. We're very selective in what we buy and we're very focused on buying properties that drive the asset value of the company over the long term."

But for borrowers seeking lower costs, Rahimian does not see the financial system course correcting quickly.

"It's going to take several months if not several quarters for this to correct and frankly it could be 2024 or 2025 until we see clarity," Rahimian said.

Added MJW's Weinstein, "I think we're going to be in the higher interest rate environment for a while."