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Go Ahead — Call It a Comeback

The recovery in commercial real estate hinges on 10 key factors

It has been said that the lending and finance markets must wake from hibernation before commercial real estate recovery will happen. Well, the markets are stirring.

Commercial real estate financing is gaining momentum as the fundamentals of underwriting have been adjusted to meet current economic challenges. The realignments include aversion from the aggressive lending that contributed to the most recent economic crisis. Initially, this aversion was itself aggressive, and new financing virtually dried up. But as the economy itself has begun to creep toward recovery, lending has started to loosen up.

In fact, there are many positive signs that the market is moving toward recovery and ultimate growth. Commercial mortgage originators who are aware of the 10 critical factors affecting the commercial real estate industry's comeback can prepare themselves to capitalize.

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Commercial loan originations in 2010 increased 36 percent from 2009, according to the Mortgage Bankers Association. In a recent industry survey, 74 percent of lenders indicated they expect credit to become even more available this year. Transaction prices for commercial properties sold by major institutional investors increased 11.9 percent this past fourth quarter and 19.3 percent for 2010 overall, according to an index from the Massachusetts Institute of Technology's Center for Real Estate.

In some markets, commercial property values have increased more than 30 percent from their 2009 lows, but the climb is not distributed evenly across the country. Although major markets are improving, the secondary markets are still struggling.

As the market moves forward, it is important for mortgage brokers to recognize and stay informed about the various issues that will impact commercial lending and recovery most. Here's a look at the top 10 factors influencing the market's recovery — and your business.

Illustration: Dennis Wunsch

1. Appraisals

First and foremost, it is key that the volume and value of appraisals increases early this year. In a low transaction market, the lack of significant volume leaves appraisers in a conservative mode, especially on noninvestment-grade real estate.

With few sales transactions, appraisers are challenged to determine values accurately with limited or skewed data. Low appraisal values in turn are inhibiting lenders' ability to complete loans on viable projects. From an analytic perspective, the debate in this area is whether more appraisals result from improved market performance or whether more appraisals drive improved performance.

2. Job growth

Job growth is at the crux of reducing the record-high vacancy rates that have plagued office, industrial and retail properties in the past few years. These rates have slowed, but job growth is critical to keeping them from skyrocketing again. Indicators show improvement in the job market

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as the unemployment rate declined by 0.4 percentage points to 9 percent this past January — the second-straight month of decline, according to U.S. Bureau of Labor Statistics data.

This past January, 2.8 million people were marginally attached to the labor force, an increase from 2.5 million the previous January. Employment in the retail trade has increased by 123,000 jobs since December 2009, despite minor fluctuations this past December. Manufacturing trades posted job gains of 49,000 in January. At the same time, average hourly earnings for all employees on private, nonfarm payrolls increased by 8 cents — or 0.4 percent.

3. Economy

The economy as a whole is the key influencer in returning the market to or above pre-recession levels. In the past 12 months, financial-market activity has been largely driven by refinancing, consolidation and renovation. Banks are noting that borrowers are making increased efforts to negotiate better terms on the front end of a deal. Demand within the wholesale credit markets began to show improvement toward the end of 2010 and likely will have a broader impact on the financial market this year.

There is about $3.2 trillion in outstanding debt in the U.S. commercial real estate sector, of which $1.6 trillion is being held on bank and thrift balance sheets. Although challenges are still anticipated for banks from commercial real estate loans and the securities backed by these loans, they are no longer considered a threat to the financial system, according to Patrick Parkinson, a Federal Reserve Board official. Borrowers' greatest obstacle may be obtaining new credit backed by properties they currently own.

4. Interest rates and inflation

By changing interest rates, the Federal Reserve tries to help stabilize the economy; lower interest rates are supposed to spur spending and investment. As interest rates increase, the money supply decreases, and inflation will result.

The anticipation is that the 10-year Treasury rate will increase to offset the economic restructuring. According to the U.S. Department of Treasury, the daily yield curve rate was hovering around 3.5 percent this past February. As lenders make loan decisions, they likely will require higher interest rates — ranging as much as 3 percent greater than today's interest rates — in an effort to offset the decrease in the money supply.

