

Trends in Commercial Real Estate Finance

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Overview

General Comments

Interest Rates

- Floating Rates
- Fixed Rate Indices
- Permanent Loan Rates

Property Types

Loan Programs

- Mezzanine Debt
- HUD 221(d)(4)
- HUD 223(f)

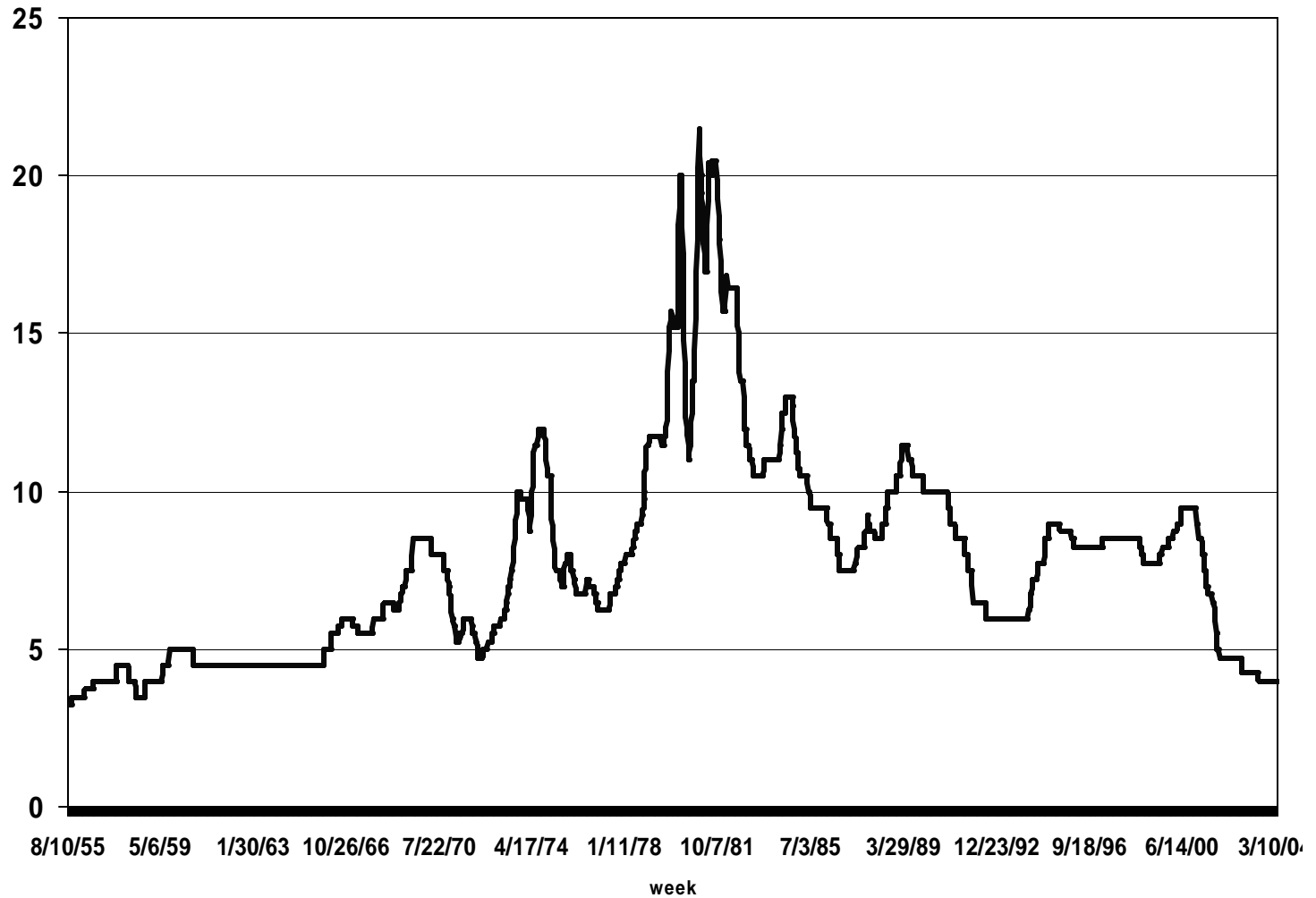
Refinance Dilemma

In General ...

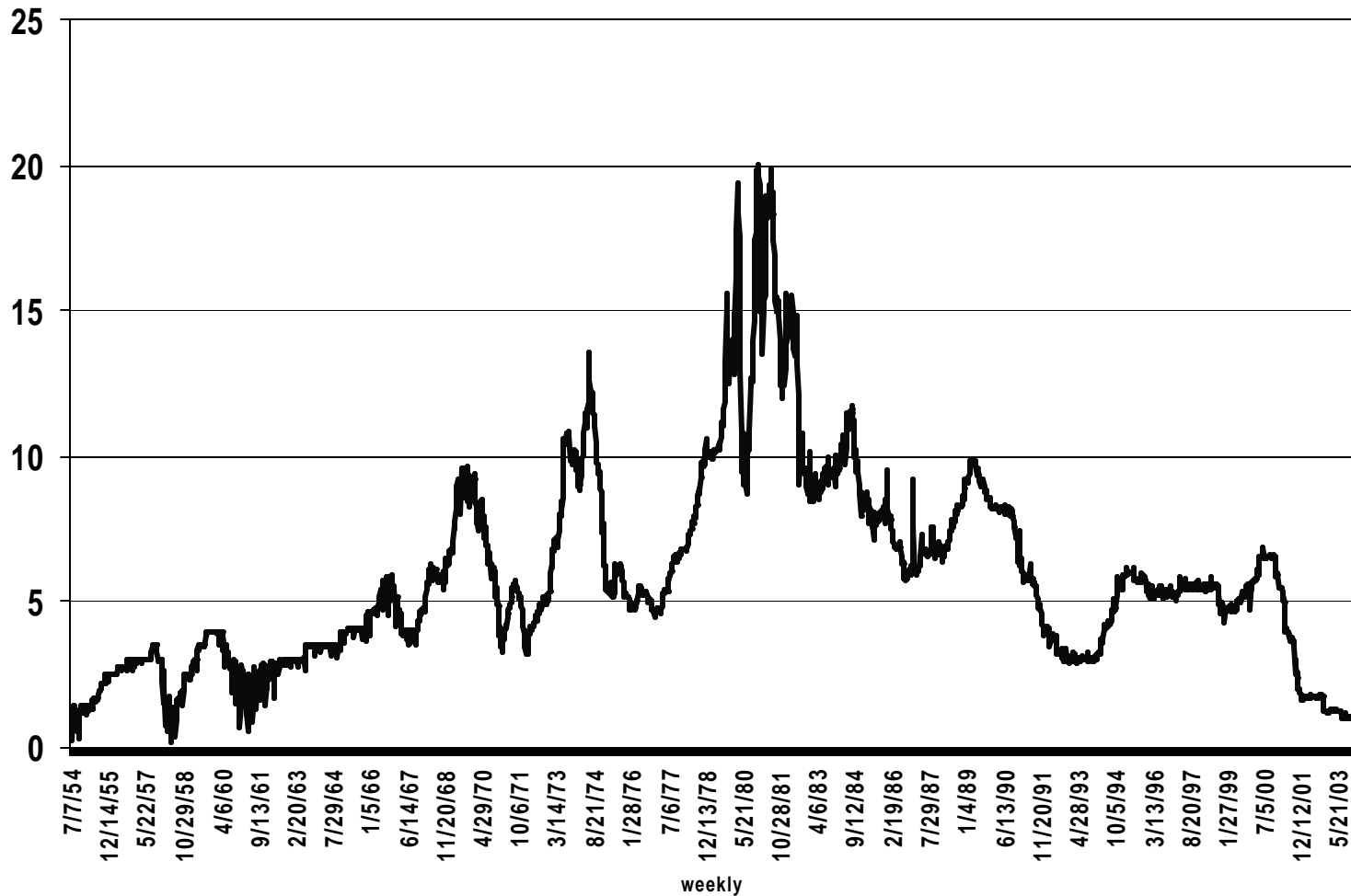
Interest Rates – “What a Long Strange Trip”

- **Where are interest rates?**
- **Will interest rates move?**
- **Will the election year have an impact on rates?**

