A CREF Renaissance

— by JAMIE WOODWELL —

Property values are nearly back to their 2007 levels. Property incomes exceed their 2007 levels. Mortgage originators are competing for loans. ¶ It's official. Commercial real estate finance markets are back. To be fair, the rebirth began in earnest in 2012 and was in the offing in 2011, but the full body of the market has only firmly reemerged in the last few quarters. ¶ This renaissance has been made possible by climbing property incomes, rebounding property values and still-low mortgage rates. The strength of the rebound is evidenced by mortgage origination levels that are nearly back to what was seen in 2004, and multifamily originations that are hitting new highs. ¶ Perhaps most importantly, the momentum that the CREF renaissance has established is likely to carry the industry over the 2016–2017 loan-maturity hump with only a fraction of the pain that was expected just a year ago. ¶

Like a phoenix, the commercial real estate finance sector is—once again—reborn.

Property income

Slow but steady growth in the U.S. economy has rejuvenated commercial real estate markets. Vacancy rates are coming down, rents are going up and incomes are strengthening.

Increasing economic activity has raised demand for commercial real estate space across property types. Office vacancy rates have ticked down consistently, if slowly, in recent quarters—to 16.9 percent during the third quarter of 2013 from 17.6 percent at the end of 2010, according to Reis Inc., New York.

Retail vacancies are down to 10.5 percent from a high of 11.1 percent. Multifamily vacancy rates, benefiting from the move away from homeownership, are leading all property types with vacancies that have fallen to just 4.2 percent from a recession high of 8 percent.

The improvements in operating conditions have helped properties' bottom lines. According to data from the Chicago-based National Council of Real Estate Investment Fiduciaries (NCREIF), net operating incomes (NOIs) at industrial properties—the laggard when it comes to income growth—have risen 4.2 percent from their recession lows and now sit 9.5 percent below their pre-recession high (see Figure 1).

Office property NOIs have risen 4.8 percent since hitting a recession low in the fourth quarter of 2011 and are now just 1.5 percent below their pre-recession high.

Most strikingly, average net operating incomes at apartment and retail properties have never been higher.

If one compares today's net operating incomes with what they were 10 years ago—when many of the loans that are now being refinanced were originated—industrial NOIs are 0.2 percent lower but office NOIs are 8 percent higher, retail NOIs are 24 percent higher and apartment NOIs are 59 percent higher.

NOIs are higher today than they have been at any time in the last 10 years for apartment and retail properties and—except for a brief period in 2009 and 2010—for office properties as well.

Given how low interest rates have been, property incomes—and a property's ratio of income to debt payments (or debt-service coverage ratio, DSCR)—have generally not been a significant barrier to financings. Even so, strong NOIs mean greater financeability for commercial and multifamily properties.

And as NOIs continue to rise, the ability of commercial properties to meet underwriting hurdles should continue to improve.

This is especially true for office properties which, 10 years ago, were experiencing NOI declines associated with the bursting of the dot-com bubble. The fact that office NOIs fell 15 percent between 2001 and 2006 will mean that in coming years, 10-year growth in NOIs (e.g., NOI growth between 2004 and 2014 or NOI growth between 2005 and 2015) at those properties will get an added boost.

Collateral value

Even more central to the renaissance of commercial real estate finance has been a rebound in property prices.

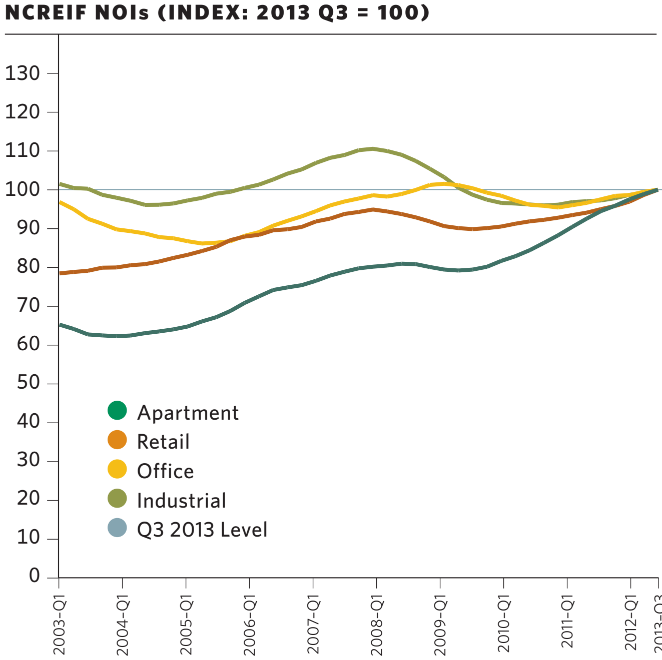
Values of commercial and multifamily properties rose a full 10 percent in the first three quarters of 2013, according to the Moody's/RCA Commercial Property Price Index (CPPI). That is on top of increases of 11.6 percent in 2011 and 8.1 percent in 2012.

