# HOW LIQUID THE MARKET *REALLY* IS

By Steve Bergsman

At a time when real estate markets appear to be as liquid as they did before the Great Recession, occasional blips on the radar screen belie the fragility of capital flows.

The latest market arresting moment came in December when the U.S. Senate adjourned for the year without extending the Terrorism Risk Insurance Act, which was due to expire on the last day of 2014.

The problem was that securitized loans, most importantly commercial mortgage-backed securities, are required by law to include terrorism risk insurance. Under TRIA, the federal government is the reinsurance backstop in case of a terrorist attack against a commercial property.

"The act was blocked in the Senate on a Wednesday," recalls **Gabriel Silverstein, SIOR**, president of Angelic Real Estate, New York. "On Thursday, every major CMBS (commercial mortgage – backed security) shop stopped funding loans that couldn't get terrorism insurance. A lot of year-end closings of CMBS suddenly stopped."

A flash bulletin to the Independent Insurance Agents & Brokers of America, noted: "market stability in terms of both pricing and availability of terrorism coverage, as well as the ability to maintain adequate and expanding levels of capacity over time, are contingent on the continued existence of TRIA. Without a federal backstop, terrorism risk insurance would almost certainly become less available."

Although the current capital market is extremely liquid, it is also extremely brittle, says Silverstein. "One of the major real estate funding sources shut down in a matter of five hours. It's a little scary how susceptible the market eco-system is right now. A billion dollars worth of loans that were supposed to close in the last two weeks of the year suddenly didn't close."

This should be a great time to be a broker for commercial real estate. The market hasn't seen such liquidity since the boom times before the recession. There is even capital available for new development.

What makes this market different than those crazy years from 2004 through 2007 is that everyone appears to be lending smarter, with moderate leniency, at about a 70 to 75 percent loan-to-value range for a good product in a good location, and a higher regard for the credit quality of a tenant.

There are still some limitations to the lending market, but for many brokers, especially those in secondary metros, what has greased the way to increased transactions has been the rise of the local and regional banks.

During the recovery years after the Great Recession, the first product types to attract new capital were multifamily and urban office in gateway cities. Industrial fell into place next, followed by suburban office and retail.

If we just look at one of the laggards, retail, we can see how the mix of lenders has begun to change.

As of the beginning of the second half of 2014, CMBS remained the biggest source of capital for retail, followed by the banks, local, regional, and the too-big-to fail, reported Real Capital Analytics in New York. Deals financed by national banks hit 9.38 percent of the retail market in 2013, while regional/local banks financed 11.87 percent of retail deals. Those numbers for regional/local banks jumped in 2014 to 13.04 percent and 19.04 percent, respectively.

Generally, the national banks are lending everywhere, with a focus on CMBS loans, which are marketable to institutional investors. The local banks, which don't have conduit operations, make balance sheet loans and they are best positioned to compete for those loans in markets where CMBS is unwilling to go.

Insurance companies, national banks, and some equity players strive for the big, top-end of the lending markets. CMBS filled in behind. Once you get to deals where CMBS can't get done, then local banks have stepped up.

Although it might seem counter-intuitive, it's probably easier to get a $400 million deal done in San Francisco, than it is to get a $4 million deal done in San Pedro.

Liquidity for tertiary markets, exurbs, and small deals have been slower to come-back, which certainly impinged the business of SIOR brokers who don't work Class A markets. Indeed, many SIOR members prefer entrepreneurial efforts in secondary markets. Thankfully, these brokers are also having very good years, mostly due to the liquidity supplied by their local banks.

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The Geenty Group operates out of Branford, Conn., and the bulk of the company's sales transactions are in the $1 million to $4 million range.

"Frankly," says **Kevin Geenty, SIOR**, a principal in the Geenty Group, "our clients have had no difficulty finding good, available funding for 75 percent to 80 percent of purchase price."

This is an older market and many buyers have relationships with local and community banks going back two or three generations. As Geenty points out, "over the past 30 years the bulk of the mortgage money needed by our buyers has come from regional and small community banks."

In the recent recovery, that mix has changed as the regional banks have been less active in his area and the slack taken up by the community banks.

"The community banks are what we are relying on right now," says Geenty. "They used to do only small loans of $1 million to $2 million. If they did anything larger, they would partner with another bank, usually one of the regionals. We have a $4 million loan closing soon and that is with a smaller bank with just three branches. That bank is not partnering."

He adds, the national banks are not a factor in his market for mortgage loans of $4 million or less due to out-of-state underwriters and loan decision makers.

When *Professional Report* checked in with **Lester Osborn, SIOR, CCIM**, founder of Piedmont Properties/CORFAC International in Charlotte, N.C., he told the magazine, "I can see the Bank of America tower from where I'm standing." To which, he added, "I've been in business 25 years in Charlotte and I've never been called upon by Bank of America."

