Financing in a Down Economy

Gabriel Silverstein, SIOR is president of Angelic Real Estate, a New York City-based investment banking and investment brokerage firm specializing in build-to-suit and other unique financing structures, as well as off-market brokerage transactions.

Elusive Equilibrium: Disparity Continues in the Real Estate Financing Markets

By Gabriel Silverstein, SIOR

In a 45-minute span one recent afternoon, we were awarded a new build-to-suit deal based on providing a creative full financing of the project, and we also added a new lender to our list of securitizing lenders. In that same 45 minutes, almost simultaneously, Credit Suisse announced the shuttering of its CMBS platform only a year after restarting it. Two steps forward, one step back. Such has been the way of the real estate financing world the past 12-18 months. The effects on different sectors in real estate, on investors and on tenants and brokers have been not only far-reaching, but quite varied.

It would be inaccurate to make a blanket statement that financing is difficult to obtain in the market today. However, it would certainly be less accurate to suggest that the financing market is anywhere yet near a healthy equilibrium. Examining different market segments yields a very different view of the same world. Here I will focus primarily on the office and industrial markets.

Build-to-Suit Financing

Much of what we do at Angelic Real Estate revolves around financing construction and long-term ownership of build-to-suit and other single tenant projects. Single tenant properties of all asset types have been one of the stronger performing investment real estate sectors in the U.S. the past three years. Increasingly, that has included larger industrial and office buildings costing $10 million to $100 million, whereas three years ago, the market's strength was limited mostly to smaller retail buildings such as Walgreens and CVS stores.

In 2009, there was literally one competitively priced financing partner for build-to-suit projects (USAA), and they pretty much funded every new industrial build-to-suit in the US for an 18-month period. That finally began to change in mid 2010. For most investment grade and non-credit tenants there are multiple options for almost any product type/variation and any market. It wasn't until mid 2011 that the lease terms weren't a minimum of 15 years or longer, but the less robust a local market, the more unique the product, and the weaker the tenant credit, the more likely 12 or 15 years or more may still be required or may at least be able to garner significantly better pricing and terms for both debt pricing and take-out values.

One strategy we have employed extensively the past 18 months on build-to-suits is wrapping full funding into a project in a way that eliminates the construction loan and developer carry during construction, with the permanent ownership acting not just as a take-out partner, but paying for the costs of building the building along the way. This has been a necessary and effective alternative financing strategy absent traditional construction and construction-to-perm lending, though that is changing.

For construction lending we are able to get to as high as 85 percent loan-to-cost lending from traditional construction lenders for projects with good, long-term credit tenancy.

Multi-Tenant Buildings

The average office or industrial tenant is generally in a multi-tenant building. While Manhattan and Washington, D.C. class A office buildings have gotten a significant amount of press the past year, and Houston and Chicago both set all time price per square foot sales records on trophy office buildings in 2011, the falloff in financing liquidity from trophy buildings in core markets to the rest of the world is a dramatic one.

The competition among the CMBS lenders who have remained active, and more recently among the larger life insurance companies and pension funds, has been dizzying for trophy office properties in top-tier or high second tier cities. These lenders, however, have been participants at much lower leverage points than five years ago by limiting the buyer activity on the largest buildings to institutional buyers for the most part. Many of the buyers of the 2005-2007 era, in contrast, were private buyers who used financing of up to 85 percent LTV, which allowed them to pay more for buildings with less money at risk, driving prices higher, cap rates lower, and keeping the market exceptionally "liquid."

For value-add properties, generally the market for larger loans ($10 million and larger) has seen institutional private lenders willing to provide non-recourse "bridge" lending options with single digit interest rates. Outside of their sweet spot, however, there are mostly more opportunistic bridge lenders charging 10 percent to 12 percent or more, plus sometimes two or more points to the lender. For less risky properties that cost of debt is too expensive to allow for a well-functioning market, which puts landlords at a disadvantage, and tenants at risk. Mezzanine lending too has also been at lower leverage points than market equilibrium would normally see, and has limited itself to larger, class A properties in select core markets. Class B properties in second and third tier cities are only just starting to see the financing markets reopen.