All told, property prices have risen 47 percent from their recession lows in 2009.

The result: Based on the Moody's/RCA index, property

FIGURE 1

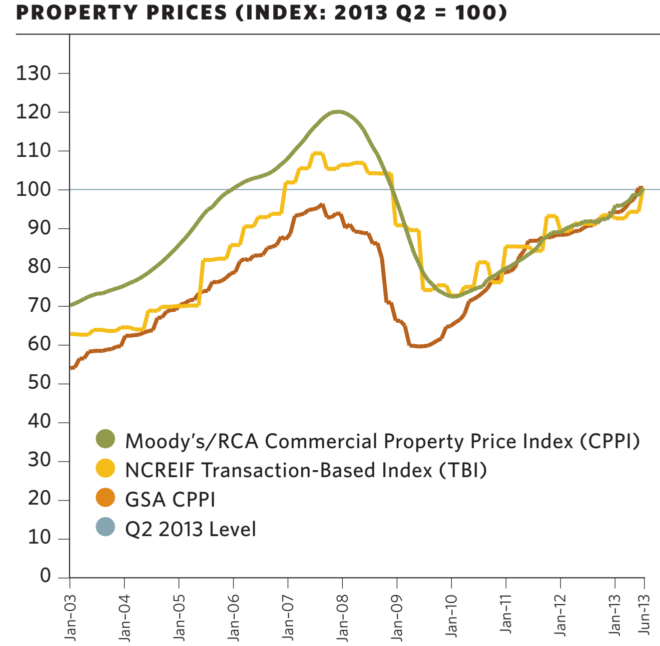
NCREIF NOIs (INDEX: 2013 Q3 = 100)



SOURCE: National Council of Real Estate Investment Fiduciaries (NCREIF)

FIGURE 2

PROPERTY PRICES (INDEX: 2013 Q2 = 100)



SOURCES: NCREIF, Green Street Advisors (GSA), Real Capital Analytics Inc. (RCA) prices are now just 12 percent below their 2007 peak. By this measure, prices need to rise only 3.25 percent per year between now and 2017—the year in which 10-year loans made at the peak of the market will be coming due—to regain their 2007 levels. (Remember, they rose 10 percent in just the first three quarters of 2013.)

By other measures, property prices have already regained most, if not all, of their peak levels. At the end of the third quarter of 2013, the NCREIF Transaction-Based Index (TBI) was just 5 percent below its 2007 peak and Green Street Advisors' CPPI had already surpassed its previous peak (see Figure 2).

> With commercial property incomes and values once again supporting borrowing, commercial real estate lending has been reawakened.

This recovery in commercial real estate prices means that more and more properties that had been underwater on their mortgages, mezzanine debt, preferred equity and other obligations now have recoverable equity for their owners. It also means new loans or acquisitions are far more likely to "pencil-out" at terms palatable to existing owners.

Property income growth is one reason for the rising property values. Low capitalization (cap) rates is the other.

According to Real Capital Analytics Inc., New York, third-quarter cap rates came in at 7.7 percent for industrial properties, 7.1 percent for retail properties, 7.0 percent for office properties and 6.2 percent for apartment buildings (see Figure 3).

For comparison purposes, office property cap rates are just 50 basis points above their all-time low from mid-2007. Apartment cap rates are just 10 basis points above their all-time low from last year.

But the low absolute level of cap rates continues to contrast with a strong spread—on a historical basis—between cap rates and base Treasury rates.

