The Capital Markets: Who's Still Lending and How

By Amy Wolff Sorter

It’s been a tough couple of years for commercial real estate borrowers.

Higher-for-longer interest rates, coupled with a pullback by traditional lenders, have led to a gap in borrowing. Debt maturities continue to raise additional concerns. Many sponsors wonder if they can find enough debt and equity to buy, build, rehab or refinance in the current environment.

The answer is yes. Debt and equity can be found. While loan origination volumes aren’t anywhere near the frothy days of 2021 and 2022, experts told Connect CRE that there is capital to be had for many CRE projects.

The Lending Environment’s Bifurcation

CRE lending means that one party (the lender) provides funding for another party (the sponsor), which uses those funds to buy, build or rehab. The sponsor repays the financing over time (known as “term”).

That’s the simple side of commercial real estate lending.

In reality, the lending space is far more complex. Katherine Bissett, a partner with Cox Castle, dubbed today’s lending environment a tale of two cities.

On the one side are office and other distressed properties, which are starting to reach resolution by way of foreclosure, deed in lieu of foreclosure or discounted payoff. The outcome might not be great for the owner. However, “it allows for a basis reset, meaning these buildings can be underwritten, sold and financed based on valuations much closer to market realities,” Bissett explained.

On the other side? Increasing loan origination volume—but from non-traditional lenders. Bissett and other experts explained that debt funds, insurance companies, bridge lenders, mezzanine lenders and others have issued loans that were once the purview of banks. “The non-traditional lenders are also engaging in secondary market transitions with regional and other banks to increase their liquidity and ability to make more loans,” Bissett added.

Andrew Kim agreed, explaining that bridge lenders obtained a higher share of commercial real estate lending due to bank pull-back and “an abundance of deals that no longer pencil from a permanent take-out sizing on a cash-neutral basis,” said Kim, who is Thorofare Capital’s Director, Originations.

Furthermore, bridge loans and other forms of alt lending can be a lifeline for sponsors in an uncertain environment. “Bridge loans provide the necessary breathing room for these borrowers to execute their strategies, whether that involves improving occupancy rates, upgrading facilities or simply waiting out market volatility,” said T.R. Hazelrigg IV, president and co-founder of Avatar Financial Group LLC.

Also coming into play are creative types of lending, such as that offered through Commercial Property Assessed Clean Energy (C-PACE). C-PACE, a program authorized by state legislations and local governments, helps finance energy efficiency, renewables and sustainable upgrades for commercial real estate. Funds obtained through C-PACE can cover everything from using low-emissions materials for construction to purchasing energy-efficient HVAC and water systems.

Jessica Bailey, president and CEO with Nuveen Green Capital, said the C-PACE industry is experiencing phenomenal growth. It provides flexible capital at a fixed rate and low cost. “C-PACE is becoming more widely available, now in 40 states – including all major CRE markets,” Bailey said. “At the same time, there is a growing emphasis on sustainability within CRE, with tenant demand increasing for sustainable buildings.”

Bridge and mezzanine loans and other forms of financing might be doing an excellent job of providing liquidity in many areas. But Red Oak Capital Holdings CEO Gary Bechtel issued a note of caution. “The bridge space continues to be active,” he acknowledged. “But with indexes like the prime rate and SOFR still at elevated levels, transactions are harder to pencil than a few years ago and require more equity or structure.”

Here’s the issue. In some cases, that equity, especially preferred equity, can be more challenging to pin down.

The Struggles with Equity

Many lenders (traditional and non-traditional) like sponsors to contribute more cash when seeking loans. However, obtaining preferred equity (which sits between senior debt and common equity in a capital stack) can be complicated. As a result, debt/equity ratios are shifting in the CRE capital stack.

“In a normal year, our closed transactions are probably about 80% debt and 20% joint venture equity,” said Zack Streit, president of Priority Capital Advisory. “This year, I’m guessing our closed transactions will look like 95% debt and 5% joint venture equity. Joint venture equity capital is unfortunately pretty scarce at the moment, and I hope that changes.” While plenty of preferred equity exists, “it’s relatively expensive and only works in select situations,” Streit said.

Walker & Dunlop’s Susan Mello also explained that the current environment means raising limited partner equity commitments has been a challenge, especially with development deals. “Capital sources are pivoting to acquisitions,” explained Mello, executive vice president and head of the W&D Capital Markets platform. “These tend to be underwritten to comparable returns with less risk and shorter time frames.”

