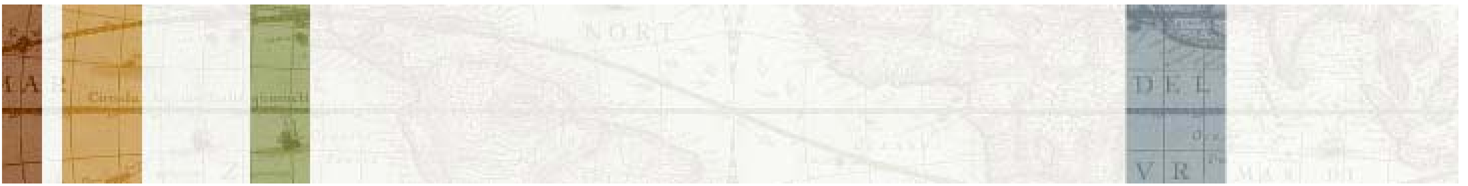

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Nontraditional Lenders Gain Multifamily Market Share

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Multifamily housing is leading commercial real estate s recovery with strong rent growth, rising values and high occupancies, which is enticing non-traditional funding sources especially life insurance companies to attempt to gain market share.

James Tramuto, the Houston, Texas-based executive vice president of Jones Lang LaSalle s capital markets group, real estate investment banking, notes that major life insurance companies including MetLife, Northwestern Mutual, Teachers, and Alliance have been a big component of multifamily finance this year.

A lot of these big life insurance companies began really competing, and competing hard, with Freddie Mac and Fannie Mae, he says.

At the end of the second quarter, life insurance companies had increased their share of multifamily mortgage debt outstanding by $701 million from the first quarter to a total of $48.1 billion. The sector holds 6.0 percent of the $802.2 billion in multifamily mortgage debt outstanding. But it accounted for 18 percent of the overall $3.9 billion in cumulative increase in debt during the quarter.

Life companies trailed just behind agency lenders and banks and thrifts the two most active segments of the market and were more active than conduits and state and local governments, which historically have been bigger players in the multifamily sector than life insurance companies.

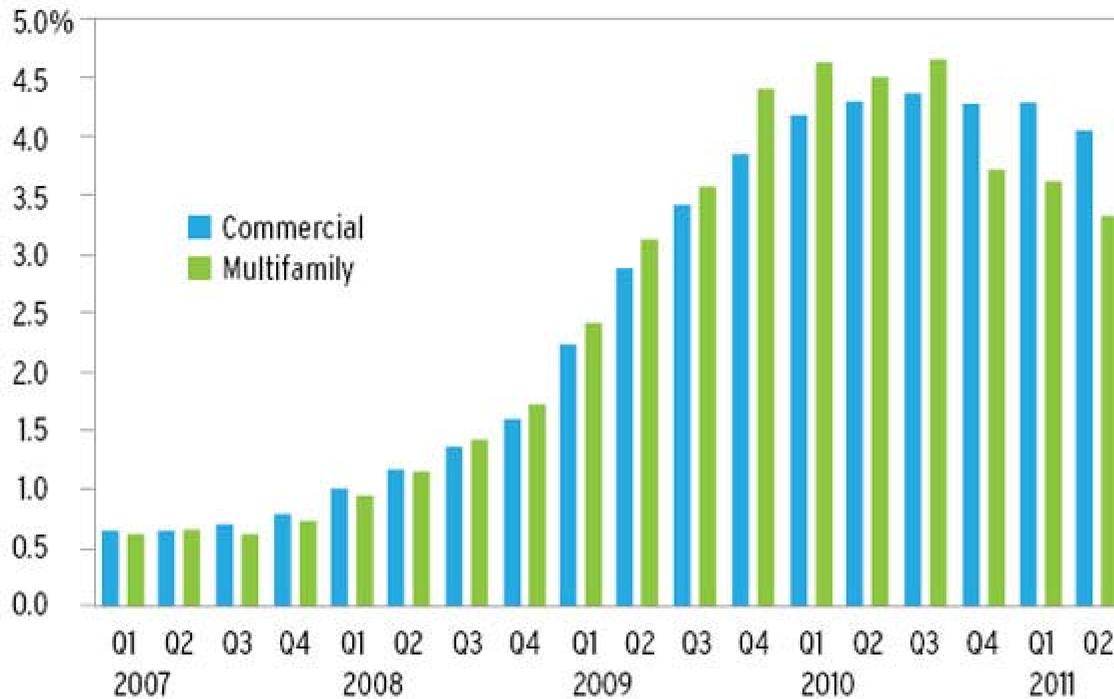
At the depth of the market in 2009, government agencies accounted for approximately 75 to 80 percent of lending activity, says Dan Fasulo, managing director and head of research for Real Capital Analytics (RCA), a New York City-based real estate research firm. As the market has recovered, the share of debt financing by the GSEs has declined to about 50 percent, he says. Insurance companies, meanwhile, have grown to account for nine percent of multifamily lending in the first half of 2011, up from 1 percent in 2009.