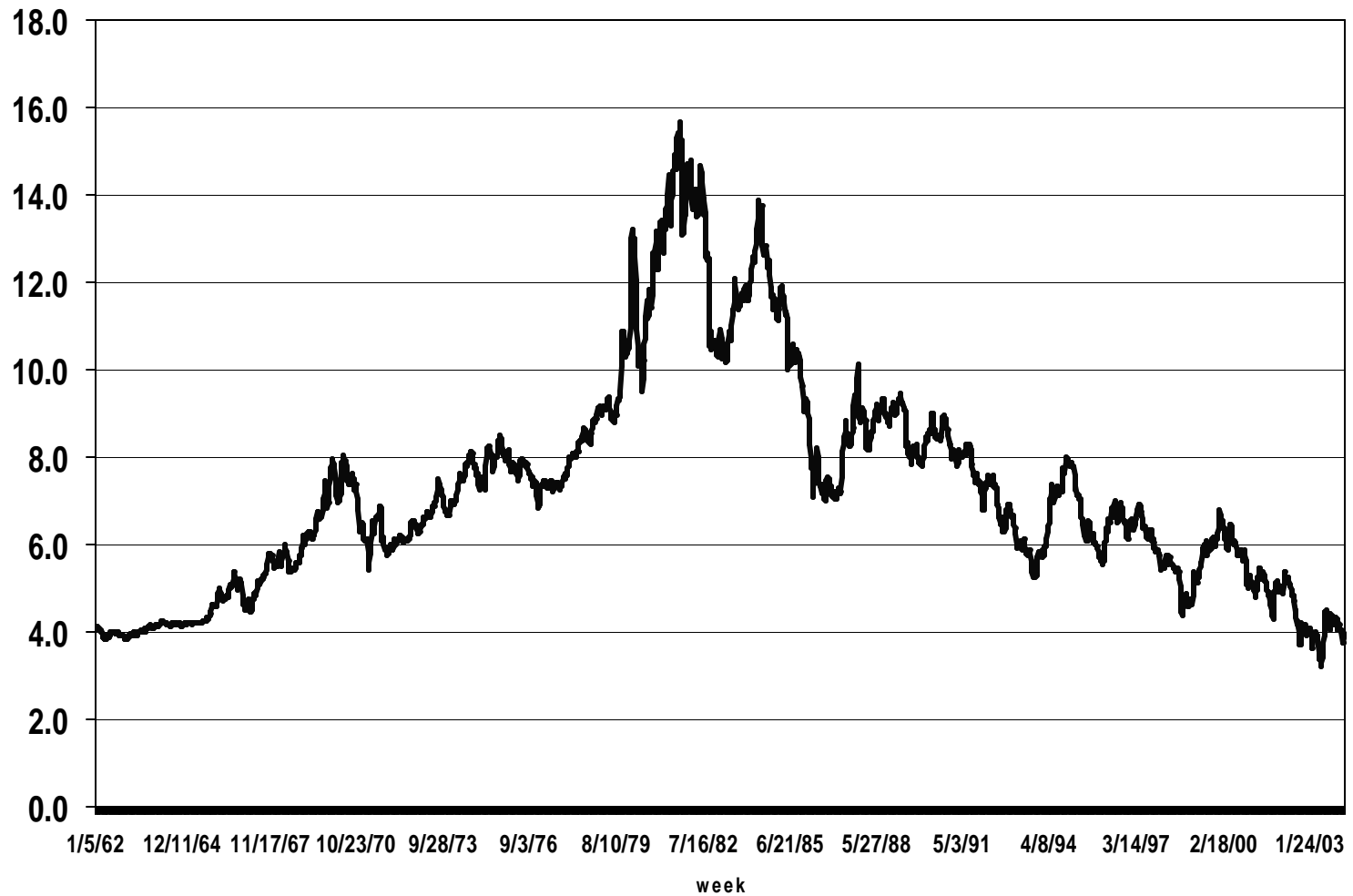
Prime Rate: 1955 through current



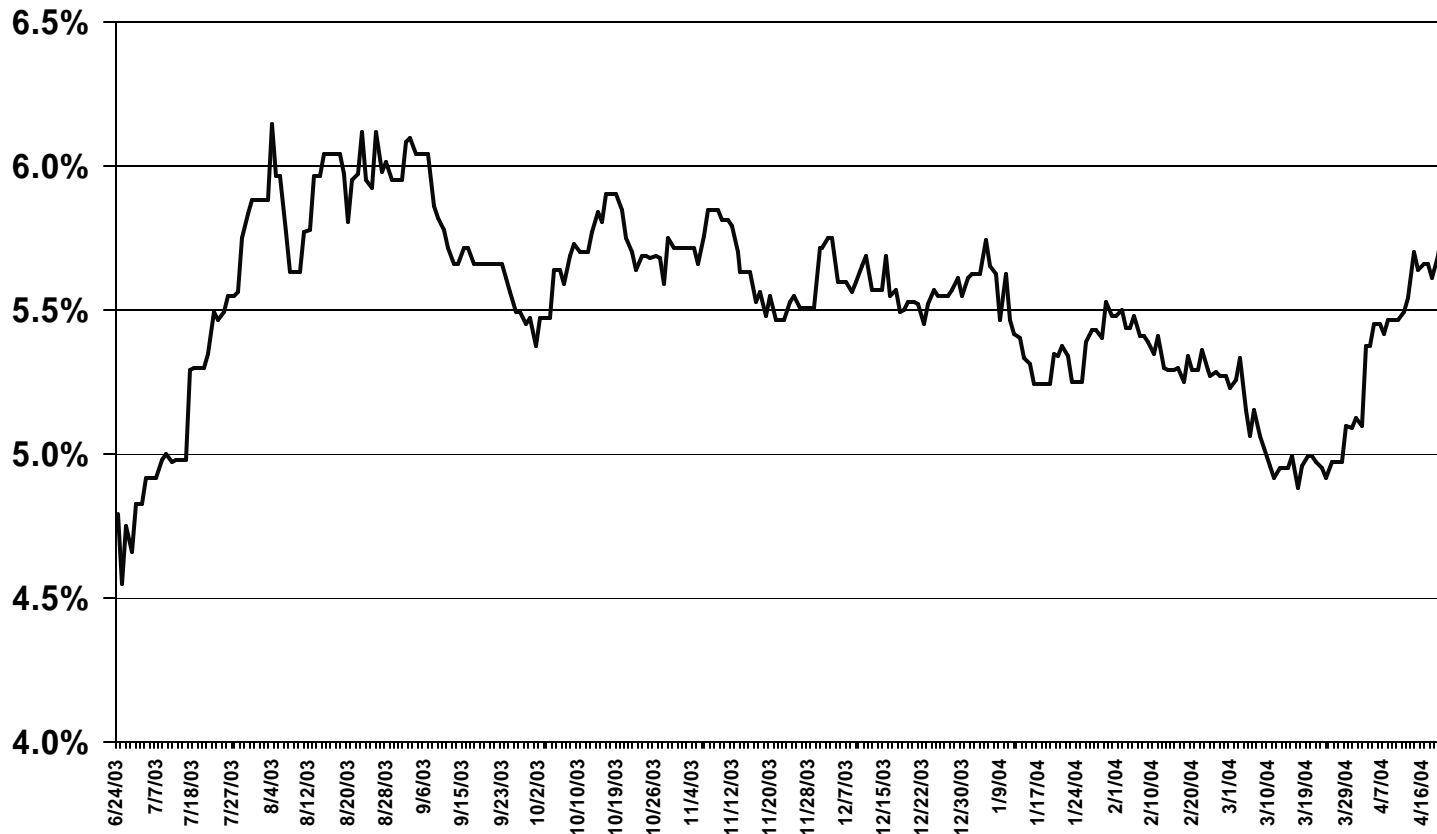
Fed Funds Rate: Weekly Trends 1954 - 2004



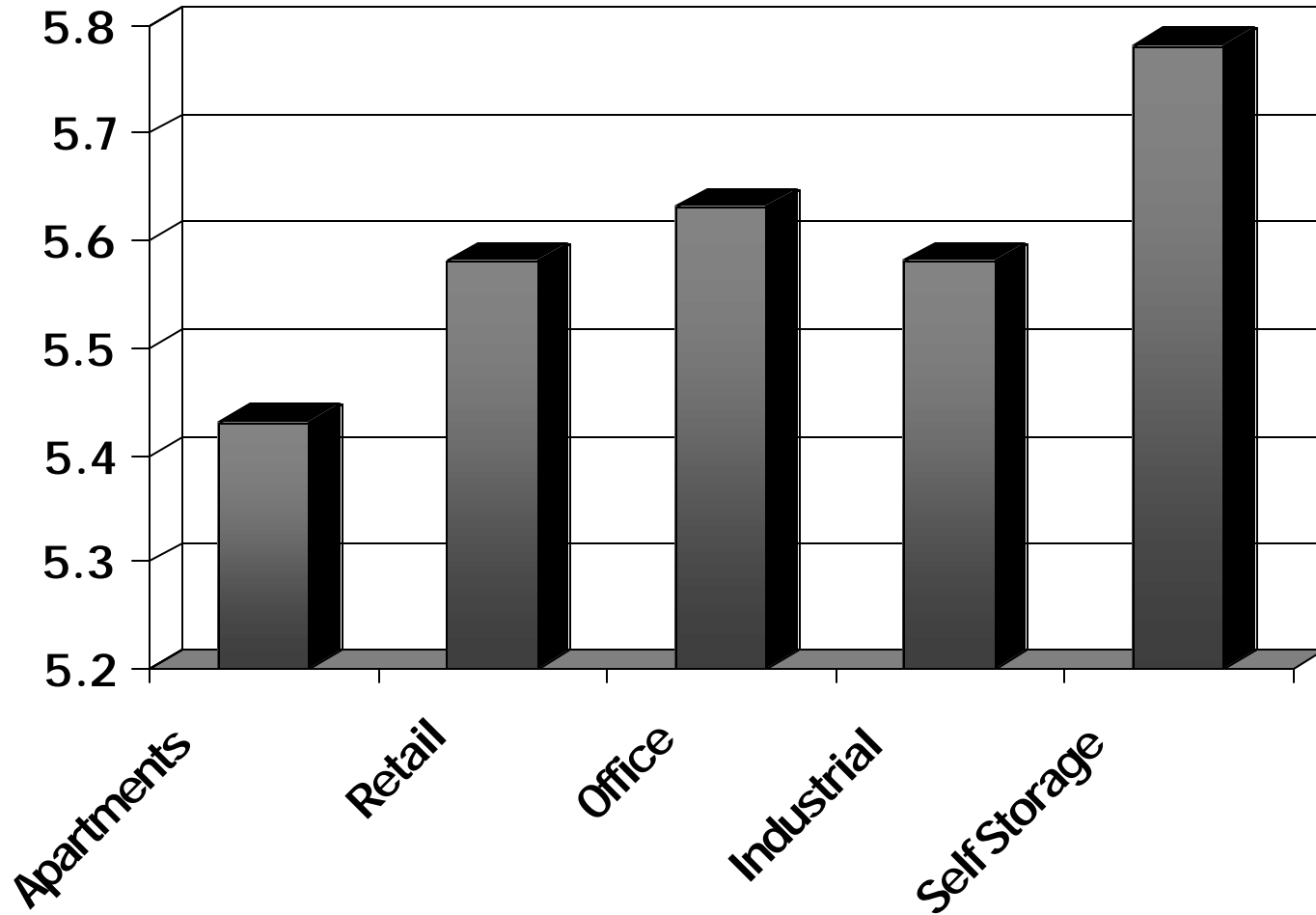
10-Year Treasury: 1962 thru Current



Fannie Mae 10-Year Loan (Tier II ++)



