Eye on CRE Capital Markets: The Rearview Mirror and a Look Forward

By Amy Wolff Sorter

A short time ago, obtaining capital to build, buy or refinance was easy. Money was ridiculously cheap thanks to low interest rates and lenders lined up to support real estate projects.

What a difference a few years make. These days, banks have vastly reduced their CRE exposure. Property valuations are in turmoil, making financing challenging to determine. Higher-for-longer interest rates have jacked up the cost of capital. Additionally, the banking industry is circling the wagons as it tightens restrictions and calls for less leverage in deals.

But as with most things in the commercial real estate industry, the above is painted with a broad brush. Plenty of nuance is involved with the capital markets and CRE financing these days. Connect CRE reached out to industry experts to plumb those nuances. The result is a more realistic current picture and a more accurate outlook.

So, What is Really Happening?

Here's what made 2023 such a complex year for capital markets.

Part 1: The Interest Rates

Yes. Capital markets DID struggle during the past year. A continued increase in the Effective Federal Funds rate (EFFR) boosted the cost of capital, which put the brakes on CRE construction and investment.

Those who could build and buy realized that "the rise in short-term rates has required more equity from developers and owners in new projects and at the time of renewals," said Brian Heflin, chief operating officer with PlainsCapital Bank. Added to this was the increase in direct costs due to ongoing inflation. "As a result, most projects required additional debt/equity to solve the shortfall, burdening these construction projects," Heflin said.

Part 2: Banks Gone Wild

None of this was helped by the 2023 collapse of Silicon Valley Bank, First Republic Bank and Signature Bank, to name a few. Cox, Castle & Nicholson Partner Adam Weissburg said the impact caused other lenders to go out of business while "the industry, in general, was hit hard."

And according to Shahin Yazdi, executive managing director with Colliers Structured Finance Group, the remaining banks tightened lending standards to rebalance their books. "Many were stuck with a portfolio of fixed, low-interest rate loans that were below current borrowing costs," he explained. "They also had to right-size their loans, as higher interest rates impacted values."

Part 3: Volatility and Confusion

Capital markets dislike uncertainty. Plenty of uncertainty abounded in the previous year, dragging down investment activity in its wake. "When the future gets foggy, it doesn't matter if you're a bank or an investment fund or an endowment or an individual managing a 401k," said Jeff Salladin, Revere Capital's Managing Director, Real Estate. "Investor activity slows."

hat uncertainty also exerted a negative impact on underwriting. According to Tower Capital's Co-Founder and Managing Partner Adam Finkel, volatility makes it difficult to pinpoint valuation, exit cap rates or interest rates, especially regarding bridge or construction loans or refinance. Because of this, "it was challenging to underwrite deals while obtaining the leverage people sought," he said.

Part 4: Not All Was Negative

Getting back to the capital market nuances, 2023 wasn't all doom and gloom due to the following:

More realistic borrower expectations – This led to "an increasing amount of higher quality transactions that we could transact on as well as having a better forward view of the take-out market in the near term," said Gary Bechtel, CEO of Red Oak Capital Holdings.

A decrease in lender rates late in 2023 – Because of this, "borrowers that were in a position to move quickly could lock in rates that were 50 to 75 basis points below where they had been most of the year," Northmarq's President – Debt & Equity Jeff Erxleben commented.

Well-capitalized borrowers were in a fantastic position – Yazdi noted that these entities could launch construction in tight markets. They could also "jump on buying opportunities from sellers who were pressured to dispose of their assets," he added.

A Good Story Still Matters

The days of cheap and easy money are gone. But liquidity is still available. Today's lenders want assurances that the money they risk will provide hoped-for returns. Noted Jon Pharris, President and Co-Founder of CapRock Partners: "Lenders will be more accommodating to large borrowers, and less forgiving to smaller developers or investors who don't have strong balance sheets."

Because of this, "loans are being looked at more critically," according to T.R. Hazelrigg IV, president and co-founder of Avatar Financial Group. Hazelrigg suggested that substance over form be prioritized. "Money will be available for high-quality projects, with strong, experienced sponsorship that can keep some skin in the game," he said.

Favored Assets

Multifamily and industrial have been the standard darlings of years past. This is despite the growing nervousness over pending debt maturities (multifamily), increasing vacancy rates, and overbuilding unease (industrial).

At the other end of the list – unsurprisingly – is office. But this sector is broad; Bechtel pointed out that while urban towers are struggling, their suburban mid-level facilities are performing well.

Retail is also generating some lender interest, with Salladin pointing out, "I think we have seen a lot of the 'Amazon Effect' already baked into the market. There are many good reasons for shoppers to visit well-positioned and managed properties, and I see opportunities there."

Some lenders also like the stories connected with non-traditional asset types. MetroGroup Realty Finance Vice President Ivan Kustic explained that one life insurance company provided long-term financing for car dealerships, a storage yard, a cement plant – and even Chicago and New York office buildings in Chicago.

Mo' Money from Borrowers

Lower leverage and higher equity are almost a must in this day and age. Furthermore, pinning leverage down these days is also complex. But Colliers' Lee contended that as lenders begin moving stalled loans (leading to more viable basis plays), new lenders could offer leverage based on the new values.