Tramuto says that he believes life insurance companies are getting into the multifamily sector because they are now able to acquire product that the agencies would have beaten them to in the past. For example, for a multifamily deal that JLL is marketing in Houston right now, he says, it s a 50 percent leveraged deal and the life company rates are just out of sight.

He adds that life insurance companies are attempting to overweight their balance sheets with multifamily product now because there are many indicators that point toward the sector outperforming other property types over the next three to six years. In addition, life insurance companies are not only stepping up to fund projects, but are becoming one-stop shops.

State of the market

While this past year has shown multifamily to be commercial real estate s shining star, it has also been a schizophrenic year for financing, says Stuart M. Saft, chair of New York City-based law firm Dewey & LeBoeuf LLP s global real estate department. We seemed to go through periods of feast and famine in one year there ll be tremendous amount of activity and then all of the sudden, it quiets down. There s financing available, and then all of the sudden, it disappears.



Default rates on multifamily loans are now lower than for broader commercial real estate and have declined for three straight quarters.

Saft cites concerns about a double-dip recession and both increased and decreased government intervention in the housing crisis as reasons the multifamily market continues to teeter.

Still, it remains the preferred property type among investors. According to the annual Emerging Trends in Real Estate report from the Urban Land Institute and PwC, gleaned from surveys and interviews with investors, apartments scored the highest for investment and development prospects of all commercial property types. For investment, apartments scored 6.74 on a scale of one to nine more than a point higher than investors second choice, 5.49 for the industrial sector.

There are good reasons for investors bullishness. Home ownership rates continue to fall, pushing more people toward the rental market. Overall home ownership rates have dropped from a peak of 69.2 percent in 2004 to 66.3 percent as of the third quarter of 2011, according to the Mortgage Bankers Association (MBA). In other words, according to Jamie Woodwell, vice president of commercial real estate research at the MBA, there has been a decline of about 800,000 home owner households and an increase of about 4

million renter households.

According to Marcus & Millichap Real Estate Investment Services, the vacancy rate for the multifamily sector will fall to 5.8 percent by the end of 2011 down from 6.9 percent in 2010 and 8.0 percent in 2009. In addition, the firm expects cap rates to end the year at 7.2 percent about 100 basis points lower than where they were in 2009.

Vincent Costantini, managing partner at The Roseview Group, a boutique real estate investment firm based in Boston, says the increased demand for multifamily is currently allowing investors to achieve valuations of up to 20 times their operating income.

Increasing competition

But life insurance companies will continue to face strong competition in trying to place deals. Agencies and banks remain big players.

Because of Fannie and Freddie, the availability of debt in the multifamily sector is better than it is elsewhere in the commercial property markets, says Steve Weilbach, the San Francisco-based senior managing director and national head of multifamily at Cushman & Wakefield. Current all-in borrowing rates for long-term, fixed-rate debt are in the mid-4 percent range, which are at or near historical lows.

This year, Cushman & Wakefield forecasts that its multifamily investment sales activity will be up significantly compared to 2010, reaching almost $3.0 billion compared to $1.9 billion the prior year.

And the multifamily finance sector is becoming crowded enough that underwriting standards are coming under pressure in the most active markets, according to Sam Chandan, founder and principal of Chandan Economics LLC, a New York-based real estate economics research firm.