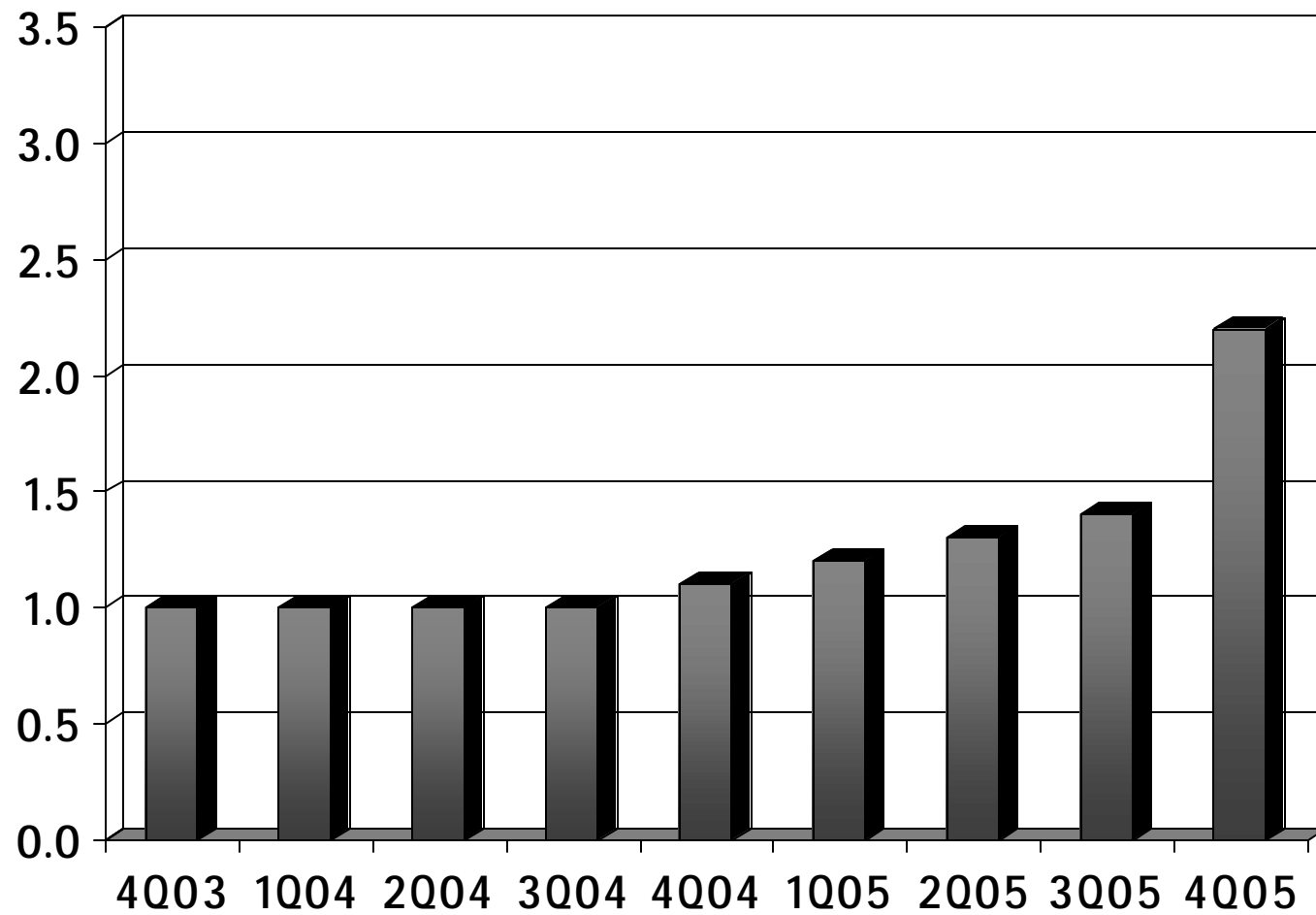
Conduit Pricing



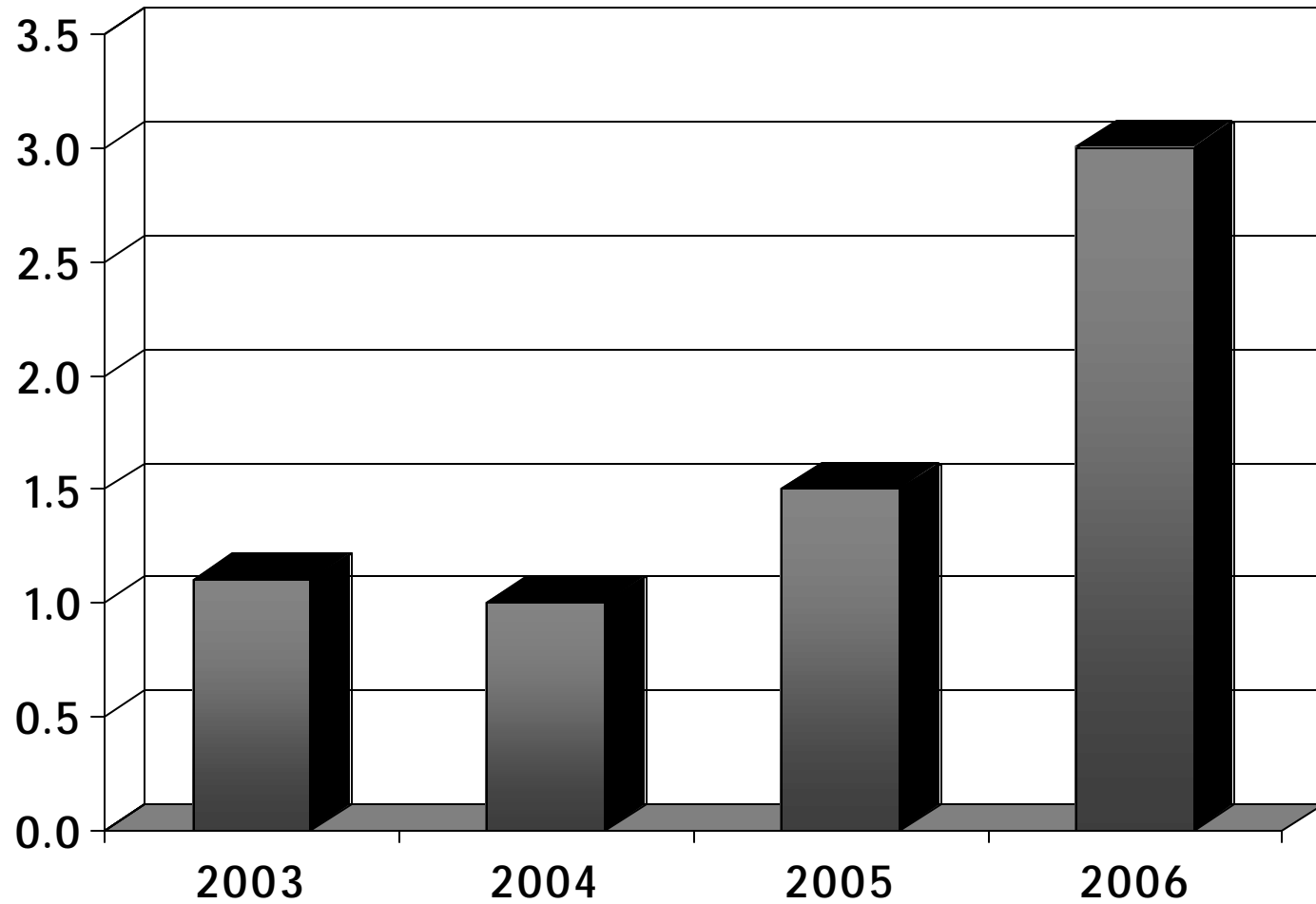
Interest Rates – Will They Move?