"Our company is more of a small boutique firm," Osborn explains. "We tend to do business with the local, home-grown companies, the guys with the 15,000-square-foot to 40,000-square-foot requirement. These are users, owner-occupants,

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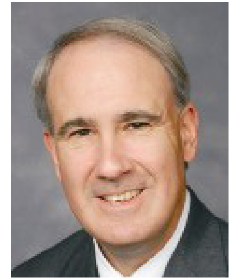

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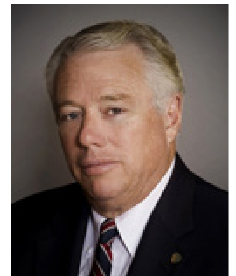

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who are just now pulling out of the economic slowdown, starting to enjoy the recovery and have confidence again."

These local companies are also expanding, which means they are in need of greater space. Transactions are being financed by a hodge-podge of credit unions, regional and local banks, and start-up financial institutions spun off from the big nationals, especially Bank of America and Wells Fargo (formerly locally-based Wachovia).

"I've done 10 to 15 of these deals in 2014," says Osborn. "Recently, I had a client purchase a building for $515,000. He put down 20 percent and financed the rest at 4 percent interest on 20 years. A local bank did the deal."

Sometimes it takes a little more work.

"I recently closed on a building that had been on the market for quite some time," Osborn recalls. "We found a tenant who wanted to lease for five years. The owner didn't want to lease, so we found an investment group to buy the building. The financing was similar to the last story, 20 percent down, 80 percent financed, and an interest rate at 4.25 percent. With a tenant in hand for years, it was easy to get financing."

The wider situation is that the mainstream lenders don't go small, says Osborn. "They don't finance the single-tenant, owner-occupant buildings under $1 million. So, most of us in this market have gotten set up with the regional and smaller local banks, developing relationships."

To some extent, big cities face the same situation. **Tom Davenport, SIOR**, president of Lavista Associates in Atlanta, also reports extensive local banks activity.

"Community banks took the biggest hit in the downturn," says Davenport. "Now they all have a push to generate loans and increase yields. The local banks are lending. Certainly on owner-occupied real estate they are extremely aggressive."

The Atlanta metro is geographically wide-spread and when asked if there are limitations even for the local banks, Davenport says the far exurbs remain a risky bet. "If you had a busted shopping center that couldn't be reconstructed in the next five years, the lenders would shy away," he says. "However, if you have a good story, financing might be available."

As an example, Lavista was involved in the acquisition of what Davenport called a "well-located suburban retail center" that lost two major tenants and was reduced to 25 percent occupancy. An investment group acquired it at an "attractive price" and as a true value-add play. The investment group also had one end-user in pocket and because of that it was able to obtain 50 percent loan-to-value financing. Not the best LTV around, but pretty good terms considering the shopping center was only 25 percent leased at the time of purchase.

"There are still a few situations where it is very challenging, particularly in tertiary markets and locations, and product types off the beaten path," says Silverstein.

As an example, Silverstein's company financed two retail centers within a week of each other in 2014. One was in Lexington, Ky., population about 300,000, and the other Lake Charles, La., population under 100,000.

"There was a substantial difference among the lender pools for the two, very similarly profiled assets in the market at the same time," Silverstein says. "Lexington is a big enough city that a lot of lenders would still go there Lake Charles was not."

Also problematic for liquidity are short-term lease rollovers except in primary markets. In the instance of the latter, what's particularly challenging is a situation where there is a sole company in a single-tenant building and the lease is due in three years or less. Sometimes in multi-tenant buildings, all leases roll over in the near term, and financing for those buildings can be difficult.

Across the pond, European commercial real estate markets also appear to be greased with liquidity, and transactions in 2014 were ample.

Indeed, the problem in Europe is "too much liquidity and no product," says **Hans-Ulrich Berendes, SIOR, CRE, FRICS, CEO** and founder of Berendes & Partner Consulting GmbH/ CORFAC International, Germany.

"Banks are lending money," Berendes says. "LTVs are going up to 75 percent. And don't forget Europe has a lot of insurance and equity companies — and they don't know what to do with their money so they are lending as well."

Even in Europe there are limitations. Outside of Germany and the United Kingdom, a lot of capital has been flowing to Spain, where the market is more opportunistic. However, if you want to do real estate business in Spain, you need to import your capital because as Berendes says, "the banks aren't lending there."

In Spain, the banks are instead happy to get rid of their distressed loans. "Why should they get back into real estate lending," asks Berendes. "The main players are banks and they are selling their loans and assets.

The real estate recovery could be fragile in Europe as well.

As Berendes observes, office rents have flatlined despite Class A office buildings in gateway cities being sold at extremely low cap rates.

"That's a problem," Berendes muses, "because that might mean there is a bubble again." ■

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