Executive summary | July 2024

Wipfli Real Estate Leaders Exchange

Host: Cory Bultinck | Wipfli

SME: Matthew Ruark | Key Bank

Facilitator: Josh Iverson | Profitable Ideas Exchange

Introduction

Fifteen leaders from the real estate industry met virtually to share leading practices and discuss topics of mutual interest based on an agenda created through a series of pre-interviews. From Wipfli, Cory Bultinck, national real estate leader, hosted the exchange and Austin Evans of Profitable Ideas Exchange facilitated.

Matthew Ruark, head of commercial and senior housing mortgage production at Key Bank, joined to provide subject matter expertise. The focus of the discussion covered the following topics over the course of the hour:

- Capital markets and deal flow
- Deal approaches in the current environment
- Market dynamics and trends in real estate
- Hedging risk

Capital markets and deal flow

Key Bank's Matthew Ruark opened the conversation with an overview of capital markets and deal flow.

- While transaction volume is down and interest rates are up, elective refi and sponsors are making every effort to extend existing debt without new debt. The result is unprecedented massive maturities, a reality that the real estate industry must deal with in 2024 and 2025.

- The NPA report projects $930 billion in commercial real estate mortgages maturing in 2024, representing 20% of the total mortgages. Banks and commercial mortgage-backed securities (CMBS) are the two largest owners of the maturities, and this is causing liquidity concerns.

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Capital markets and deal flow

Despite massive mortgage maturity and liquidity concerns, capital markets are open.

- Spreads have been tightening all year long and agencies are reducing pricing to drive duration but are facing competition from non-agency lenders.
- From a multifamily perspective, the Federal Housing Finance Agency's caps are down compared to last year, at $70 billion each, and likely to go up if there is a rise in market demand.
- Five-year requests are on demand with some flexibility of five and seven years, and banks are competing in the multifamily space on lease up deals while agencies are having trouble competing on pricing and interest-only loans.

From a CMBS perspective, the market was down 40% in 2023 and many banks were on the sidelines trying to figure out what to do with their own portfolios.

- CMBS trends in 2024 indicate it is positioned for a comeback, providing real liquidity in the market. Retail is the leading contributor in CMBS while multifamily popularity is growing in the asset class, quickly replacing office which has dropped off.
- It is harder to do office in CMBS as the percentage of pools has dropped from 30% to about 12%.

Deal approaches in the current environment

As highlighted by Ruark, the current interest rate environment in the industry is normal, while the low rates in the last three to four years were not.

- In another example, a leader pointed out that young brokers have been worried about the 10-year rate at 4% or 5%. The leader explained that the current 10-year treasury is at 4.35%, which is below the 50-year average from a historical perspective.
- Some confusion may arise as the markets emerge from the unprecedented 10 to 15 year run of government quantitative easing and manipulation of interest rates, with most prices artificially inflated by low interest rates.
- The leader was optimistic that investors will be able to deal with the current 4.3%-4.5% 10-year treasury.

Deal approaches in the current environment

One leader highlighted that low interest rates are causing incorrect pricing and negative leverage.

- Ruark explained that, as rates started to rise, some investors believed that rental rates would continue to rise at a pace that would keep up or outpace the interest rate increases, hoping to get a cut to 6% this year and get back to business as usual. But those who were leaning on negative leverage in 2022 and early 2023 are stuck because suddenly, multifamily and industrial rental rate increases have slowed down. If the investors were on short-term floating rate deals, then they will experience difficulties as they begin to deal with their business net plans not coming to fruition.

Even though commercial real estate is a normal business environment, the present interest rates are painful, noted one leader.

- Their company is currently refinancing several deals and leveraging relationships with some local banks. The leader was concerned that the spreads banks are putting on the company's projects or deals are making it impossible to access credit despite the glut of capital in the markets.

Market dynamics and trends in real estate

Banks have experienced challenges in recent years that Ruark attributes to long fixed-rate loan terms that mismatched assets and liabilities from a duration perspective.

- A leader discussed the impact of federal policies on liquidity and credit extension which are making it difficult for banks to lend to small businesses and individuals. CMBS are filling the gap, but without a functioning CMBS marketplace, the real estate marketplace will struggle to exist.
- Currently, retail lending is the leading asset class for CMBS, highlighting the need for a functioning community bank system to fill the existing gaps.

Market dynamics and trends in real estate

While banks are willing to work with clients on distressed assets, regulatory pressure may increase costs.

- One participant noted issues with multifamily bridge loans, suggesting recapitalization opportunities.
- Some banks have gone into special servicing to deal with regulatory pressure.
- A big volume of multifamily bridge deals has moved into special servicing as their business plans did not materialize into rental rate growth, leading to debt defaults. According to Ruark, the deals were fundamentally flawed and should be recapitalized.

Ruark explained that banks are not interested in holding on to an asset and seeing if they can turn it around.

- They try to quickly dispose of them based on the principle that your first loss is your best loss. On the off-balance sheet side, there has been some willingness to take some assets back and try to work through them, but the turnaround has been difficult, and banks are going back to disposing of the assets as quickly as possible.

Hedging risk

The current regulatory environment increase in regulatory inquiries is making it difficult for companies to form and maintain strong relationships with banks.

- An increase in regulatory inquiries takes away the time banks would spend meeting clients as they have to do a lot of paperwork and reporting.
- Also, depending on whether the regulator is a nationally chartered bank or U.S. state-chartered bank means that there might be differences in how regulators view things and the kind of pressure they apply at different levels and within different organizations. This creates inefficiencies in the market because everybody is reacting to a different set of rules.

Hedging risk

One organization is trying to determine whether to do five-, seven- or 10-year debt terms due to uncertainty on where interest rates may go.

- Ruark emphasized the importance of understanding the components to an all-rate, including spreads and indices for individual companies, depending on how they view rates. Currently, there is a demand for longer duration paper which provides a buying opportunity on spreads.

To hedge interest rate risk, one company prioritizes long-term fixed-rate debt through swaps and avoids floating rates.

- Although swaps have led to some financial loss, the company chooses to stick with the approach, and most debts have now been extended out beyond 2030, which makes the rates bearable.
- According to the leaders, swaps work, especially when the company is not constantly churning their portfolio. Swaps fix interest rates and help companies get through the period of high escalation in rates.

Another leader observed that the "wall of maturities" is difficult to manage, as many sponsors want to be short-term, betting on rates coming down.

- This has led to increased demand on the five-year paper, which will lead to lack of liquidity in the system in five years.
- The leader underpinned the importance of laddering maturities and having duration in the system to manage debt maturity risk.

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