yes

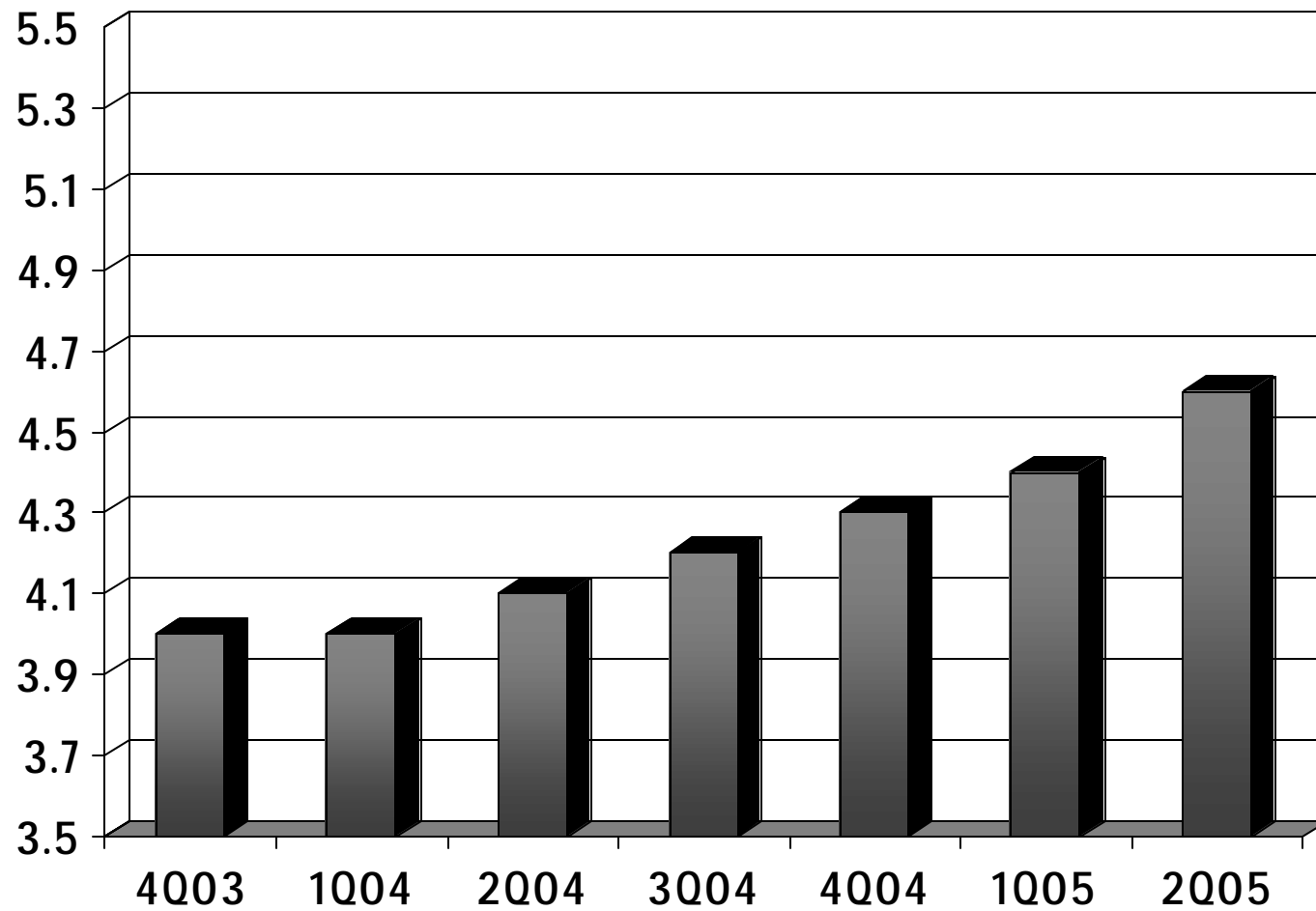
MBA Forecast: Fed Funds Rate



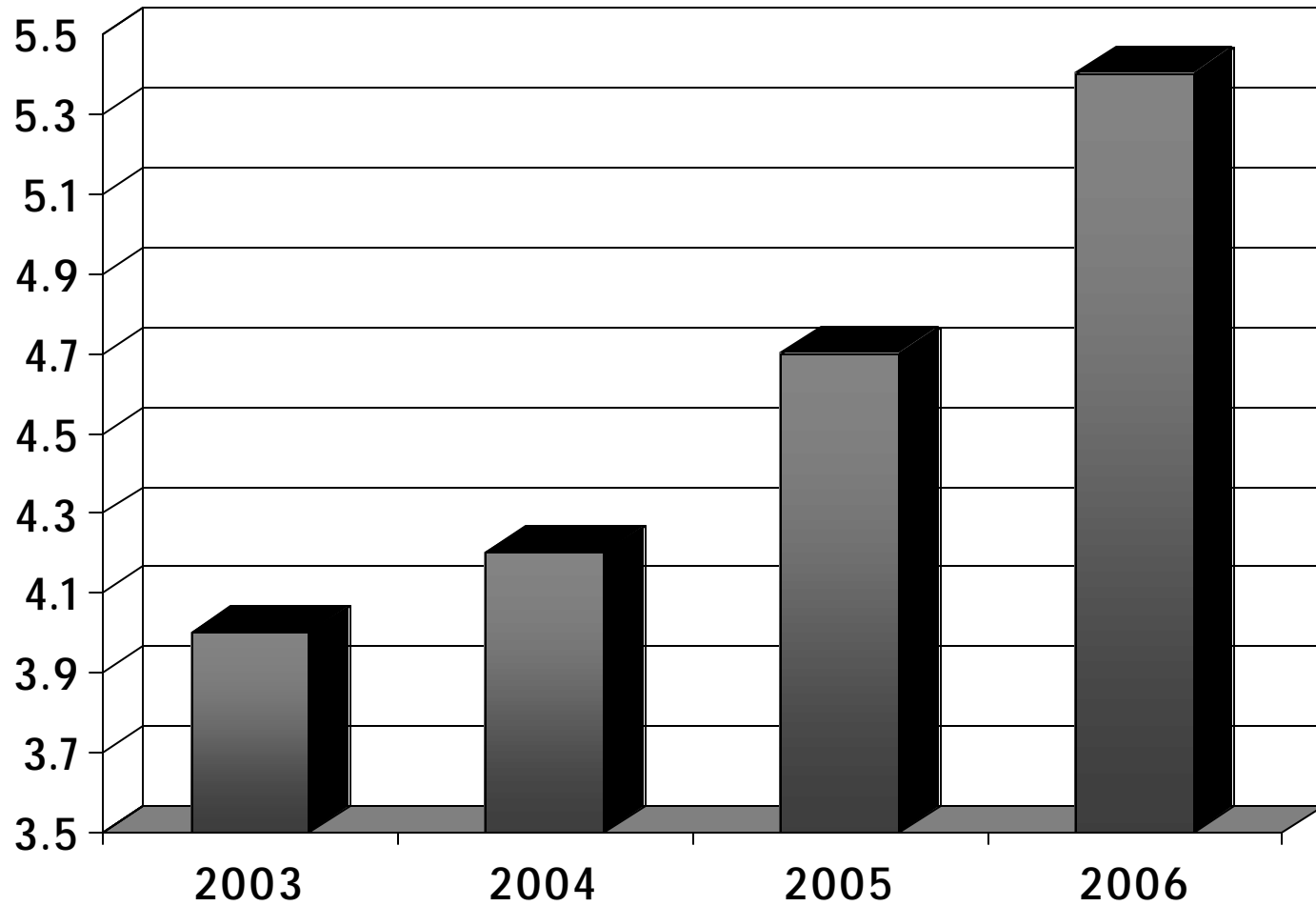
MBA Forecast: Fed Funds Rate



MBA Forecast: 10-Year Treasury



MBA Forecast: 10-Year Treasury

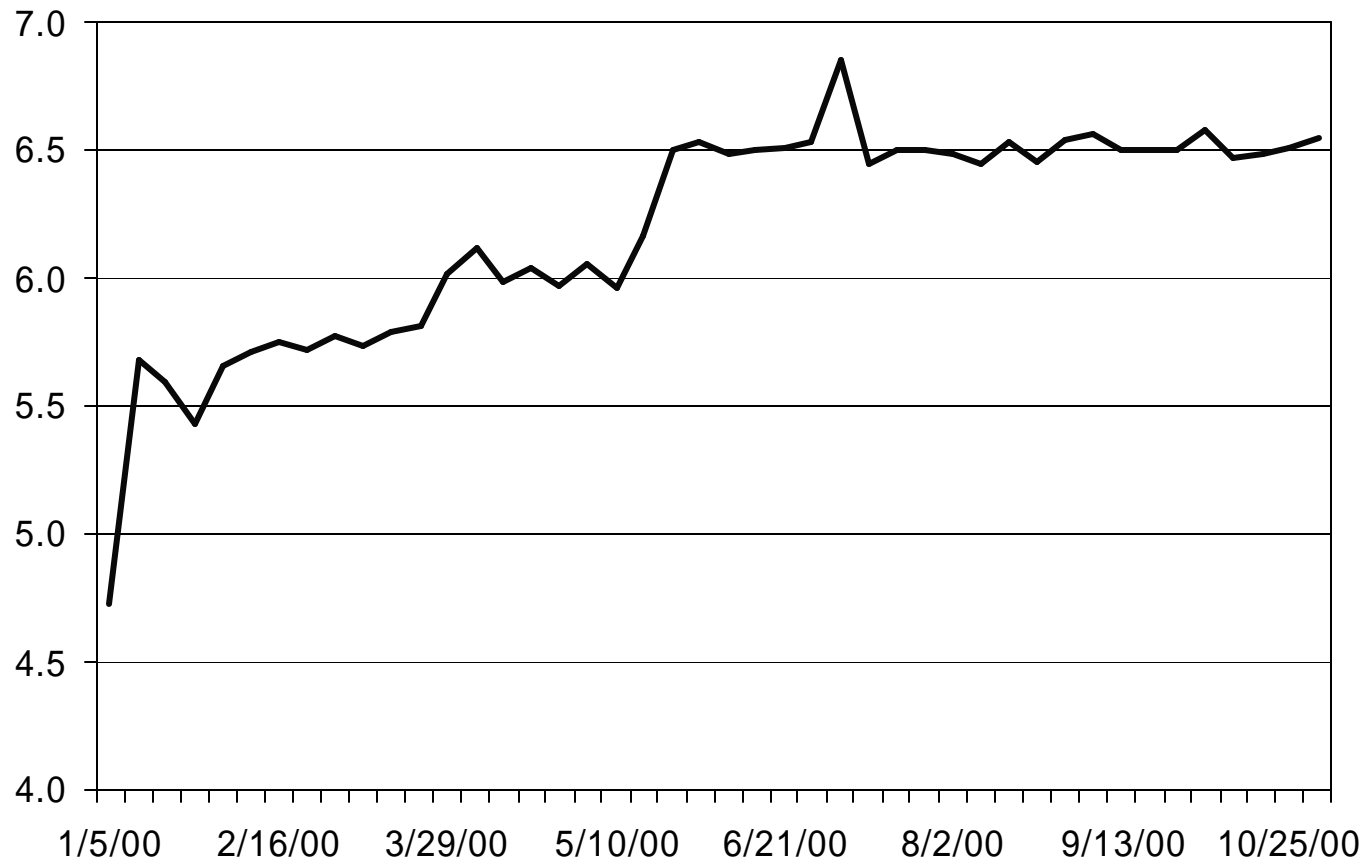


Election Year Impact on Fed Funds

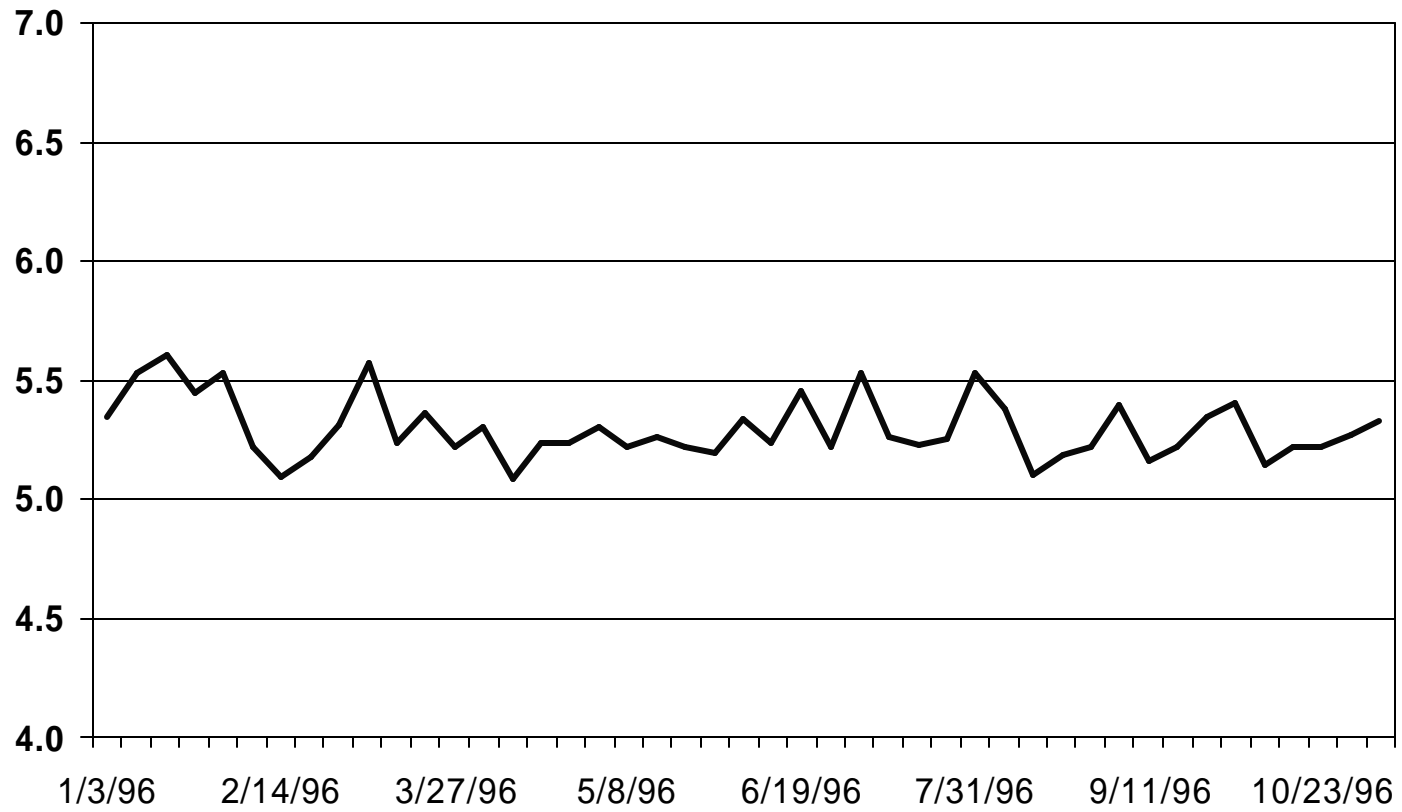
There is a school of thought that says interest rates will be held constant in an election year.

What is the history on this issue?

