By Odell Murry
President
California Mortgage Association

Be Ready to Sail When Rates Are Raised

Higher interest rates won't undermine the health of commercial properties

After years of speculation about the Federal Reserve's quantitative-easing policies, players in the commercial real estate market are apprehensive. The Fed's policy of purchasing large amounts of Treasury notes and mortgage-backed securities has served as an anchor that kept interest rates from sailing off into their normal, choppy course in the past few years. These historically low interest rates have been accepted as the new norm, however. When the Fed hinted earlier this year that it was preparing to gradually taper off its bond-buying program, the market jumped, and some alarmed investors scrambled to refinance before higher interest rates set in.

This past September, the Fed postponed any such action and announced that it would stay the course with its bond-buying program. Despite the temporary relief, the market's concerns about the prospect of increasing interest rates are understandable. Investors fear that higher interest rates will mean higher capitalization rates, which will depress property values.

Any correlation between increasing rates and the health of the commercial real estate industry is much more complex, however. Property values are the product of many variables within the economic ecosystem, and commercial mortgage brokers and other real estate professionals must understand all the factors at play before advising clients.

Not everyone is bracing for bad tidings, however. Some experts are convinced that the real estate landscape has shifted fundamentally to create new opportunities in markets previously overlooked. And although interest rates are likely to

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Illustration: Dennis Wunsch

Odell Murry is president of the California Mortgage Association and founder and president of MAI Financial Services Inc., a private-mortgage company and institutional commercial mortgage broker. He originates life-insurance-company institutional and private-mortgage loans on apartments, industrial, retail and most other income-producing commercial real estate. He also serves as chairman of the executive committee of the University of Massachusetts W.E.B. Du Bois Center. Reach Murry at OMurry@MAIFunding.com or (866) MAI-FUND.

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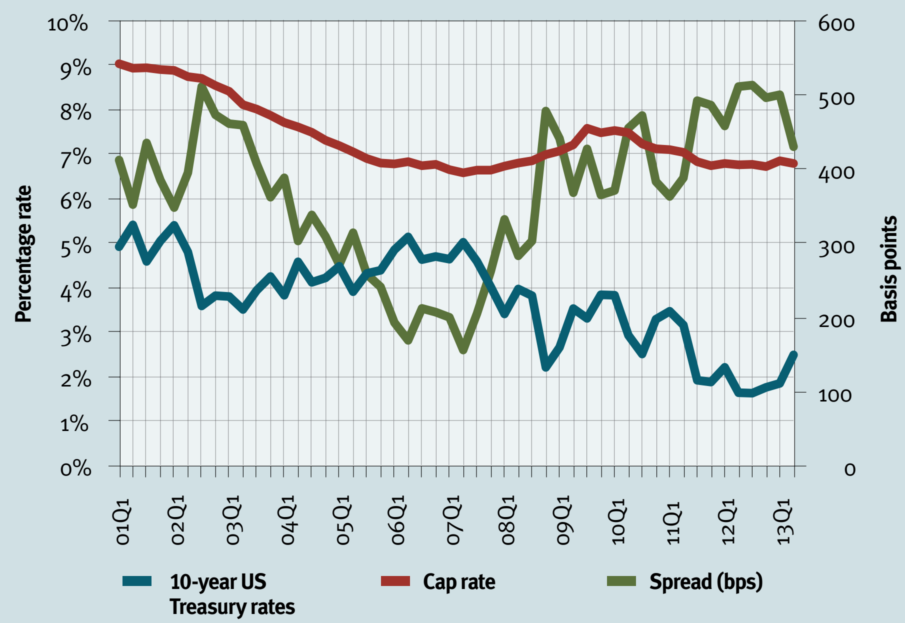
increase eventually, it is important to remember that they remain relatively lower than in the years preceding the recession.

Even more good news is that history indicates that under the right conditions, periods of increasing interest rates can be linked to stronger real estate returns — the relationship between higher interest rates and lower property values is only half the equation.

Interest rates generally increase when the economy is experiencing growth. A growing economy means job growth, more consumer-based spending, increased demand for commercial space, higher rents and lower risk of loan default. With increasing spending, credit typically becomes more readily available, which boosts demand for commercial properties and creates business opportunities for commercial mortgage brokers.