With the 10-year Treasury averaging 2.7 percent during the third quarter of 2013, the spread between average office cap rates and Treasuries was 4.3 percentage points. That spread fell as low as 1.7 percentage points in 2007 and rose to 5.6 percentage points in 2012. Since 2001, the spread between office cap rates and Treasury yields has averaged 4 percentage points.

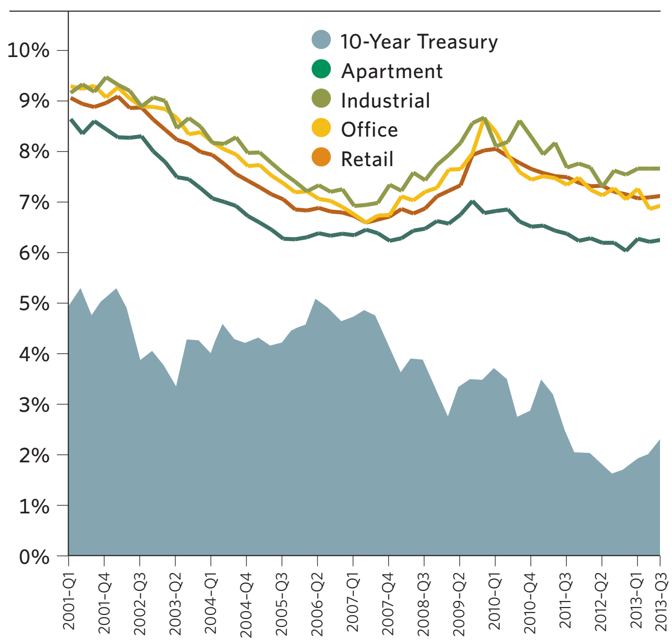
Lending

With commercial property incomes and values once again supporting borrowing, commercial real estate lending has been reawakened.

Through the first three quarters of 2013, commercial and multifamily mortgage originations were running 14 percent ahead of 2012's first three quarters, and every major investor group has shown a strong appetite to put money out the door (see Figure 4).

FIGURE 3

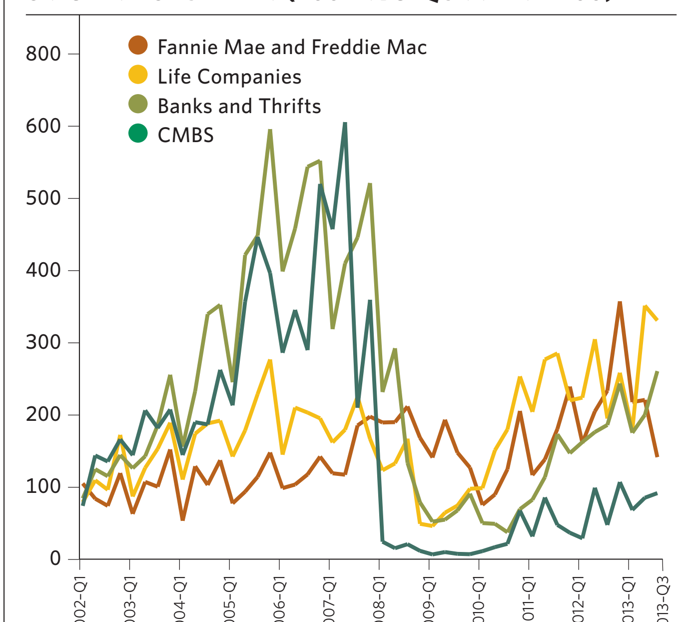
COMMERCIAL/MULTIFAMILY CAPITALIZATION RATES



SOURCES: RCA, Federal Reserve Board

FIGURE 4

COMMERCIAL/MULTIFAMILY MORTGAGE BANKERS ORIGINATIONS INDEX (2001 AVG. QUARTER = 100)



SOURCE: Mortgage Bankers Association (MBA)

Banks

In the first three quarters of 2013, originations for bank balance sheets ran 22 percent ahead of the first three quarters of 2012—putting banks close to their 2004 originations pace.

During the last three quarters, banks added (net) $18 billion of multifamily loans to their balance sheets (a 7 percent increase) and $16 billion of other mortgages backed by income-producing properties (a 3 percent increase).

The $51 billion in commercial and multifamily mortgages banks added to their books in the 12 months ending in September 2013 is the largest increase since the series began in 2007.

Across all these investor groups, the appetite for commercial and multifamily mortgages is strong.

