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The Never-Ending Search for Yield

By Erika Morphy
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*W*hen it is all said and done, 2012 will likely be recorded in industry annals as the year deals finally closed—unlike in 2010 and '11, when buyers and sellers would find one reason or another to hit the brakes on transactions. “We are in a unique period right now when both parties are inspired to get deals done,” says Kevin White, director of business development for Virtus Real Estate Capital. And financing? That is a nobrainer, he says, and indeed the Austin, TX-based real estate private equity sponsor is moving forward with its own transactions with an eye to locking in as much debt as possible. “That way, if we hit the wrong end of the cycle, we have enough term left on the loan to ride it through,” he says.

Fortunately for White, the securitization markets are happy to oblige. Earlier this year the company acquired a 264-unit, 1,056-bed student housing community near East Carolina University in Greenville, NC. It secured 10-year debt from Freddie Mac with a two-year IO term at a 4.16% interest rate.

“The attractive part about this deal is that in the future it can be resized during that ten-year period,” White says. “One of the issues with locking in long-term debt is that a lot of the time prepayment penalties make it very rigid and there is no flexibility on the exit.” In that scenario, it becomes too expensive to defease the loan.

With Freddie Mac's willingness to resize the transaction, however, the new buyer can assume the existing loan, placing more debt on it if necessary at whatever the current interest rate is. “The blended cost of debt would probably be much less for the borrower, depending on where interest rates are going,” White concludes.

Freddie Mac, for its part, is more than happy to shoulder the risk; it has any number of securitization vehicles, many recently introduced to the market, on which to slough it off.

There are no worries about demand for these securities, at least if recent history is any indication—most of the GSEs multifamily securitization transactions have been, in fact, oversubscribed by investors on the prowl for yield.

Demand for yield—any yield over what the Treasury rate is offering, which is a very low bar —has been pushing investors and lenders into various segments of the commercial real estate capital markets for the last few years. Hence the $41.09 billion REITs have raised in 2012 year to date through the end of September—$7.54 billion more than the $33.56 billion raised in the prior-year period, according to SNL Financial. Hence, the interest in REIT IPOs, especially among companies interested in tapping the recovering single-family home market. Hence, the steady uptick in CMBS originations—with September proving to be a particularly robust month. And hence Virtus' raison d'etre. “We invest through blind pool discretionary funds,” White says. “Our job is to find those opportunities in which to invest our investors' money.”

The GSEs—Fannie Mae and Freddie Mac—are arguably the poster children of this drive for yield. In recent months, the two agencies have been tweaking their typical multifamily securitization models in response to burgeoning demand.

“What they have been doing is not policydriven,” says Willy Walker, CEO of Bethesda, MD-based Walker & Dunlop. “That is, this hasn't been a directive from the Federal Housing Administration.” Fannie Mae, for example, has brought to market recently multifamily REMICs that included shortterm collateral in a separate tranche—sevenyear and, more unusually, five-year paper.

Freddie Mac, as another example, brought to market a $450-million K-P certificate— a new variation of its K-Certificate— comprised of seasoned loans the GSE had on its portfolio and that it fully wrapped. And both GSEs have brought to market structured offerings backed exclusively by floating rate loans in recent months.

“The appetite for Fannie Mae and Freddie Mac MBS, whether they are single or multifamily, has been voracious,” Walker says.

The timing has been perfect for the GSEs' experiments. “Borrowers are looking for floating rate deals and shorter maturities so they can finance out if rates start to move. So that is the product that is being originated for them.” Meanwhile, investors are starved for yield, he adds, “so this is a good time to shovel off anything.”

To be fair, it is not just the perpetual lowinterest rate environment and subsequent search for yield that is fueling demand for these securities. The Federal Reserve Bank's latest round of quantitative easing is doing its share too—this time it is specifically targeting GSE paper, albeit single-family MBS. That still gives a boost to multifamily securities because with the Fed snapping up single-family MBS, investors have nowhere else to go but to the multifamily products.

There are other signs of a broadening of the commercial real estate capital markets. Steven T. Kolyer, a partner with Clifford Chance, points to the reemergence of CRE CDO after an absence of several years, as an example. “We will see several more in the next few years,” Kolyer predicts.

These vehicles offer an important new finance option to the market, especially REITs, he continues. “The beauty of the CRE CDO is that it is actively managed. CRE CDOs can leverage their assets, and keep them consolidated on the balance sheet.”

The more traditional providers of finance are also active in the market, observers say. “If anything, liquidity in the market has skyrocketed,” says Ayush Kapahi, cofounder of HKS Capital Partners LLC in New York City. He cites a number of retail centers the firm has financed in a market in Texas via local banks. “This is not a primary market but the numbers worked and the bank was interested in doing it.”

Not that bank lending has returned to the pre-crash levels. (Indeed that statement can be applied to just about any form of finance.) Bank lending remains constricted for real estate in many cases and changing requirements will likely keep it so for the foreseeable future. Indeed, one of the requirements of Dodd-Frank is yearly stress testing for financial institutions, an activity largely believed to lead to scaled back lending for many asset classes including commercial real estate.

Still, some observers remain hopeful about the market's course. The CMBS market, as it continues to re-emerge, will fill in some of these gaps, Kapahi says. “In some cases, it is the only alternative for certain deals, especially large loans.”

Like bank financing, CMBS, it hardly needs to be said, is nowhere near the origination levels of the pre-crash days. However, it has been on a steady track of improvement since it shut down in 2009. There was about $30 billion of CMBS originations in 2011; 2012 is widely expected to surpass that. Economists surveyed by the Urban Land Institute expect that in 2014 there will be $60 billion in originations.

