MARKET COMMENTARY

July 18th, 2022

These are unprecedented times, displaying financial metrics and Federal Reserve actions that have not been seen before. Thus, we will begin this commentary with the top three things we don't know. This list must preface the comments that follow:

- We don't know what interest rates will be tomorrow next month, next quarter, or next year
- We don't know what credit appetite will be tomorrow, next week, next month, or next year
- We don't know what inflation will be, the Federal Reserve's response to inflation, and/or if we see any policy responses outside of the Federal Reserve

With that being said, here are our observations and opinions about the current state of the Commercial Real Estate Lending Market.

Interest rates rapidly increased in March and April of 2022, starting with long term rates and eventually short-term rates followed. Since then, rates have slightly pulled back but are still at a 24-month high. This change has caused several changes for lenders on commercial real estate loans.

1) Lenders funded with deposits are originating the majority of new transactions. These are **banks** and **credit unions**. As interest rates rise, these institutions have the cost advantage. Transaction deposits do not pay interest and deposit account rates increase slower than other short-term rates. Furthermore, some banks and credit unions will lock in interest rates at application or upon term sheet acceptance, mitigating the borrower's risk of their interest rate increasing. However, the banks and credit union are not without their challenges:
    a. Bonds held on the books of these institutions had to be marked down. When interest rates rise, bond prices fall. This directly affects the bank's capital and their total capacity to lend.
    b. Many banks do construction loans to borrowers. At completion, these projects were often sold or refinanced off the bank's balance sheet. In Q2, the second part of this activity slowed. This along with the combination of doing most of the new originations in the quarter, banks and credit unions are filling up on commercial real estate loans.
    c. Q2 earnings for the banks will tell us more information. Just how rapidly did commercial real estate loans grow? Are loan loss reserves increasing, further reducing available capital to lend?

d. Some banks and credit unions are showing signs of credit tightening and more capacity as their commercial loan pipelines decrease, allowing more time to underwrite, analyze, and process deals.

2) **Alternative Permanent Lenders**: Agency Lenders, Commercial Mortgage Backed Securities Lenders, and Life Insurance companies have dominated the commercial real estate space over the past two years. Low rates, artificially driven by the Federal Reserve purchasing these assets, drove CRE/IRE investors toward loan products that resembled bonds and these lenders provided those loan products.

Today investment grade bonds can be purchased on the open market paying rates higher than commercial real estate borrowers will pay. The screen shot below are the bonds currently being sold out of Fidelity's book.

Understanding This Table	3mo	6mo	9mo	1yr	2yr	3yr	5yr	10yr
CDs (New Issues)	2.00%	2.35%	2.55%	2.90%	3.25%	3.30%	3.55%	4.00%
BONDS								
U.S. Treasury	2.42%	2.81%	3.06%	3.17%	3.16%	3.16%	3.06%	2.93%
U.S. Treasury Zeros	--	--	--	2.95%	3.05%	3.09%	3.03%	3.04%
Agency/GSE	2.40%	2.74%	3.14%	3.25%	3.32%	3.56%	3.70%	4.71%
Corporate (Aaa/AAA)	0.76%	2.64%	2.31%	2.44%	3.33%	3.39%	3.18%	--
Corporate (Aa/AA)	2.01%	2.55%	2.95%	3.32%	3.29%	3.85%	4.09%	4.21%
Corporate (A/A)	2.32%	3.27%	3.15%	3.69%	4.20%	4.52%	4.65%	5.43%
Corporate (Baa/BBB)	2.82%	4.11%	4.34%	4.73%	5.10%	5.81%	6.60%	6.34%

It's difficult for a Life Insurance company to be competitive on a commercial real estate loan when they expect to make more interest on an investment grade bond, which is currently paying 6.6% for a five-year term. The company's Treasurer or Chief Financial Officer would rather buy the bond on the open market than originate the real estate loan.

As bond rates remain attractive, Fannie Mae and Freddie Mac may start making rate exceptions and/or repricing products, given borrowers have moved to banks and credit unions for their lending sources. This move by investors have reduced the agency lenders loan pipelines significantly and slowed originations.

3) **Bridge Lenders**: Each lender's funding is unique, but in general these lenders use a combination of equity from investors and short-term line of credit borrowings. The Federal Reserve is rapidly raising short-term interest rates, which directly increase bridge lenders cost of borrowing. Bridge lenders are dealing with heightened risk in their portfolio, transactions could be held on

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their books longer due to the changes to permanent lenders. These two issues both reduce the capacity for new bridge loans and cause the pricing on new transactions to increase.

Based on conversation with bridge lenders, they are remaining busy originating bridge loans for CRE investors that:

a. Are purchasing assets that are being repositioned
b. Entered in a purchase agreement prior to rates increasing substantially, making the asset no longer cash flow and meet the 1.25 DSCR by permanent lenders
c. Are or were in the middle of a construction project – many traditional lenders have backed off on construction loans given inflation and the amount of existing construction loan on their books

What does all this mean if you're a borrower?

Quality matters. How easy is the borrower work with? Are company financial statements up to date and easy to understand? Does the borrower provide accountant prepare financial statements (compiled or reviewed) to go along with tax returns? Are tax returns filed on time or are they extended? Is the borrower's schedule of real estate owned complete and easy to understand? What specific experience does the borrower have with this property type? What is the credit and wherewithal of the borrower?

Exceptions must be limited for the lender: How many issues are there with the deal? What is "outside the box"? A few months ago, lenders may have accepted four or five smaller issues with a loan, now they may only accept one or two. Additionally, when there's more loan demand than capacity to fulfill, underwriters, credit officers, and credit committees migrate to the best transactions.

When lenders say the word relationship, they mean one of two things: **Deposits and Track Record**.

- **Deposits:** If an institution is loaning a borrower money, that borrower should place deposits with the bank in return. This differentiates a loan request from any type of debt that can be bought on the open market.
- **Track Record:** How many similar transactions have you completed, either with that lender or with similar lenders that have been successful? If you're reborrowing from the same lender, they know your track record. If you're borrowing from a new lender, then building a clear and presentable track record detailing prior projects is critical to your transaction.

Be prepared to let multiple lenders see your transaction: What was an acceptable risk to your current lender may no longer be acceptable.

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