UNDER CONTROL

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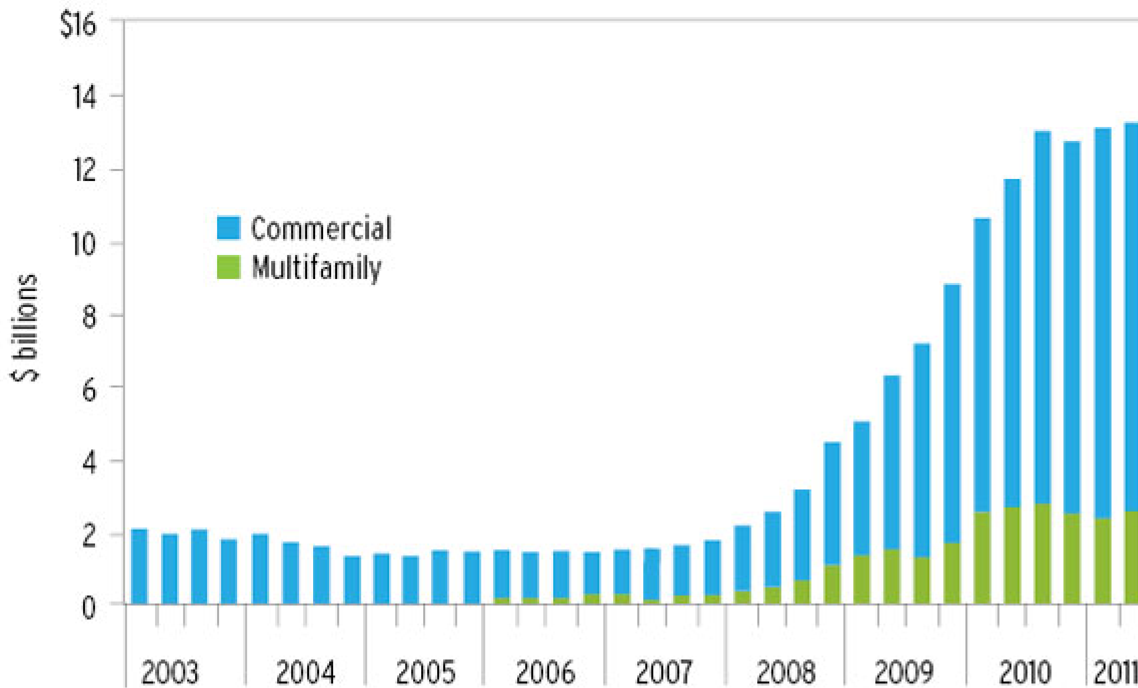

Source: FDIC, Bank Call Reports, Chandan Economics

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During the second and third quarters of this year, average interest rates on five-to-10-year fixed-rate multifamily loans was 5.1 percent, according to Chandan. However, for well-qualified buyers in cardinal markets, he adds, there are several loans in the 4 percent to 5 percent range.

In a report released by Chandan Economics in early November, which examined the 600 banks that hold the largest apartment lending exposures, 278 of these banks increased their net exposure to the apartment sector in the second quarter. On average, these banks increased their apartment loan balances by just under $22 million. That is not an insignificant number given the previous declines, says Chandan, adding that 35 banks increased their apartment balances by $50 million or more.

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However, Weilbach acknowledges, on a national perspective, pricing for debt varies materially from region to region. So in as much as New York was a favored market by investors, the debt market is not the same in Arkansas as it is in New York, he says, which is one of the few things that drives investment activity in some of the secondary and tertiary markets.

Also, Weilbach continues, because of the underwriting criteria currently in use which is more conservative and requires the use of in-place income rather than projected income as was allowed at the height of the market even though interest rates are attractive and capital is available, obtaining lending is becoming more stringent.

Getting accepted as a qualified buyer for agency lending is a higher hurdle than it used to be, he says. So institutions certainly have no problem meeting those hurdles, but if you re a private investor with moderate capitalization, you could be challenged in your ability to access that debt, even though it s there.

Lee Kiser, principal of The Kiser Group, a Chicago commercial real estate resource and services organization specializing in midmarket multifamily properties, says that in the past year he has noticed a dichotomy nationwide between institutional grade and lower-quality real estate. As a result, he says, It is a dogfight to drag a midmarket property across the finish line."

For the first 30 months after the economic collapse, he says, Fannie Mae and Freddie Mac were the only lenders financing midmarket transactions, but since regulatory pressure increased, there are few lenders to turn to in the secondary and tertiary markets even in active metros like Chicago.

Kiser says he favors more regulation because lack of it is what caused a lot of the problems we re facing now. However, he says, It s overregulated now where we used to have a dozen lenders ready to jump into the fray on any midmarket deal, we are lucky to have two.

Both local lenders with established lines of credit and high-net worth individuals with sizable portfolios are under heavy scrutiny, says Kiser. These days, he says, closing on a deal without a buyer who has cash or exercisable lines of credit depends on a broker s knowledge of the property, its operational history and whether it can demonstrate credible cash flows, how the property fits within market trends and the broker s ability to demonstrate this knowledge to a buyer and all third parties. It s two to three times the amount of work we used to do, he says.

This development has underscored the limitations in the multifamily sector. Class-A assets in major metro markets can be financed by anybody all day long, says Tramuto. Class-B assets in major metro markets are still financeable maybe not by the life companies but Fannie Mae and Freddie Mac will still loan money on [them]. Once you start going to tertiary markets, your bucket of capital gets thinner.

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