U.S. TREASURY RATES, CAP RATES AND SPREADS



Source: Real Capital Analytics, Federal Reserve

Investor goals

As interest rates fluctuate, expect investors to look to the spread between cap rates (annual net operating income (NOI) produced by the asset, divided by its sale price) and the 10-year Treasury yields to gauge the real estate market. Although the spread is complicated, it boils down to this: The larger the spread, the higher the investors' confidence. Within the past year, the spread peaked at almost 400 basis points. More recently, it averaged around 300 basis points. This is still considerably higher than the historical average.

Investors also look to the spread between cap rates and the mortgage constant (that can be determined by dividing the annual debt service by the mortgage principal). The mortgage constant will be higher than the interest rate for an amortizing loan because it includes principal as well as interest. Investments look attractive when the annualized mortgage constant is lower than the cap rate.

Commercial mortgage brokers must be aware of investors' goals. In today's improving economy, investors are seeking alternatives to the volatile stock market. Commercial real estate is a competitively priced hard-asset alternative that offers a solid return — rents — for longer-term investors. Commercial real estate investors who took advantage of depressed prices back in 2009 now are reaping their rewards, as prices have recovered slowly in the past five years in most major metropolitan areas.

With the recent recovery, the reshaping of the U.S. economy has caused a fundamental shift in the commercial real estate market. Several cities formerly considered secondary markets broke into the primary markets. Although primary markets are associated with less risk, market saturation in those cities has left investors seeking products in the secondary and tertiary markets to generate higher profits. There are signs of recovery within secondary markets, but tertiary markets have yet to show signs of cap-rate compression. This is the natural progression of market stabilization. Investors, developers and lenders all stand to benefit if they are willing to tolerate a minimal increase in risk within these noncore markets. Within this context, commercial mortgage brokers can play a critical role in positioning their investor clients ahead of the curve for successful deals.

Understating rates

Commercial mortgage brokers should be aware of the scope of impact that increasing interest rates will have on their borrowers' investments. In general, interest rates profoundly influence any type of investment. Not only does the interest rate directly impact financing costs, which influences property values, but it also alters the availability of capital, which subsequently affects supply and demand.

These shifts in property values and availability of capital inevitably are reflected in the underwriting process. In the valuation phase, two critical aspects of a property are evaluated: its income and its market value. These characteristics are evaluated using two primary risk-assessment ratios: loan-to-value (LTV) ratio and debt-service-coverage ratio (DSCR). The LTV is calculated by dividing the amount of the loan by the value of the collateral, which in most cases is the real property affixed to the loan. The DSCR is

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calculated by dividing the collateral's NOI by the debt service on the loan.

With most types of investments, longer-term holdings shield investors from the shorter-term market volatility associated with rising rates. Investors using short-term financing are particularly susceptible to the effect of rising interest rates on property purchased at a distinct cap rate because a sudden drop in property values could increase the LTV significantly. If the change falls outside of the lender's accepted parameters, the lender could require the investor to come up with additional capital.

Increasing interest rates also can be problematic with regard to the DSCR. If interest rates increase substantially after the loan amount was sized, the original loan amount might not meet the minimum requirement, resulting in the need to reduce the principal amount of the loan. In certain circumstances, especially in the case of well-positioned properties, some lenders may be willing to reduce their minimum DSCR requirements. Although this is certainly not the norm, such a concession ultimately benefits both parties.

In a higher-rate market, common underwriting practices should work to alleviate concern. Exit cap rates often are assumed to be at least 50 to 100 basis points higher than going-in cap rates when determining terminal cap rates. This serves as a buffer in which cap-rate increases are offset automatically in return expectations. This buffer, along with current above-average cap-rate spreads, offers investors built-in protection from higher cap rates. In addition, investors may adjust terminal cap rates by adjusting future cash flows based on their perception that lease rates may increase.

The outlook

Improving economic conditions with slightly elevated rates have brightened the outlook for the commercial real estate market, at least temporarily. But the window of opportunity is closing as more rate increases are likely to come, even if not immediately. Commercial mortgage brokers may come across many investors who see this as the last opportunity to refinance and lock in low interest rates, or take advantage of attractive property values combined with low rates.