Election Year Impact on Fed Funds: 2000



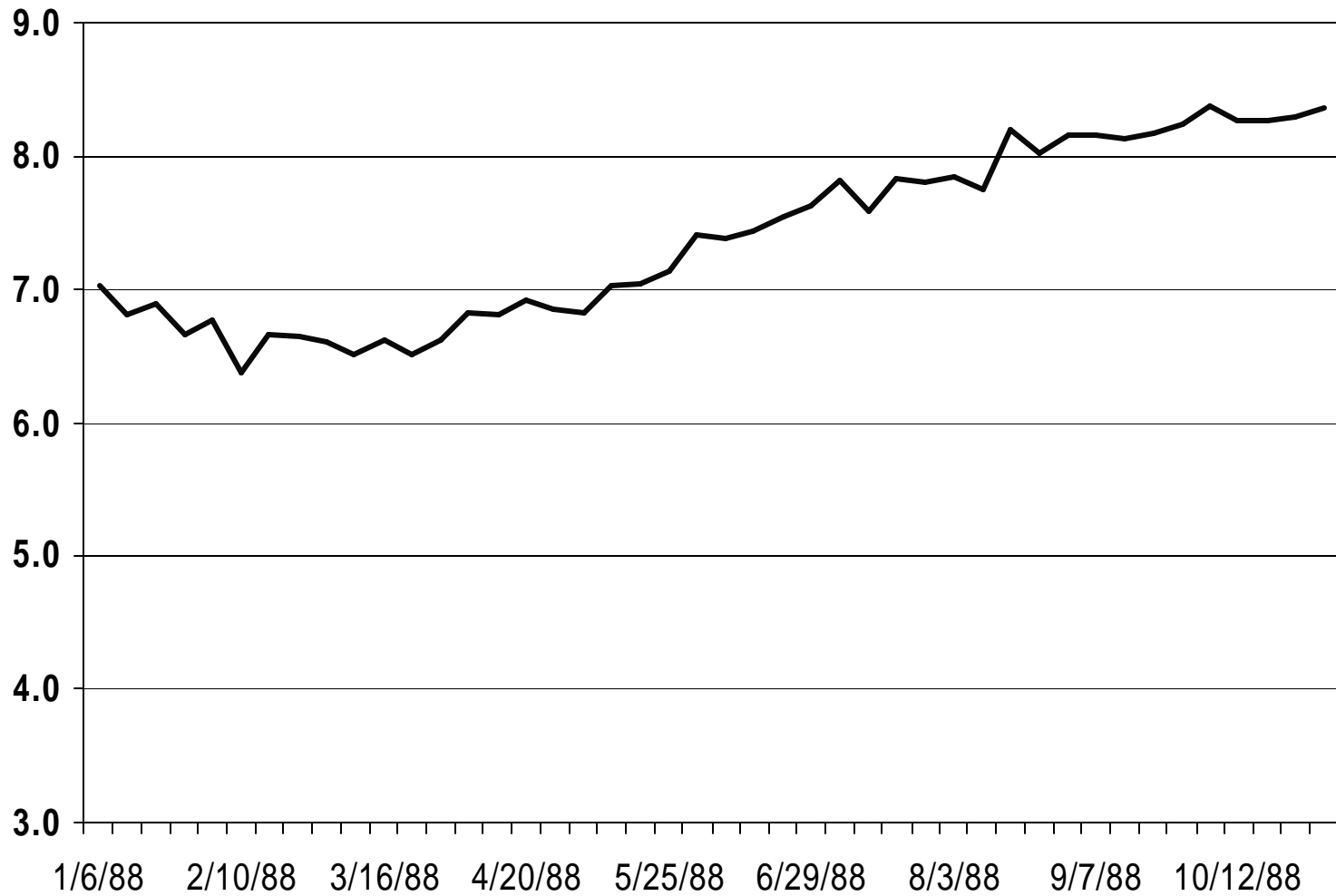
Election Year Impact on Fed Funds: 1996



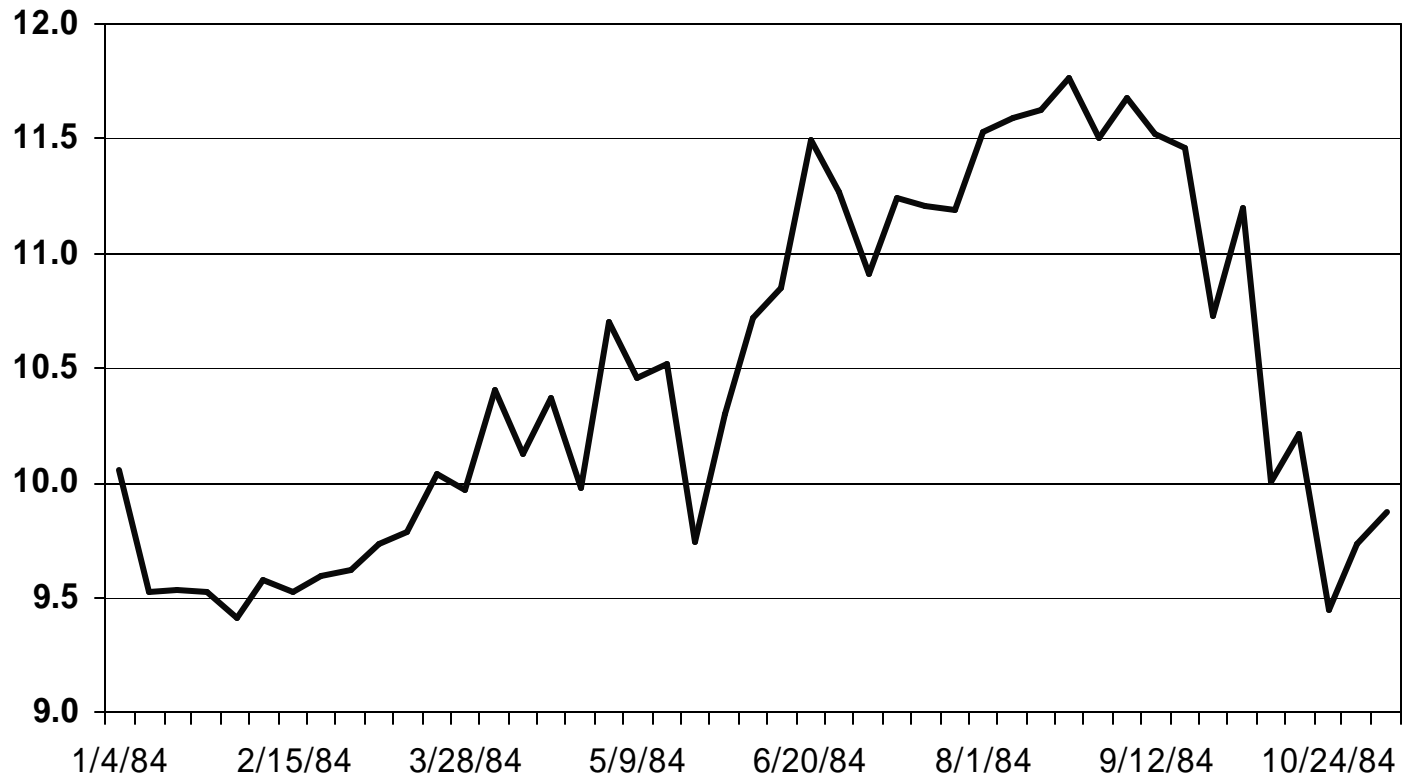
Election Year Impact on Fed Funds: 1992



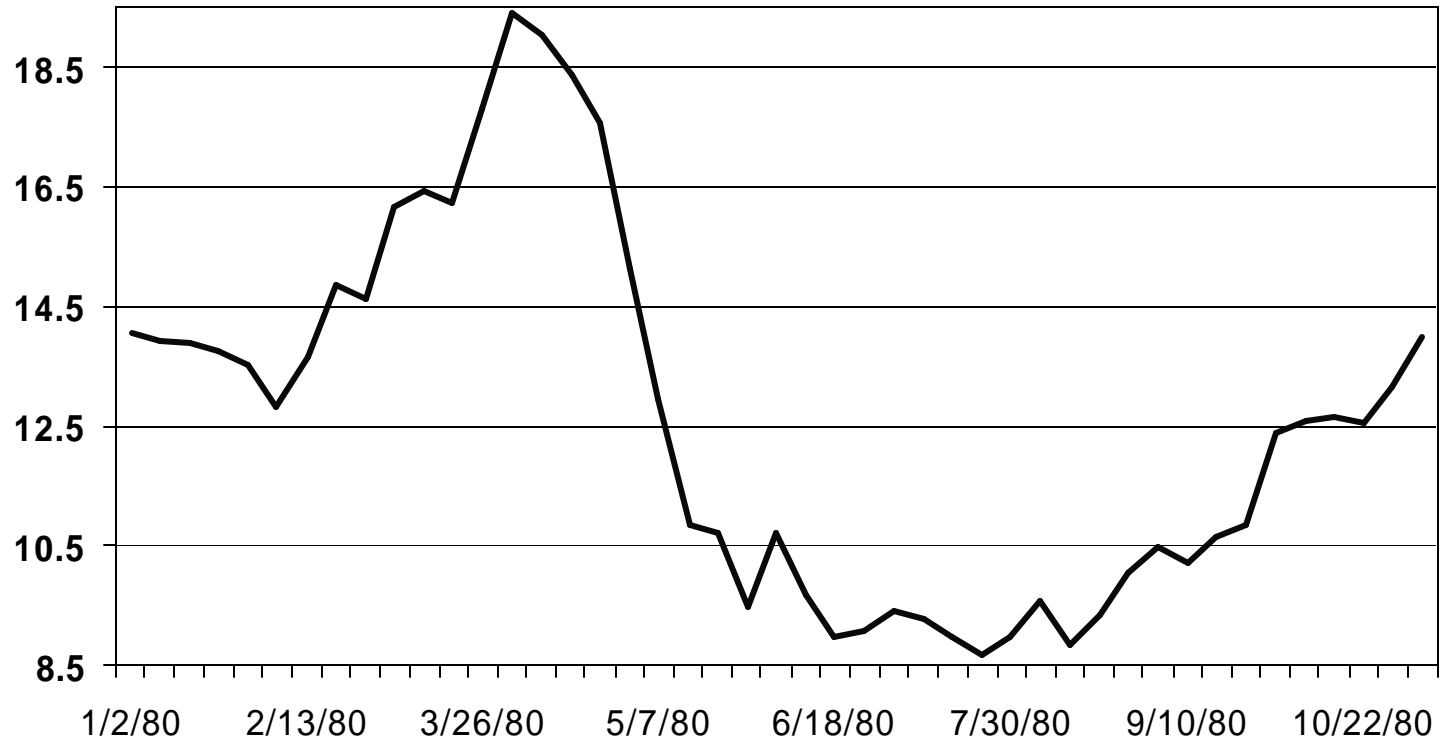
Election Year Impact on Fed Funds: 1988



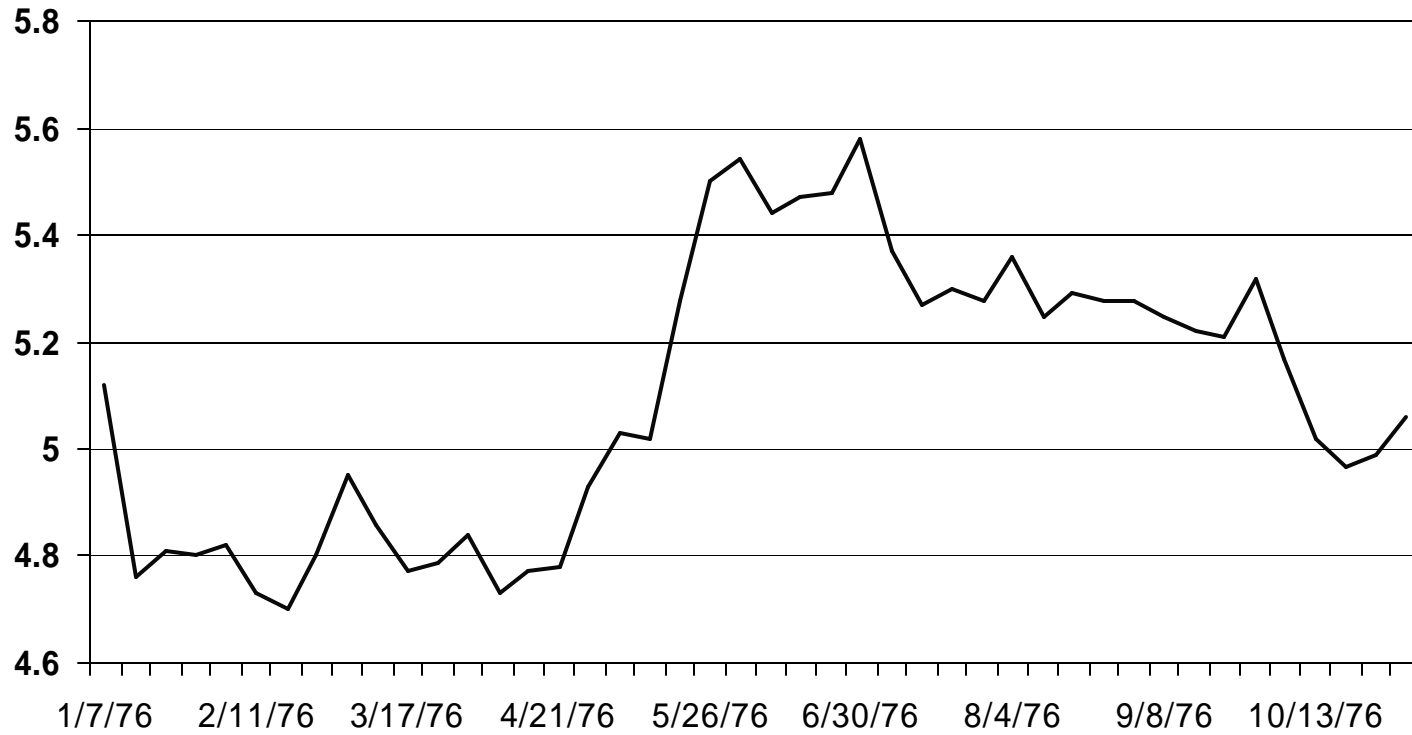
Election Year Impact on Fed Funds: 1984



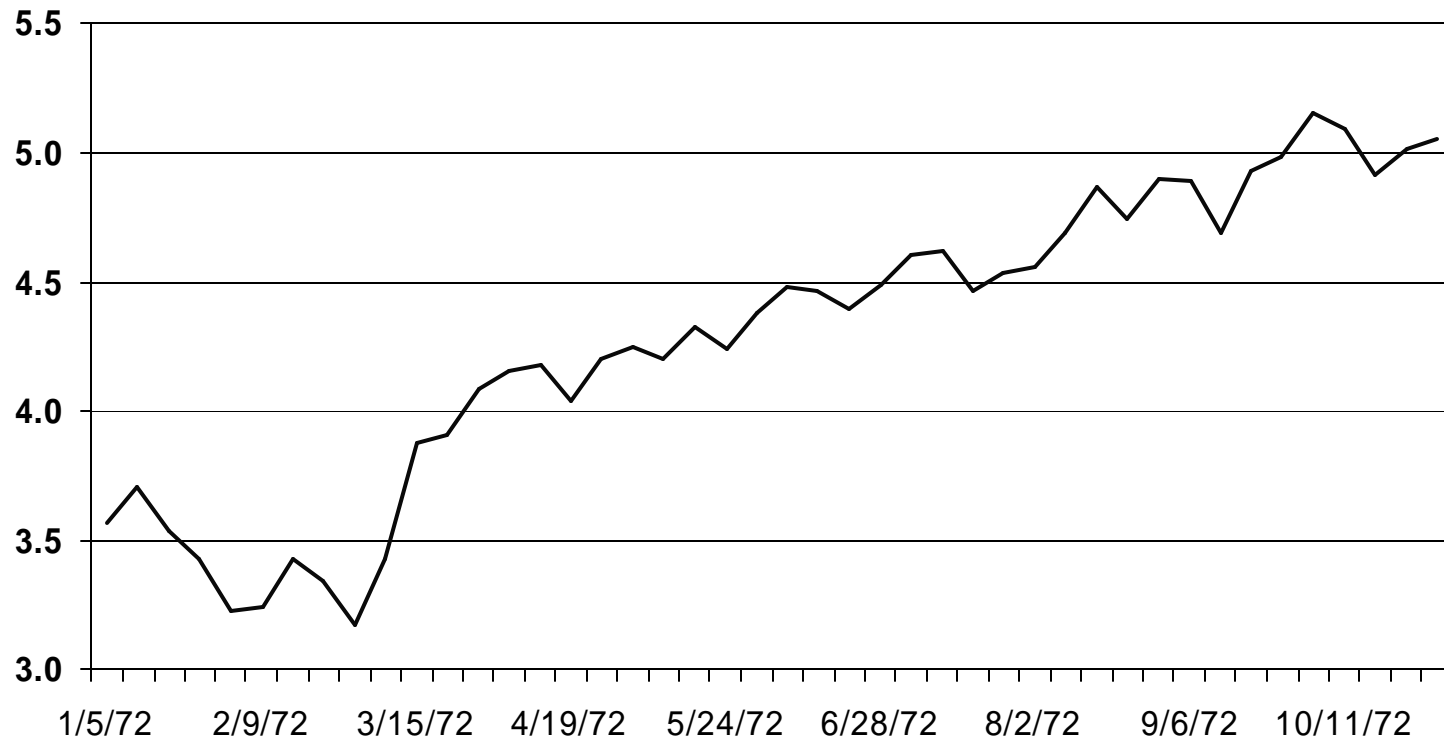
Election Year Impact on Fed Funds: 1980