Life insurance companies

Originations for life insurance companies in the first three quarters of 2013 ran 20 percent ahead of the first three quarters of 2012, with originations in the second and third quarters the highest on record.

Building on the $50 billion of originations in 2012, 2013 is likely to set a new record for life companies. And the new originations are more than matching any runoff from their existing loan portfolios. Between the third quarter of 2012 and the third quarter of 2013, life companies increased their holdings of commercial and multifamily mortgage loans by $13 billion.

CMBS

Originations of loans for commercial mortgage-backed securities (CMBS) were 44 percent higher during the first three quarters of 2013 than they had been in the same period of 2012. And after hitting $44 billion of new issuance in 2012, according to *Commercial Real Estate Direct,* the market is expected to exceed $80 billion in 2013.

The yields that investors demand to invest in CMBS have fluctuated with changes in the broader capital markets—with new issue super-senior AAA spreads starting the year averaging 67 basis points above swap rates, rising to 120 basis points in July and tightening back to 93 basis points by the end of November. In early 2007, the comparable spread was less than 25 basis points, but a growing, and increasingly competitive, cast of CMBS lenders and investors is bringing expectations that 2014 issuance could increase to anywhere from $90 billion to more than $100 billion.

Fannie Mae, Freddie Mac and FHA

In February 2013, the Federal Housing Finance Agency (FHFA), the conservator for Fannie Mae and Freddie Mac, released its 2013 strategic plan for the government-sponsored enterprises (GSEs). In it, FHFA set the goal for each entity to reduce its 2013 multifamily loan purchases to 90 percent of their record 2012 levels.

Through the first half of the year, multifamily originations for the GSEs were running 20 percent ahead of 2012's first-half volume. After pulling back significantly in the third quarter, third-quarter year-to-date GSE originations were down 3 percent from 2012's year-to-date totals, setting up a fourth quarter that could end up being the second-largest on record, but still down 20 percent from 2012's record fourth quarter.

The Federal Housing Administration's (FHA's) recent volume, four times what it did in 2005 on the multifamily front, has been buoyed by a heavy dose of refinance activity—particularly through its 223(f) and 223(a)(7) programs.

Through the first three quarters of calendar year 2013, multifamily originations for FHA were 27 percent higher than during the same period in 2012. Initial endorsements—a sign of coming volume—of $16.8 billion through the third quarter were 17 percent higher than year-to-date 2012 levels. Given the recent dependence on refinance activity, increases in interest rates are already having an impact on the FHA multifamily pipeline.

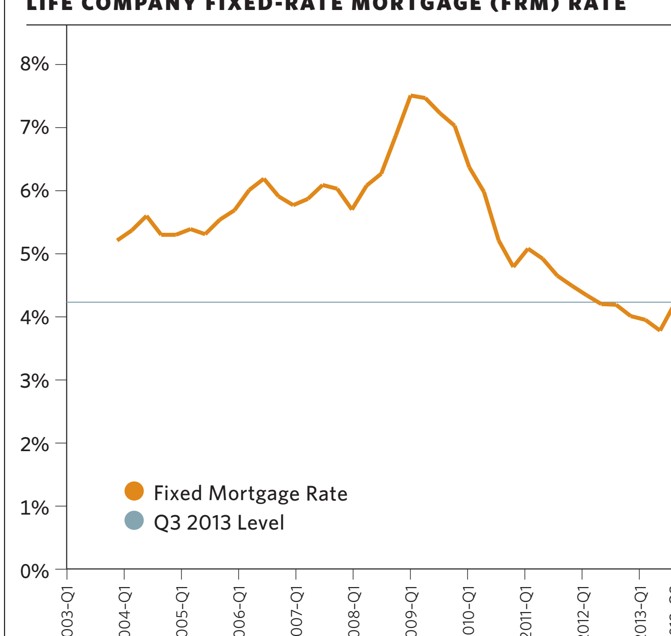
Competition

Across all these investor groups, the appetite for commercial and multifamily mortgages is strong.