Speculative Development

Many markets, particularly in the Midwest, can't fathom spec development today. However, there are several exceptions to this for big box industrial product, including the Inland Empire in Southern California, Salt Lake City, Miami and the 1-81 corridor of the eastern Pennsylvania market. Absent reasonable traditional financing, some of this speculative development, including Liberty Properties' and Exeter Properties' Pennsylvania projects respectively, are being built entirely with cash equity on hand, using no outside financing.

Skanska is in an even more elite league right now, building one of the very few large speculative office buildings anywhere in the country–a 300,000 square foot building in Houston's Galleria submarket. This project, too, is being constructed without lender involvement.

"Good News" Moneys & Other Niche Funding

For tenants and tenant reps, this often unmentioned funding can be the most critical piece of a landlord's being able to execute a lease negotiation. Making sure the landlord can pay the tenant improvement moneys–and the leasing commissions–is something tenant reps used to take for granted, but this practice is no longer applied. Today there are many tenant reps with painful war stories of landlords that couldn't fund the leases they signed. In one such instance, it took the downfall of Anglo-Irish Bank to force the sale of a loan on the class A 225 West Washington in downtown Chicago for a new lender to enter the picture with a willingness to fund a $7 million TI and commission package for a large lease with Allianz–a lease that had been held in escrow, not knowing if the landlord would be able to fund those and keep the tenant.

Recognizing this as one of the last (and historically weakest and mispriced) sectors of the market, Angelic has just opened a new $500 million fund in a joint venture. The fund will provide non-recourse financing on 100% of the costs of tenant improvements, commissions, and other transaction-related costs for high quality tenancy. The City of New York and Kraft are two tenants who have recently completed projects with this unique funding option. I expect to see other creative niche financing products born from the adversity of this current market as "normalcy" continues to remain elusive.

Recourse vs. Non-Recourse

Anyone whose real estate career spanned from 2003-2008 may not know the definition of the word "recourse." At Angelic we very rarely structure and place recourse loans, with the exception of construction loans, which will almost always be recourse to the developer during the construction period. There are still non-recourse lenders for almost any property today, but we have found that often there are only one or two lender options available for a given deal, making it difficult to set up a very competitive lending process. To avoid recourse on higher LTV loans, we structured some loans with lender participation in the future equity upside; in essence giving up some potential future investor profits to the lender in order to avoid having the borrower take recourse risk on the loan. In other cases we have had traditionally non-recourse borrowers acquiesce and seriously consider recourse or partial recourse loans as alternatives, though we have successfully avoided having to go that route on any project thus far.

For smaller properties and for user-owned projects, considering recourse loans will open up more opportunities with community and state banks, which are generally more healthy and ready to lend than their larger regional and national counterparts. A well functioning CMBS market is something we sorely miss for smaller loans in secondary locations, as CMBS lending was one non-recourse lending source that charged very little premium for being in a secondary location or class B product before the recession. For tenants, brokers and investors in smaller metro areas, this is still having a very negative impact on market dynamics. The re-stabilizing of small loan CMBS programs will be one of the key areas to help restore equilibrium between borrowers and lenders, and in turn between tenants and landlords in those markets.

Overall, we can see that at the beginning of 2012, the financing markets are almost universally improving over the recent past, but not at the pace that most market participants would like to see. There are significant low cost financing options available to most buyers of multi-family, good credit single tenant and trophy multi-tenant office buildings. Construction loans with pre-leasing to credit tenants are available in most situations. However, construction loans for spec development are almost non-existent and second and third tier markets are still ignored by many larger lenders. A better functioning financing market will help improve overall market transaction volumes and will help building owners provide tenants the funds they require from their landlords to fund building and tenant improvements and to pay brokerage commissions.