Election Year Impact on Fed Funds: 1976



Election Year Impact on Fed Funds: 1972



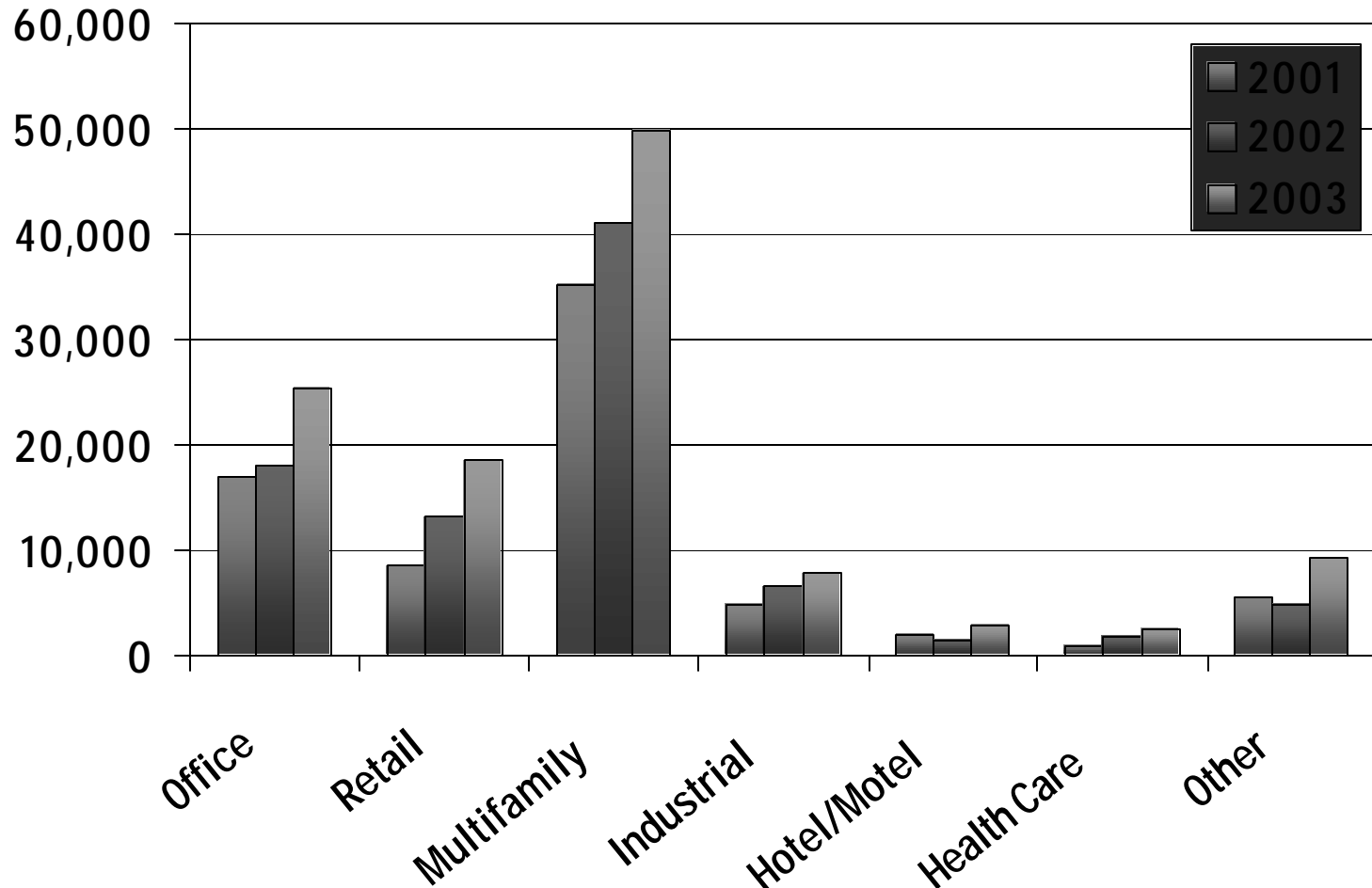
Interest Rate Conclusions

- Rates have been at their lowest for an extended period.
- They have a LOT of room to go up.
- Most indications are that rates will increase in the very near future.
- The fact that this is an election year by itself is not an indicator of what rates will do.

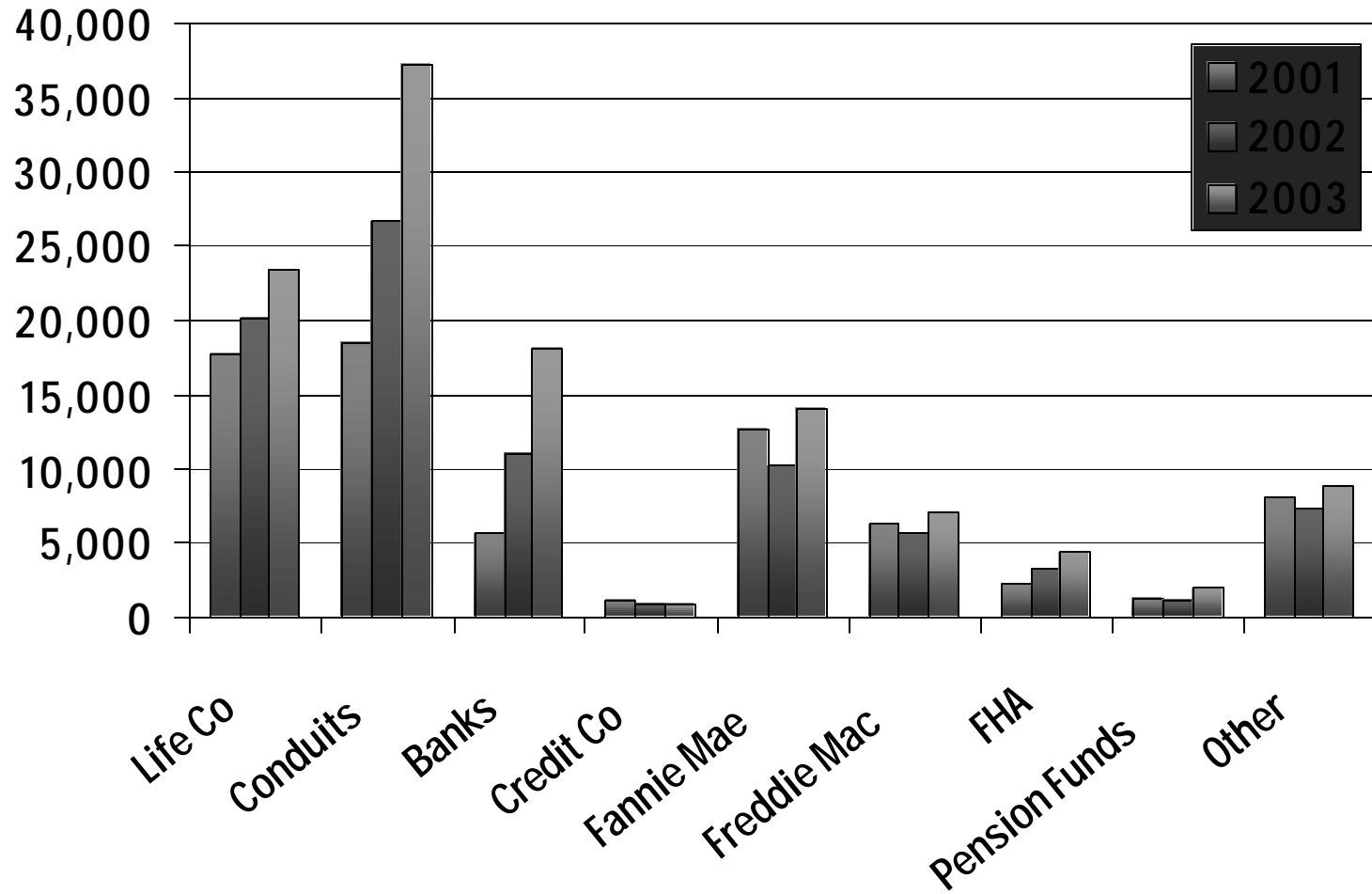
Property Types

- Apartments are still the most highly sought property type as indicated by permanent financing terms.
- HUD insured apartment construction loans are probably being cut back for the immediate future.
- Construction and permanent loans for office and retail properties are still available, but ...
- Grocery anchored shopping centers are being looked at more carefully as the anchor credit evolves.
- Hotel financing is making a limited comeback.

