The Multifamily Market Enters a New Era

Rising rates and a new president are fostering uncertainty ahead

By Yuen Yung

The multifamily real estate market has been on the rise in recent years. Real estate research company CoStar Group, for example, reported that loan originations increased by 26 percent year over year this past third quarter. Will that growth continue in 2017?

Commercial real estate brokers should be aware of two factors that are likely to have a major impact on the multifamily market in the year ahead: interest rates and deregulation. Rising rates could potentially slow multifamily loan-origination growth to a snail's pace, compared with recent years. President Donald Trump's move to pare down financial regulations, however, could have the opposite effect, at least in the short term.

Just like all sectors of the market, the multifamily real estate landscape is rapidly changing in the wake of rising interest rates and the election of a new pro-deregulation president. The combination of those factors could have a significant impact for mortgage brokers serving the multifamily real estate industry.

The Federal Reserve raised short-term interest rates for the second time in a decade in December 2016, and it again boosted rates this past March — for a total bump of a half percentage point, raising the federal-funds target rate to a range of 0.75 percent to 1 percent. While the recent increases were relatively slight, they are only the beginning of what is expected to be a continuing upward push on rates. This is underscored by Fed officials predicting rates will rise two more times this year.

Photo illustration by Dennis Wunsch

Trump spoke out in favor of raising rates during his presidential campaign, contending a rate bump would pop a "big, fat, ugly bubble." As demonstrated by his recent executive order aimed at scaling back regulations enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, he intends to keep his campaign promises.

Currently, the multifamily market remains strong. In fact, the Association of Foreign Investors in Real Estate said multifamily assets represent one of the most sought-after investments. This presents an opportunity for mortgage brokers already in the multifamily real estate sector and also for those looking to expand into an area with a large potential for growth.

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With that in mind, there are some major changes in store for multifamily real estate lending that brokers should be watching for in the coming months and years. In the face of those changes, and as rates rise and regulations are stripped away, new opportunities for brokers also are emerging, especially in the nonbank lending arena.

Unpredictability

There is evidence to suggest that lending in the multifamily market may slow down. When it becomes more expensive to borrow money, as it does when rates rise, then multifamily real estate projects have a more difficult time making the internal rate of return necessary to secure deals. That means fewer deals happen, unless lenders and mortgage brokers work together to think outside of the box.

At the same time, there is evidence that lending may speed up as a result of executive-branch regulatory overhauls. Experts are predicting Trump will deregulate banks enough to make it attractive for them to increase lending. Trump announced plans this past February for "cutting a lot out of Dodd-Frank," to make it easier for businesses to borrow money. With fewer barriers, banks may originate more loans and take advantage of the potential to enjoy higher spreads afforded by rising rates.

To cover all of their bases, mortgage brokers may want to consider widening the financing options they typically recommend to clients to include more nonbank lenders. As rates rise, additional means of securing financing may become necessary for multifamily real estate investors.

Decreasing leverage

While the short-term possibility exists that banks will increase lending in the advent of Trump´s new deregulatory policies, his unpredictability and isolationist stance on trade — as well as his immigration policies — are making many people nervous about what the future holds for the global economy, which ultimately affects markets on the home front.

Rising rates alone can result in financial institutions lending less because the cost of lending goes up. Any sharp stock market drop prompted by investor uncertainty in the strength of the nation's economy would amplify this effect. Either of these potential circumstances, or a combination of the two, could lead to a reduction in the volume of multifamily real estate investment deals that get off the ground.

To better illustrate the point, here's an example: If investors typically received around 80 percent leverage on a project and, as a result of rising interest rates and stock market uncertainty, banks choose to lower the amount of leverage they will offer to 60 percent, it creates a 20 percent financing gap. That gap has to be covered if the project is to move forward. If the stock market also is in turmoil, the amount of capital available from equity investors to cover the gap also is diminished.

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For mortgage brokers comfortable with a second position in such a deal, however, that 20 percent financing gap represents an opportunity to help clients get creative with their capital stack. That means having access to alternative sources of financing is key.

Bridging the gap

Given the chance, nonbank lenders will make up the difference on underfunded projects. Private lenders or private equity structures are a natural next step for securing the extra funding necessary to make multifamily real estate transactions happen. They offer several advantages over traditional financing, including:

- **Lending requirements** that are less rigid and can be negotiated between two parties;
- **Funding that can be secured** faster than via traditional banks; and
- **Typically, lower fees** and closing costs for clients.

The cons, of course, include the fact that nonbanks often extend loans that have higher interest rates than banks offer, and the loan terms are usually shorter than what banks offer. Still, when a deal is on the table and a lack of funding is the only thing in the way of moving it across the finish line, higher interest rates and shorter terms are a price many multifamily real estate investors are more than willing to pay.

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With the inevitable changes on the horizon because of rising interest rates and a new president in the White House, commercial mortgage brokers would be wise to consider steering borrowers who are seeking multifamily financing toward nonbank lenders — in addition to pursuing traditional bank loans. Now is the time to reach out and solidify existing relationships with private lenders and to establish new connections.

Mortgage brokers should always be prepared, especially when the market moves. By keeping an eye on emerging trends and shifting your strategies based on these insights, you will have the advantage early in the game — before the market changes the rules. ■