Evidence of that strength can be seen in the mortgage

FIGURE 5

LIFE COMPANY FIXED-RATE MORTGAGE (FRM) RATE



SOURCE: American Council of Life Insurers (ACLI) rates being offered to borrowers. Equity investors in commercial real estate refused to follow interest rates to their extraordinarily low levels in recent years—increasing the spread between the base Treasury rates and property cap rates. Lenders, on the other hand, competed mortgage rates right down along with Treasuries, such that the average contract rate for fixed-rate mortgages (FRMs) for life company borrowers in the second quarter of 2013 was 3.8 percent—a record low (see Figure 5).

Despite the competition, however, top-line underwriting terms have held relatively steady. Underwritten loan-to-value (LTV) ratios have averaged 62.5 percent for CMBS loans in 2013 (through October), according to J.P. Morgan Securities, New York. That compares with average underwritten LTVs of 63.3 percent in 2012, 61.7 percent in 2011, 57.3 percent in 2010, 67.9 percent in 2008 and 69.5 percent in 2007.

Rating agencies have their own measure of LTV that takes into account not the actual market value of the property but a theoretical "stressed" property price based on a long-term average cap rate and other factors.

The Moody's stressed LTV averaged 99.8 percent through the first three quarters of 2013. The only three years during which it averaged more than 100 were 2006, 2007 and 2008. But the fact that the underwritten LTVs have remained relatively subdued while the stressed LTVs have risen is likely just as much a statement about how strong property values are as about aggressiveness in loan underwriting terms. It is also yet another reminder of how low cap rates have fallen.

The outlook

The commercial real estate finance market has been reborn as property markets have healed, as few alternative investments have provided as compelling a return, and as lenders have provided low-cost financing at competitive terms.

Where the market goes from here will depend on the footrace between cap rates and property incomes, and on a continued desire on the part of lenders to put money to work in the sector.

Footrace

There has been concern that as the economy improves and the Federal Reserve begins to taper its purchases of Treasury bonds and mortgage-backed securities (MBS), rising interest rates will drive cap rates higher and property values lower. Rising interest rates are likely to put upward pressure on cap rates, but at least some of the increase in base rates has already been absorbed by the large spread that has existed between cap rates and Treasury yields.

With that spread already declining, future interest-rate growth will increasingly be met by a parallel rise in cap rates. All else being equal, such an increase would lead to property value declines. Luckily, all else is not equal, and the same economic growth that will be pushing interest rates up should also be putting upward pressure on rents and property incomes.

The result will be that going forward, property price increases will have to be driven not only by property income growth, but by property income growth that exceeds any rise in cap rates.

The delinquency rates of mortgages held by life companies, Fannie Mae and Freddie Mac all remained remarkably low.

Lending appetite

Commercial and multifamily mortgages earned their due during the recent recession. The delinquency rates of mortgages held by life companies, Fannie Mae and Freddie Mac all remained remarkably low. At banks, charge-off rates for commercial and multifamily mortgages were lower than for any other major type of loan or lease.

This strong performance, coupled with the strong relative return mortgages have provided, have generated significant demand among investors. The growth in demand has lifted the originations market such that recent years have seen record originations levels for Fannie Mae, Freddie Mac, FHA and life insurance companies even as demand has been returning from banks and from the CMBS market.

Each of these investor groups will be seeing shifts in that demand in coming years, some from natural market changes and some from regulatory and legislative actions.

The overall market is likely to continue to grow, although perhaps not at the same rate we have been seeing. And continued market-share shifts between investor groups are likely.

Perhaps the biggest unknown is whether regulatory or legislative changes surrounding the Dodd-Frank Wall Street Reform and Consumer Protection Act, Basel III, FHFA oversight or some other action will cause one or more major lender groups to significantly shift their appetite.

Hump days

More than $200 billion in non-bank-held commercial and multifamily mortgages will be maturing in each of the years 2016 and 2017, up from $119 billion maturing in 2013. How those loans get absorbed by the market will depend on 1) how property incomes relate to their 2006–2007 levels, 2) how property values relate to their 2006–2007 levels, 3) how mortgage rates relate to their 2006–2007 levels and 4) how much capital each investor has to refinance the mortgages they have coming due.

It has taken half a decade, but with property incomes, property values and the appetites of lenders all experiencing revival, the current CREF renaissance is reinforcing the benefits of working in a relatively long-lived asset class. **MB**

Jamie Woodwell is vice president of commercial real estate research for the Mortgage Bankers Association (MBA) in Washington, D.C. He can be reached at jwoodwell@mba.org.