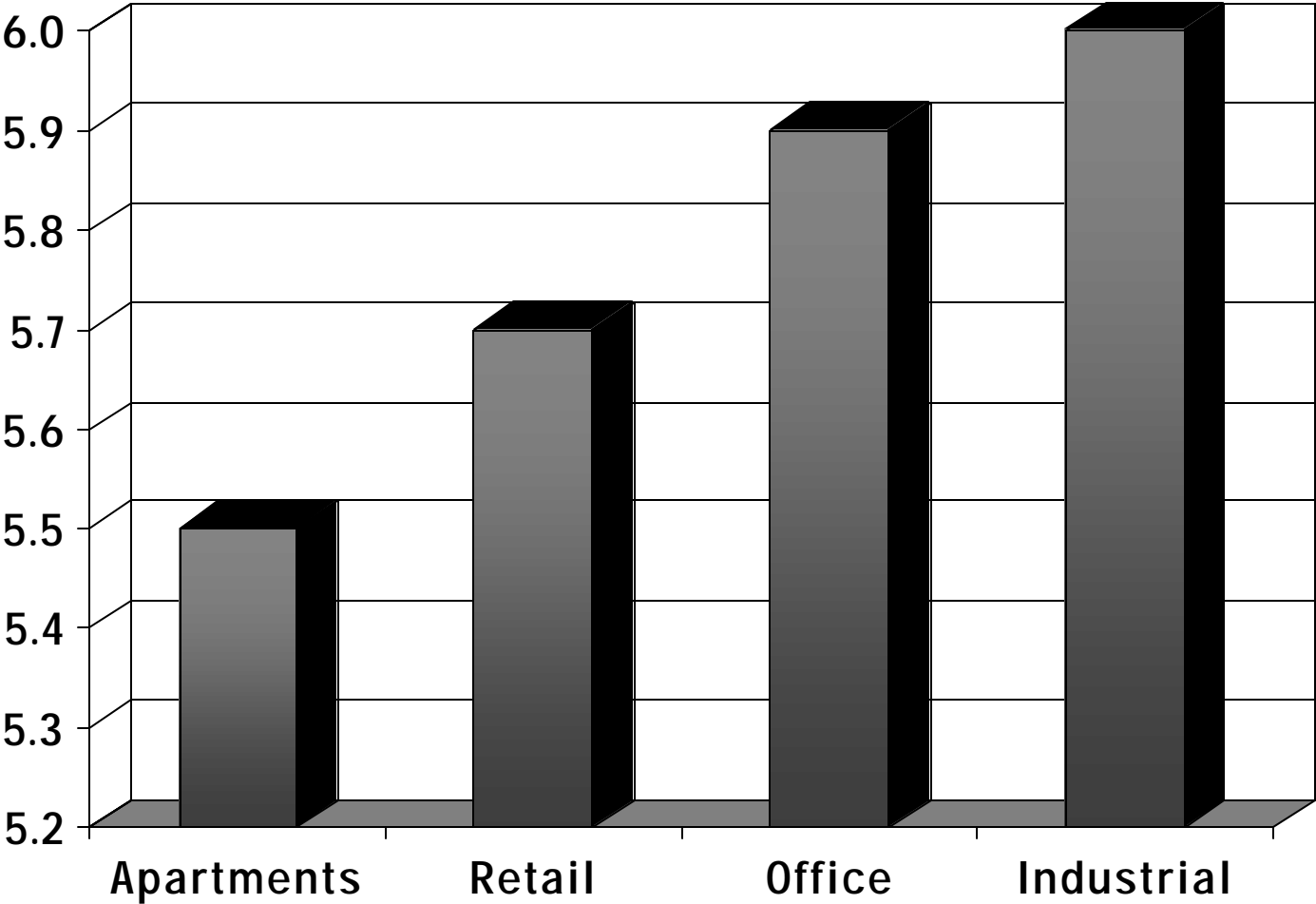
Origination by Property Types: 01-03



Origination by Lender: 01-03



Conduit Pricing



Property Types - Conclusions

- In the permanent market, apartments are king
- Apartment construction will need traditional financing sources
- For deals outside of “the box”, a good story still gets a loan from creative lenders at higher pricing
- Office and Retail construction probably require substantial pre-leasing

Loan Programs - Spotlight

Mezzanine Debt

HUD 221(d)(4)

HUD 223(f)

Loan Programs – Mezzanine Debt

- Fills the gap between what the lenders are willing to lend and what the owners are willing to put in
- On a permanent loan, it can increase the loan-to-value up to 85% in most cases and in some cases up to 95%
- On bank loans, available on a case-by-case basis
- There has to be a good story and serious potential for value creation
- Most mezzanine players have \$5mm minimum
- Pricing is in the low teens for lower leverage and high teens for higher leverage, both with exit fees and minimum guaranteed returns

Loan Programs – HUD 221(d)(4)

- Exclusively for multi-family properties
- Market rate deals! Not affordable housing, Section 8, rent controls, etc.
- New construction or substantial rehabilitation
- Includes an interest-only construction period and a fully amortizing permanent loan – up to 40 years
- Generally lower equity required
- Probably not available at the present time for new construction in the Baton Rouge area, but could be available for Sub Rehab

Loan Programs – HUD 223(f)

- Exclusively for multi-family properties
- Market rate deals
- Refinance of existing properties
- Fully amortizing permanent loan – up to 35 years
- Generally lower equity required
- Generally readily available

The Refinance Dilemma

The consumer's refinance decision making process involves a cost benefit analysis:

- Will the money I save on interest be more than the cost of refinancing during the remaining period of time that I own the property?
- Do I extend the amortization and reduce my monthly payments further at the expense of equity generation or do I keep my monthly payments the same?
- Do I pull out cash now to pay off other debts?

The Refinance Dilemma

The commercial refinance dilemma is similar:

- **Cost/Benefit analysis**
- **Decision whether to extend the amortization**
- **Decision whether to increase the debt**
- **All done within a discounted cash flow context**
- **All done within the holding period**

The Refinance Dilemma

Basic differences:

- The residential decision does not involve income generation.
- There is generally a balloon payment associated with the commercial loan.

The Refinance Dilemma

The Most Frequent Commercial Dilemma:

- I have four years left to go on my permanent loan and the prepayment penalty is 15% to 20% of the loan balance.
- If I wait four years I can refinance without a penalty, but I roll the dice on interest rates and property values, plus miss out on current cash flow.
- If I refinance now, I improve cash flow for the next ten years and know what I can borrow, but I lose some equity.

The Refinance Dilemma

Is this important to the real estate agent?

- The financing in place on property listed for sale has to be dealt with for the sale to occur. It must be assumed or paid off.
- A property with *better financing* that can currently be obtained in the market is probably worth *more* to the purchaser than a property without any financing.
- A property with *worse financing* that can currently be obtained in the market is probably worth *less* to the purchaser than a property without any financing.

The Refinance Dilemma

Owner Cash Flows:

- Initial transaction costs
- Initial financing costs and down payment to purchase the property
- The monthly difference between net operating income and debt service
- Any net cash you get to pull out of the deal along the way, both in terms of increasing primary debt at renewals and junior financing at various times, net of financing costs.
- The cash you keep when the property ultimately sells.

The Refinance Dilemma

Basic Premise:

- **\$1 of Cash Today is Worth More Than \$1 of Cash Tomorrow**
- **\$1 of Cash I Can Get Today is Worth More Than \$1 of Equity I Can't Get Until Tomorrow**

Assumptions:

- **\$4,500,000 Property**
- **\$400,000 Annual NOI**
- **Loan Balance of \$2,800,000**

Options:

- **Refinance at the same 8.5% interest rate for 10 more years.**
- **Choice of a 20 Year and a 30 Year Amortization**

Issues:

- **Get more monthly cash flow with a 30 year amortization**
- **Sacrifice generation of equity**

	Scenario 1	Scenario 2	Difference
Loan Amount	\$2,800,000	\$2,800,000	
Amortization	20	30	
Interest Rate	8.5%	8.5%	
Annual Debt Service	\$291,589	\$258,355	
Annual Net Cash	\$108,411	\$141,645	\$33,234
Value in 10 Years	\$4,500,000	\$4,500,000	
Loan Balance	\$1,959,827	\$2,480,871	
Equity	\$2,540,173	\$2,019,129	(\$521,044)
Sum Of Annual Cash Flows	\$1,084,114	\$1,416,451	\$332,337
NPV of Annual Cash Flows	\$605,066	\$790,550	\$185,484
NPV of Reversion	<u>\$748,305</u>	<u>\$594,812</u>	(\$153,494)
Total	\$1,353,371	\$1,385,361	\$31,990

It's Better To Take The Longer Amortization

Options:

- **Refinance at the same 8.5% interest rate for 10 more years on a 20 year amortization**
- **Refinance at 6.0% interest rate for 10 more years on a 30 year amortization**

Issues:

- **Get even more monthly cash flow**
- **Still sacrifice generation of equity**

	Scenario 1	Scenario 2	Difference
Loan Amount	\$2,800,000	\$2,800,000	
Amortization	20	30	
Interest Rate	8.5%	6.0%	
Annual Debt Service	\$291,589	\$201,449	
Annual Net Cash	\$108,411	\$198,551	\$90,140
Value in 10 Years	\$4,500,000	\$4,500,000	
Loan Balance	\$1,959,827	\$2,343,200	
Equity	\$2,540,173	\$2,156,800	(\$383,373)
Sum Of Annual Cash Flows	\$1,084,114	\$1,985,510	\$901,396
NPV of Annual Cash Flows	\$605,066	\$1,108,153	\$503,087
NPV of Reversion	<u>\$748,305</u>	<u>\$635,368</u>	(\$112,937)
Total	\$1,353,371	\$1,743,521	\$390,150

It's Mo' Better

Options:

- **Refinance at the same 8.5% interest rate for 10 more years on a 20 year amortization**
- **Refinance at 6.0% interest rate for 10 more years on a 30 year amortization, but ...**
- **The second option requires a 15% fee equal to \$420,000**

Issues:

- **Everyone will think you've lost your mind!**

	Scenario 1	Scenario 2	Difference
Loan Amount	\$2,800,000	\$3,220,000	
Amortization	20	30	
Interest Rate	8.5%	6.0%	
Annual Debt Service	\$291,589	\$231,666	
Annual Net Cash	\$108,411	\$168,334	\$59,922
Value in 10 Years	\$4,500,000	\$4,500,000	
Loan Balance	\$1,959,827	\$2,694,680	
Equity	\$2,540,173	\$1,805,320	(\$734,853)
Sum Of Annual Cash Flows	\$1,084,114	\$1,683,337	\$599,223
NPV of Annual Cash Flows	\$605,066	\$939,504	\$334,438
NPV of Reversion	<u>\$748,305</u>	<u>\$531,826</u>	(\$216,479)
Total	\$1,353,371	\$1,471,330	\$117,959

It's Still Better to Endure the Cost

What Were the Key Variables?

- **Monthly Cash Flow**
- **Cash at Reversion**
- **Holding Period**
(10 years in this model)
- **Discount Rate**
(13% in this model)

Options (The Refinance Dilemma):

- **Refinance at 6.0% interest rate for 10 more years on a 30 year amortization, and pay a 15% fee (increase loan to \$3,220,000)**
- **Wait four years, pay no fee, and set payments on a 30 year amortization at the then prevailing interest rate.**

Issues:

- **What will the prevailing interest rate and other underwriting terms be?**
- **What will the value of the property be and how much can be borrowed?**

The Key Variables are Still The Same

Monthly Cash Flow

- Certain only for the next four years

Cash at Reversion

- We assumed constant values

Holding Period

- A shorter period favors doing nothing

Discount Rate

- A lower discount rate favors doing nothing

Add: Do I pull out cash in four years?

- If interest rates rise, will cap rates follow?

The Refinance Dilemma - Conclusions

- There may be an opportunity for long term owners to endure a prepayment penalty and lock in low interest rates
- The best way to evaluate the options is a discounted cash flow analysis
- You cannot focus solely on the amount of the prepayment penalty
- You need to have a feel of where interest rates and cap rates are heading

Commercial Real Estate Finance – Wrap-Up

- Money is still out there for construction projects, acquisitions and permanent refinances
- Interest rates are set to change, but how much?
- There have not been major shifts in appetite for property types
- Gap financing is available for larger deals with stories
- Refinancing with a prepayment penalty may still make sense under certain circumstances