A reduction in the Effective Federal Funds Rate could also help move that dry powder from the sidelines to the borrowers. "If you combine a lower rate environment with the disposition of struggling assets, there will be a tremendous resurgence of capital available to transact on these opportunities," Lee observed.

Capital Creativity Ramps Up

The past year generated an increase in creative financing strategies. Traditional lenders have done everything they can to forestall property give-backs. "We're seeing borrowers engaged with lenders and working out extensions on their current debt," said Jonathan Lee, executive managing director with Colliers Structured Finance Group, adding that that the extensions are supported when borrowers are willing to replenish the interest reserve – and in some cases agree to pay down the loan.

Additionally, well-funded traditional lenders have offered "flexible, shorter-term financing terms to borrowers who feel as though interest rates are coming down," according to Kustic.

Meanwhile, more non-traditional lenders have entered the space. Unlike their traditional counterparts, these private debt funds and other sources aren't under regulatory restraints and can develop more creative structures.

"We're already seeing stretch senior and 'debtquity' in the market to help bridge cash-in financing requests on maturing loans," according to Bechtel. "Rescue and 'white knight' capital is also being raised in large amounts."

Additionally, Colliers' Lee explained that bridge lending sources are stepping up to take many borrowers out of their current loans. And when bridge lenders can't help, "many LP equity groups have shifted to preferred equity to bring in yield for their investors," Lee said. "This has opened liquidity considerably." This move can help borrowers preserve equity and ensure they don't have to approach investors for more.

Another potential source of liquidity? "Seller financing is still going to be a prevalent strategy, and that's something buyers have been trying to encourage," Finkel said.

But seller financing and loan assumptions have their challenges, too. Sometimes, the leverage is too low, which might not be ideal for certain situations. As such, "it will be a strategy that some explore, but it likely won't be a prevalent one because assuming a low-rate loan still results in low leverage," Finkel said.

The Trends to Watch

What will happen in the coming year? From a capital markets standpoint, trends to keep an eye on include the following:

#1 – Maturing Debt

The "elephants in the room" are pending debt maturities and what this will mean for commercial real estate financing. Trepp forecasts $544.3 billion on CRE mortgage loans coming due in 2024, with an additional $533.2 billion anticipated to mature in 2025.

The focus has been on the office sector, with its high vacancy rates and reduced cash flow. "Office will continue to suffer from a seemingly permanent, or at least long-term shift in the corporate work environment," Hazelrigg said. But multifamily is also having its problems. Commented Hazelrigg: "We'll still be stuck with excess supply due to the significant levels of financing we saw in 2021 and 2022."

Adding to the problem is that traditional lending partners will likely remain in the shadows, making refinancing difficult. Pharris predicted that money-centered banks would stay on the sidelines for much of the year, except for their best "relationship borrowers."

#2 – Opportunities Abound

Even with debt maturities and capital challenges, the experts agree there are opportunities for capital, especially with value-add plays and distress. Bechtel said he anticipates that lenders will see opportunities in deals with lower exposure and higher yields. Furthermore, “buyers will see opportunities as well, with the ability to potentially acquire an asset at a significant discount and re-set its basis going forward,” he said.

Erxleben predicted an increase in lender-controlled sales or recapitalizations. Lee also noted opportunities in affordable housing, both with ground-up development and acquisitions.

#3 – What Does the Fed Say?

The experts agreed that the capital markets’ behavior will depend on the actions of the Federal Reserve. And the Fed continues keeping an eye on inflation. The January 2024 Consumer Price Index (CPI) was up 3.1% year-over-year, well above the Fed’s preferred 2% target. Additionally, the market added 350,000 jobs in January, which exceeded expectations.

While there has been broad expectation of EFFR cuts in 2024, the Fed is operating under an abundance of caution, saying that actions will depend on the economy.

Tower Capital’s Finkel isn’t buying into the rate-cut optimism, either. “There’s still considerable uncertainty about where the rates are going to be, where cap rates are going to be, or if there is going to be a swarm of distress that hits the market,” he said.

#4 – The Upshot

Kustic’s reminder was that the current situation isn’t as dire as past cycles, which saw values decline by 20% to 30% and 15% interest rates. There is still capital available, especially for conservatively leveraged and well-managed properties.

Yazdi anticipated that capital providers would continue using discretion in issuing new loans. While limiting capital output in the short term, they’ll “start to increase their CRE lending toward the second half of the year, as markets begin to stabilize,” he predicted.

Lenders will continue to be selective in their funding. Here are other trends of note:

- Life companies will get more into the act, with higher allocations for 2024

- The national banks will support the institutional real estate clients, not necessarily local real estate companies

- Regional and community banks will be selective in their underwriting, primarily due to ongoing regulatory scrutiny

- Debt funds and credit unions will expand their activities in the CRE space

Overall, uncertainty will likely be the hallmark of capital markets, with winners and losers. Bechtel noted that lenders could take a hit on their loan portfolios. Investors might be forced to sell their assets at a considerable loss.

Noted Bechtel: “We’re in some interesting times.”