ORANGE COUNTY STATE OF THE MARKET

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How Lender Actions Will Affect The Market In 2016

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The big question on everyone's mind at Bisnow's *Orange County State of the Market* event last week in Irvine was what to expect in the year ahead.

Friedman Stroffe & Gerard shareholder and attorney Jennifer Stroffe, who moderated the Capital Markets panel, said experts are divided on whether there will be a downturn in the real estate market this year. She asked our panel for their assessment. That's Jennifer, Jason Krupoff, Shawn Hansen, Seth Grossman and Brian Good (photo below) during the panel discussion.

Carlsbad-based Meridian Capital Group managing director Seth Grossman opened the discussion, saying, "While we're very bullish in California, this is the first time since 2011 there is reason to believe things are going to change." In the past few months, lenders have pulled back on riskier deals, he said. "The market is still going in the right direction, but we are seeing a wake-up call for non-institutional players. They're saying, 'Well shoot, everything's supposed to be rosy, but my leverage is no longer interest-only.'"

"Lenders are imposing structure, so I think we're not going to see the world end, not going to fall off a cliff this year, but there is definitely a change in the market, where small or less-experienced players will not be treated as 'institutionally' as they think they deserve," Seth said.

Capital has become more selective, though not less available, said LA-based Greystar Real Estate Partners managing director Shawn Hansen. He said the cost for capital is a little higher than the middle of last year. "We're also seeing spreads widen—about 25 basis points — and are using fixed and floating debt—more floating right now using the big balance sheet lenders."

He said his firm typically sees two to three lenders vying for business on most deals, "when a few months ago we usually had five to seven highly competitive quotes. Our decision than was who do you want to pass the ball to," Shawn continued. "Now it's hit the phones, get the proceeds and let's try to make sure we're not getting stuck with holdbacks." It's a much more difficult process, he said.

Greystar is a fairly low-leverage, value-add buyer, after just 60% of loan-to-cost, Shawn said, but the firm is seeing more banks quote higher spreads, lower proceeds, less interest-only, and more holdbacks. "We are still largely ending up with loans that feel similar to last year, but it takes more effort to get there, Shawn explained, but we're doing value-add in high-barrier markets, so the yields are thin."

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As a result, underwriting is more aggressive, so his team is spending more time explaining deals to bankers to get them comfortable with the investment thesis, he notes. “Part of that is because deals are tighter, and we continue to see cap rate compression.”

The Wall Street lenders of the world are adjusting the spreads from 1.85 to 300 basis points, said LA-based iBorrow president Brian Good (photo on right with Seth), “which to me means they don’t want to do the deal at 300, they’re just hoping to scare you away.” Brian said iBorrow benefits from that, but it is getting harder to project the biggest risk-adjusted return two to three years out. He has to price the rate accordingly and sometimes float the rate to ensure, if there is a wild surge, his company won’t be caught in the middle of it.

Brian said there are signs similar to what happened in 2001, when there was some readjustment.

Bellweather Enterprise’s OC office SVP Jason Krupoff blames regulations stemming from Dodd-Frank for widening spreads. He said new regs are increasing lenders’ risk retention, so they have to charge more for capital, with loans for acquisitions increasing 25 points and construction loans 50 to 75 basis points.

Jennifer asked if there are differences, from a capital standpoint, between product types, and which ones are hotter.

Brian said retail is a challenge, especially big-boxes and shopping centers with less than 55k SF. “Any big-box component is challenging because you don’t see tenants coming out of the woodwork,” he said. Small retail centers are a challenge because they’re more costly to run than larger centers and 5k SF to 10k SF spaces often stay vacant for longer than expected.

Seth said multifamily is considered the safest product type. The cap rates are tighter, but there’s more capital out there for multifamily than other property types. CMBS spreads for multifamily and a great retail center were virtually identical 18 months ago, he said. If it was a good deal and sponsor, a construction loan with major banks was 150 to 175 basis points. But recently there’s a split: Retail is Libor plus 250, give or take, and 200 basis points for multifamily.

Jennifer asked what factors or variables will impact the market in 2016. (in photo on right are Seth, Jennifer, Jason, Brian and Bisnow’s former LA manager Sean Spear).

Jason suggested the variables will involve the global economy, the stock market and China’s troubles. Factors coming into play this year will have ramifications for the next couple of years, he said, but the good news is there’s still capital from insurance companies, government agencies and banks.

Shawn said the economy is healthy with low unemployment, but fiscal policy could negatively affect cap rates. Then again, he noted that if we look back at where interest rates were last cycle, there is good reason to believe that cap rates will not be impacted at all by a higher interest rate environment.

Shawn said his company is watching oil prices because Greystar owns apartment properties in Houston, Denver and Oklahoma City. Conversely, lower oil prices could be a benefit in California and other markets, putting more money in people’s pockets, he said. Risk exposure varies by market, so companies do their best to manage the risk or pull out of those markets, he said.

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From a lender standpoint, Seth said the market will lose its frothiness in 2016 and 2017, but buyers will continue chasing deals and pay whatever price makes sense if they can raise the equity. "Good deals will get done regardless, unless we hit 2008 again, which I don't fundamentally see in the cards at all," he said.

"I think we are going to see a dip at some point. I don't think we'll even see a rate spike—just the same volatility we've had for the last three months." Seth said lenders may consider secondary markets more risky than previously, but deals in good markets with good sponsors will get done.

Brian said there's a lot of capital in the market, but that capital could pivot quickly, with buyers investing somewhere else. For example, while Houston is a mess, Dallas and Austin are pretty good markets, he said. In the case of regional markets, investors should spend time in a market of interest to understand it, so they can explain to lenders why that market is a good investment.

"There's trouble out there, and we're being more cautious," Brian said, "but if there's a good deal, we'll be more aggressive on it."

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