5. CMBS' return

For lending institutions, the return of commercial mortgage-backed securities (CMBS) lending has serious implications for improving liquidity in the capital markets and relieving pressure on banks.

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CMBS provides banks a way to sell their loans. The volume of new CMBS issuance is predicted to be about $45 billion to $55 billion in the U.S. this year. That is a significant increase from the $10.9 billion issued in 2010 but still well below the $228 billion reported in 2007.

6. Federal policies

The economy could continue to operate at a deficit, especially if new government mandates and federal policies generate additional red tape in an already heavily regulated and scrutinized industry. Borrowers have reason for concern as additional financial regulatory reform legislation will impact the real estate industry directly by decreasing the ability to secure or provide financing.

In addition, health-care reform continues to be debated for constitutionality. It is placing stress on the economy as mandated implementation begins to affect the business sector. The government is also closely reviewing consumer-protection laws aimed at protecting individuals from predatory business practices, exorbitant prices and privacy violations.

7. Capital markets

The commercial real estate capital market has improved greatly in the past 18 months. Lenders, especially life-insurance companies and foreign banks, have reentered the commercial mortgage market. This creates more choices for borrowers to consider alongside lower mortgage rates and higher loan-to-value ratios (LTVs) for high-quality assets. Today's lenders are typically requiring LTVs between 60 percent and 70 percent.

8. The stock market

According to Federal Reserve Chairman Ben Bernanke, the second round of quantitative easing — a controversial $600 billion bond-buying plan — has contributed to a stronger stock market. Since the market meltdown in late 2008, investors have mostly been pulling their money out of U.S. stock funds and shifting into bonds or foreign stock funds. The stock-market improvement also is being driven by increased corporate profits and outlooks as the economy comes back.

9. Diversity of lenders

Although they have not historically been major players in commercial real estate finance, credit unions are beginning to approve lending activity in this arena.

Earlier this year, the second-largest credit union in Los Angeles County, Calif., for example, began offering commercial real estate loans to customers for the first time since 2006. If successful, lending in this segment will drive competition with commercial banks and encourage loan-portfolio expansion.

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Private hard-money lenders are another funding source to watch. They are in great demand for short-term loans based on a property's underlying value. Investors are the largest group of borrowers seeking this financial vehicle as they race to snatch up distressed bargains and cannot get traditional financing. If successful using this capital resource, borrowers may be able to partner with other investors to refinance the deal or sell it, realizing a profit.

As lending returns, it is vital that lenders, mortgage brokers and borrowers be prepared for a more extensive due-diligence process designed to reduce the risks that cannot be completely removed. Timing of proposed projects along with location will be weighed heavily in a lending decision. Lenders also will scrutinize borrowers' creditworthiness based on the performance of existing portfolios and previous projects. Borrowers may be required to not only prepare a new project proposal but also to provide a company balance sheet and global cash-flow statement analysis.

Brokers should prepare their clients for the reality of this lending environment.

10. Foreign affairs

Globally, the U.S. dollar is weakening because of the government printing money and Treasury bonds. Additionally, the economic crisis in Europe, which felt the impact far worse than the U.S., creates more competition.

China has significantly invested in the United States based on the criteria that it is the most stable and safest economy in the world. It is likely that China will reduce money flow inbound to the U.S. and create a supply-and-demand situation that will drive interest rates upward. China already increased one-year lending and deposit rates twice in just more than a month earlier this year to try to curb inflation, which reports say has thrown the rest of the world into a state of caution.

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All signs point to the commercial real estate market staging its comeback as capital begins to move from the sidelines and back into financing channels. Savvy mortgage brokers can stay on top of the changing landscape by watching these 10 factors and preparing their business accordingly.

Brokers should advise property-owner clients that they must be prepared to provide clear and concise documentation of stable net operating incomes that can cover debt service. They should partner with experienced commercial real estate professionals who have the capacity to provide high-level services, such as professional networking and marketing, to drive property vacancies to no or low percentages consistently. These efforts will be crucial to property owners because a more predictable income stream often will make a property more financeable for lenders.

As industry professionals, it is important to recognize the challenges in our business, educate ourselves with data to substantiate understanding, and research ideas and solutions. Armed with this knowledge, you'll likely be better prepared to identify every opportunity to do what you do best — originate loans and develop business opportunities that contribute to economic growth.