Although some investors fear that higher interest rates will cause lenders to lend only to those not in need, as was the case in 2008, that theory ignores the fact that the real estate landscape now is restructured fundamentally. Mortgage lenders have taken a more rational approach to risk in recent years. Instead of painting every loan application with the same risk-averse brush, lenders are more willing to examine loans on their individual merits to determine whether or not they meet risk benchmarks. This flexibility will help lenders tinker with formulas to factor in rising interest rates.

Commercial mortgage brokers also should be aware that many mortgage lenders have enough experience to recognize that a small increase in interest rates still will leave those rates at near-historic lows and most likely cause negligible damage to the economic engine of the commercial real estate market. Mortgage lenders have a renewed confidence, based on the extraordinary measures taken since 2008, that if the Fed sees any significant negative effects in the markets, it will either move cautiously or pull back to stabilize the market — just as it did this past September.

Finally, gone are the days when lenders viewed the real estate market with a one-size-fits-all philosophy. The perspective now is much more regional, and some areas of the country still present ripe opportunities for lenders and investors even after an interest-rate hike. The West Coast markets, for example, most likely will continue to be viewed favorably because of the potential growth of properties. Many other areas in the West also are seeing commercial property booms thanks to the burgeoning energy-sector growth. Mortgage lenders are savvy enough to shift strategy not only to accommodate increasing interest rates but also to benefit from such rates.

Private lenders

There is no doubt, however, that an

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increase in interest rates will shift the market, forcing out investors who have limited capital. But this impact likely will create opportunities for different categories of investors and lenders. For example, private commercial mortgage lenders stand to gain as interest rates climb. They typically are better-equipped to deal with a mild increase in interest rates. They tend to make quicker underwriting decisions and offer funding to short-term investors.

That said, a substantial increase in interest rates likely will level the playing field with traditional capital outlets like banks, whose primary appeal — lower interest rates — is often offset by excessive underwriting and regulatory requirements that lead to delays. In commercial real estate, time is often the equivalent of big money, and these lengthy waiting periods can make or break a deal, especially in the case of shorter-term investments.

If the eventual increase in interest rates is sudden, it may cause traditional lenders to pause and be more conservative in underwriting loans. This will make it more difficult for borrowers who have a narrow window to secure funding or who need time to stabilize or construct a project. As this shift occurs, commercial mortgage brokers will be bringing many investors seeking short-term

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and mid-term loans back to private lenders. A lower LTV and a slightly higher interest rate will seem like a small price to pay for fast, flexible financing.

Private-mortgage investors are expected to step up to meet this increase in demand to cash in on the shorter-term, higher-yield investment potential of loans secured by first-trust deeds or mortgages and away from the volatility of the stock market. It's a win-win situation for private lenders and the commercial real estate industry.

Overall, economic indicators seem to suggest that the U.S. economy is continuing to recover and grow, even if it's doing so at a slow pace. The fact that the arrow seems to be pointing in the right direction means that you can expect many lenders to be willing to take a long-range bet on providing capital for smart commercial real estate investments. Sources for low, long-term interest rates are still available. For example, life-insurance companies offer long-term 10-year to 25-year low fixed-rate loans for commercial borrowers willing to take a long view on their investments. Their loans often provide the additional benefit of more flexible terms and products. This type of financing is not only a viable alternative for existing refinance projects, but it also offers an alternative for locking in a fixed-rate forward funding, securing today's lower rates for future funding.

A potential downside to this type of financing is the initial cost attached to third-party reports and legal fees. These are ultimately the responsibility of the borrower. Low rates often may offset any prepayment penalties associated with refinancing or additional loan costs as required by the terms of the new loan, however. In many cases, the difference in a sustained lower interest rate means a higher yield, even with the higher cost of the loan. In addition, this longer-term approach to financing allows borrowers to avoid the burdensome refinancing process and the costs associated with it.

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Despite the shadow of the looming increase in interest rates, the voyage won't necessarily be entirely rough, especially for some long-term commercial real estate investors. Commercial mortgage brokers should explain to their clients that credit will not evaporate with a single utterance from the Fed in the coming year. It would be foolish for commercial real estate investors to ignore the prospect of rising interest rates, however. What they should do is factor in a modest hike in interest rates and adjust their price points accordingly. If they can plan rationally for the expected uptick, they may find even greater opportunities to capitalize on commercial real estate investments.