The fact there is limited LP equity available makes it more difficult to put together a complete, balanced capital stack. The lack of a substantial equity commitment has "resulted in many deals being put on hold until 2025," said Tom Whitesell, head of debt investment with Kennedy Wilson.

Meanwhile, GSEs Hold Steady

Government-sponsored entities (GSEs) are organizations created and backed by the federal government that direct credit and capital flow to parts of the economy. The GSEs serving commercial real estate include the Federal Home Loan Mortgage Corp. (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Fannie and Freddie provide liquidity to assist in acquiring and developing multifamily and student housing, among other things.

Lument's Deputy Chief Production Officer for Conventional Multifamily Ian Monk explained that CRE borrowers are turning to the agencies for loans because "of their consistent ability to employ capital and a higher certainty of execution. They've also found ways to get more creative and increase volume while promoting affordability efforts."

Additionally, the agencies are highly dependable, a must-have in an uncertain market. "They're consistently in the market, while other lenders have been in and out of it," commented Evan Denner, executive vice president and head of business with Marcus & Millichap Capital Corporation.

An added benefit is that both agencies have plenty of volume cap remaining for 2024 and more borrowers are taking advantage. "Because of the guaranty provided in connection with agency debt, it can often be issued at lower rates than may otherwise be available in the market," Mello said.

However, the agencies don't cover funding for all multifamily types. "Stabilized, consistent cash-flowing properties with a history of positive operations are the most suitable for agency projects," Monk explained.

What Should the Sponsor Do

Multifamily and industrial are the so-called "hot spots" for lenders. But sponsors shouldn't count on saying, "I'm building a new multifamily project!" to a lender and expect to leave with a check in hand.

For example, if a sponsor is interested in a C-PACE program, Mansoor Ghori, Petros PACE Finance CEO and Founder, said that the first step is to determine availability. "The landscape of C-PACE financing is shaped by varying state and local regulations," he commented. Certain municipalities and jurisdictions extend C-PACE to new construction; others don't. "Program requirements vary widely, including the specifics of saving mandates," Ghori observed.

What else might lenders require from sponsors? At the high level, "aside from a property's condition and market dynamics, there needs to be a focus on the sponsor's credit and experience, both of which are at the forefront of nearly every deal," Monk commented.

Added Denner: "Borrowers with strong track records and balance sheets are in high demand when lenders have limited capital to deploy."

Track Record, Planning and Experience

Mello concurred with others about the importance of a sponsor's track record and asset- and market-specific experience. Also important are realistic business and operating plans and "underwriting that isn't reliant on aggressive operating assumptions," Mello said.

A well-performing portfolio can also put a sponsor in a good position from a lender's point of view. "Prudent lenders examine the overall health of a sponsor's global real estate portfolio," Kim said. "They'll want to know if there are any deals on the watchlist, pending foreclosures or how much office exposure there is."

Just as important is the sponsor's readiness to move ahead. "We like to see sponsors with their ducks in a row," Whitesell said. "This means the equity partner signed up, budgets based off the 90%-100% construction drawing, hard cost budgets from the general contractor, permits ready to pull and so on."

For Hazelrigg and Avatar, financing the CRE project is another important component of the lending decision. "We're not tied to any particular product type," he said. "We're more interested in the strength and viability of the project itself."

What about the Balance Sheet?

The experts emphasized a sponsor's strong balance sheet as a deciding factor. But this means different things to different lenders. Thorofare's Kim suggested that the sponsor with the best chance should "be prepared to recommit into the asset with fresh cash at the closing table in the event of a refinance." Mello, for one, indicated that borrowing helps "when third-party equity isn't the key to getting the deal done." On the other hand, "we are more favorable on leasing risk and construction risk when we know that the borrower has access to substantive equity to bring to the table," according to Art Rendak, president of Inland Mortgage Capital.

C-PACE financing also examines track records and balance sheets, and it relies on a project's sustainability and location. "Some jurisdictions extend C-PACE benefits to new construction, while others do not," Ghori said. "Program requirements vary wildly, including the specifics on savings mandates." In many cases, lenders also need to approve a C-PACE assessment, he added.

Monk said that the GSEs like to see properties that perform well historically, maintain consistent collections and occupancies, are in excellent condition and are located in well-performing markets. "Simply put, the ideal Fannie or Freddie borrower is someone who has a healthy /

performing multifamily portfolio, experience in the respective market or markets and no credit blemishes," he said.