There are some changes in the CMBS market, of course, beyond the issue of volumes. Walker notes that almost a third of CMBS volume this year has been with single issuers. “Now that, I find interesting. The old way of using CMBS was to get a diversified pool of assets and geographies and borrowers and combine them for diversification. That model is completely gone. Now, CMBS is focused on the borrower instead of the asset class or geography. That is not a minor change; in the end the market's saying we don't like buying diversification, we want to underwrite the borrower and asset instead.”

Still, the reemergence of the CMBS market is spurring other forms of finance, including bridge lending. Jordan Ray, managing director of debt and equity at Mission Capital Advisors in New York City—which represents borrowers in the capital markets— has found it easier to arrange lending from interim debt funds this year. They, too, are eager for yield, but up until this year were hesitant to be aggressive in terms and conditions because the CMBS market was not a sure exit. That, though, is changing.

“Interim debt funds are more comfortable in providing leverage because they now feel comfortable with a CMBS exit,” Ray says. Ray caught up with Real Estate Forum as he was working on a transaction that became routine for the firm this year: in this particular case, a transitional hotel asset at Chicago's O'Hare airport “that opened at the wrong time” and that is closing on 7% financing from a debt fund that is planning to offload the loan into a CMBS.

In fact, Ray continues, there have been several instances in which the Mission Capital thought it would wind up with CMBS financing only to find itself financing via a debt fund instead because the end result was better for the borrower.

CMBS is also becoming a bit more flexible— or depending on one's perspective— risky. “A year ago, structures were a function of straight-line thinking—five-year, sevenyear vanilla transactions, says David Eyzenberg, principal in Avison Young's New York City office. “Now we're getting structures that incorporate cash leaks or early notification rights.”

He tells of one multi-property portfolio that had one main tenant—and all the leases coming due at same time. Underwriting the portfolio so when the loan comes due the lender feels comfortable took some creativity, he says, and the resulting structure might not have been viable a year ago. Briefly, the 10-year deal included a clause in which the lender does a cash sweep by year eight if the tenant doesn't renew.

Eyzenberg is betting that conduits will have a great fourth quarter for various reasons beyond such newfound flexibility starting. There is the life insurance lending cycle, for example. “The way insurance companies lend, they blow through their allocations early in the year and get more picky as the year wears on.”

Memories of 2008 and 2009, though, have not faded and there is a sizeable contingency of lenders and brokers that feel that current trends are paving the way for another crash.

Consider the REIT space. Although capital raising is occurring at a robust space, there are ongoing concerns that REIT valuations are too high—as their recent stock market performance in August and September would suggest.

If REITs are overvalued, it is because of the market's insatiable demand for yield and appropriate risk adjusted returns, says Al Rabil, managing partner and CEO of Kayne Anderson Real Estate Advisors in New York City. “In general, I'd argue that the market is way overbought on the fundamentals but no one is selling because every central banker in the world is promising to print money.”

The flood of money into the system, he argues, is disguising the true fundamentals of many projects. “We're building the foundation for the next bubble,” he says. “In the best-case scenario, it phases in instead of turning into another 2008. But for that to happen, the Feds have to start taking liquidity off the table.”

Ditto for the CMBS market, many say. Some of the recent deals put together are stretching the envelope, says Richard Podos, CEO of Lance Capital LLC. Worse, “we still think a high

proportion of the 2003 to 2007 outstanding loans are basically technically in default or will be technically in default. That said, we don't think that the master servicers are going to pull the trigger when there is technical default. Everyone just keeps kicking the can down the road." In the end, he says, there will be a shortfall of liquidity north of $300 billion that the CMBS market won't be able to refinance.

Virtus' White appears to have similar concerns, albeit not quite as pessimistic. The bid-ask spread between buyers and sellers is starting to come together, he says, and there is both availability of debt as well as equity chasing those assets. "We are seeing meaningful cap rate compression in all property types. But the question is, how much of that is fueled by the underlying economics of the property market and how much by the debt markets?"

There is a lot of capital chasing yield and a limited number of good projects out there, he observes. A lot of that plays into the cap rate compression, which is why sellers think this is a good market for them. All of which is fine, he says—so long as the fundamentals of a property pencil in as well. "With cap rates getting pushed down further and further there is less room for any kind of hiccup that happens at the property level," White says. "Anything from a macro event or a submarket event could cause margins to erode overnight."

The CRE capital market, though, is resourceful and in some quarters can be said to be laying the financial groundwork for a pull back in lending.

Lance Capital has developed a product that finances a gap that Podos says will be a growing problem in the coming years: lease renewals in which the tenants demand a larger TI than the owner can afford.

"Concession packages are going through the roof—tenant reps smell blood in the water and think they can get excellent deals for their clients." In many markets, indeed, they certainly can.

Lance Capital is providing TI loans to landlords that are non recourse and unsecured. In return, Lance Capital gets a strip of the tenant's rent assigned to it. "We have an inter-creditor agreement with the senior lender that says that strip is ours and they can't touch it." The senior lender agrees with little protest because it doesn't want to lend the money, he says. The landlord is happy because if the tenant is investment grade, Lance Capital can lend at rates as low as 4.25%.

Lance Capital has done about $800 million worth of such deals and Podos expects to see more as the lending environment worsens—which he is certain it will. "Maybe things look hopeful now, but I believe there will be a lot more stress between lenders and borrowers in the coming year."

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