November 2018

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Loan Originations Wane Despite Demand for Apartments, Office

Concerns about rising interest rates and weakening economic growth have led to a slowdown in commercial mortgage originations, particularly in out-of-favor asset types, despite the wide availability of debt capital.

The Mortgage Bankers Association reported that commercial mortgage originations in 3Q18 fell 7 percent from the same quarter a year ago. The biggest drop came from CMBS, which fell 53 percent year-over-year, and commercial banks, which originated 22 percent less than a year ago, according to the MBA's survey. Life companies and the GSE multifamily lenders posted slight increases in lending.

The decline in lending is more a reflection of demand than supply. No major source of debt capital is pulling back, and the number of debt opportunity funds is on the rise. However, property sales have dipped about 10 percent nationally, while rising interest rates are discouraging some borrowers from refinancing.

Since bottoming at just over 2.0 percent in September 2017, the 10-year Treasury has increased steadily and has been over 3.0 percent since mid-September. That has increased loan coupons, although loan spreads have generally come down 40 to 50 basis points over the past year, so the cost of borrowing has not risen as much as interest rates. Tightening loan spreads reflect the healthy appetite among lenders to book loans.

Another headwind to originations is the decline in property sales as buyers start to pull back. Sellers are getting fewer bids and—while acquisition yields aren't yet climbing appreciably—buyers are seeking to price in the fact that rent growth is likely to moderate as the economy slows in coming years.

One way that borrowers are exercising caution is in the increasing demand for floating-rate loans relative to fixed rate. Floating-rate loans provide borrowers with more flexibility to sell or refinance. Some borrowers are paying for interest rate caps that provide certainty for debt-service payments while giving them the flexibility they desire.

The growth of floating-rate deals has been a boon to debt funds at the expense of commercial banks and CMBS. Debt funds are taking market

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share from commercial banks for construction and redevelopment loans. CMBS, meanwhile, is seeing less demand for medium-sized fixed-rate conduit loans. An increasing share of CMBS issuance this year has come from large single-borrower loans.

Lenders are acting much differently at this stage of the cycle than they were in the last cycle, when loan terms became ever-more aggressive until the market collapsed. Today lenders are competing hard on pricing, offering more interest-only periods and easing some covenants, but are keeping leverage at 60-70 percent and requiring borrowers to have significant equity stakes. Whether that will be enough to prevent a wave of defaults when the next downturn occurs is not clear, but debt sources will have less capital at risk this time around.

Lenders are also discriminating among property types to make their portfolios as recession-proof as possible. Demand for industrial and multifamily—property types that are expected to retain strong demand in upcoming years no matter how the economy performs—is insatiable while there are fewer lenders that want to add holdings in asset classes that have a less certain fundamentals outlook. MBA reports that loan volume in the third quarter declined 55 percent year-over-year for health care properties, while retail (28 percent), hotel (19 percent) and office (17 percent) also fell. Meanwhile, the volume of loans backed by multifamily and industrial properties each rose by 19 percent.

—**Paul Fiorilla,** *Director of Research*

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