Then, There's the Miscellaneous

Hazelrigg pointed out that a good sponsor story goes beyond the numbers. "We want to see a well-thought-out strategy that addresses the key components of the project," he explained. The strategy should include a realistic business plan and exit strategy, as well as how the sponsor plans to add value to the property and ensure the loan can be repaid/retired on schedule.

Or as Red Oak's Bechtel put it: "It's incumbent upon the borrower and his/her broker to be able to lay out to us the business case, demonstrate the need in the market and the borrowers' ability and experience to be able to execute on the business plan.

Given the broad array of assets and financing available, Mello with Walker & Dunlop noted that "most assets can get financed. It's generally a matter of loan proceeds and pricing."

Even office? Yes, if the terms are right. Streit said he was involved in financing an office acquisition in Costa Mesa in Orange County. The property was being acquired for about $300 per square foot, which was a significant discount to the seller's cost basis and had nearly a double digit in-place cap rate. The property started out at 90% leased when Streit started on the assignment and was 100% leased at closing, showing positive leasing fundamentals. On the buy-side financing, "We had multiple term sheets and significant lender interest this deal," Streit said. "It certainly defied the conventional belief that all office is tainted."

A Mixed Lending—and Transaction—Outlook

As of this writing, it's anticipated that the Federal Reserve will cut the Effective Federal Fund Rate (EFFR) when the Federal Market Open Committee meets later this month.

"With interest rate cuts expected to happen, we are expecting more money that has been on the sidelines to come back into play," said Whitesell with Kennedy Wilson. "This will result in some more competition in the market." MMCC's Denner agreed, saying the pipelines have been more robust due to recent index movements. Still, he said that capital continues to be on the sidelines, waiting for the Fed's actions and messaging.

Ghori agreed that "fluctuating interest rates, economic uncertainties and evolving government policies affect the industry," adding that it's important to understand how such variables might impact the C-PACE programs' effectiveness and reach.

However, Caroline Dreyfus, partner with Cox Castle, cautioned against too much excitement with pending Fed cuts. "There is no indication yet of regional banks jumping back into the real estate lending business, particularly not in construction loans," she said.

Rendak concurred, noting that banks aren't leaping back into the lending mix anytime soon. Traditional lenders continue to deal with CRE balance-sheet exposure and new capital requirement uncertainties. On the other hand, Fed cuts could mean debt-yield requirement changes and possibly more aggressive loan-to-cost ratios. "These predictions are all predicated on a relatively stable economy and the absence of the geopolitical risks," Rendak added.

Avatar's Hazelrigg also cautioned against too much rate-cut exuberance. "Interest rates aren't going to plummet immediately. They'll still be elevated, and traditional lending terms will be more stringent," he said. For borrowers struggling with loan maturities or other challenges, products like bridge loans "will be an essential tool to manage their needs until market conditions improve and they can secure better financing," Hazelrigg said.

Meanwhile, Dreyfus said that interest rates have been stable, while debt funds, insurance companies and preferred equity "continuing to take up the slack left by regional and national banks." Additionally, Kim pointed out that property valuations are close to bottoming out, with credit spreads tightening. "We also foresee the bridge lending space becoming more competitive due to alternative lenders re-entering the market, as well as permanent capital sources providing more aggressive terms," he said.

Nuveen Green's Bailey said that the C-PACE outlook is excellent both in the current environment and moving forward. For example, the program could be used to recapitalize projects as construction starts have slowed and borrowers take advantage of C-PACE's flexible financing terms. "We believe that C-PACE, which was once considered a niche alternative financing mechanism, will continue to receive more mainstream adoption," Bailey added.

Meanwhile, some experts are forecasting positive momentum, based on the Treasury rates. "With the recent drop in Treasuries and the outlook for a softening of rates by the Federal Reserve at their September meeting, exit stress tests have gotten a bit easier recently," Bechtel commented. "I see this trend likely to continue through the balance of the year, barring any recessionary pressures. I think that will help make transactions a little easier to pencil."

Most agreed that 2024's financing and transaction volumes will exceed those of 2023, and the trend should continue in 2025. "I think we're finally turning the corner after two pretty tough years of higher rates," Priority Capital's Streit commented. Furthermore, a hold in Treasury rates combined with a couple of EFFR cuts "could be a real shot in the arm for the real estate market," he said.