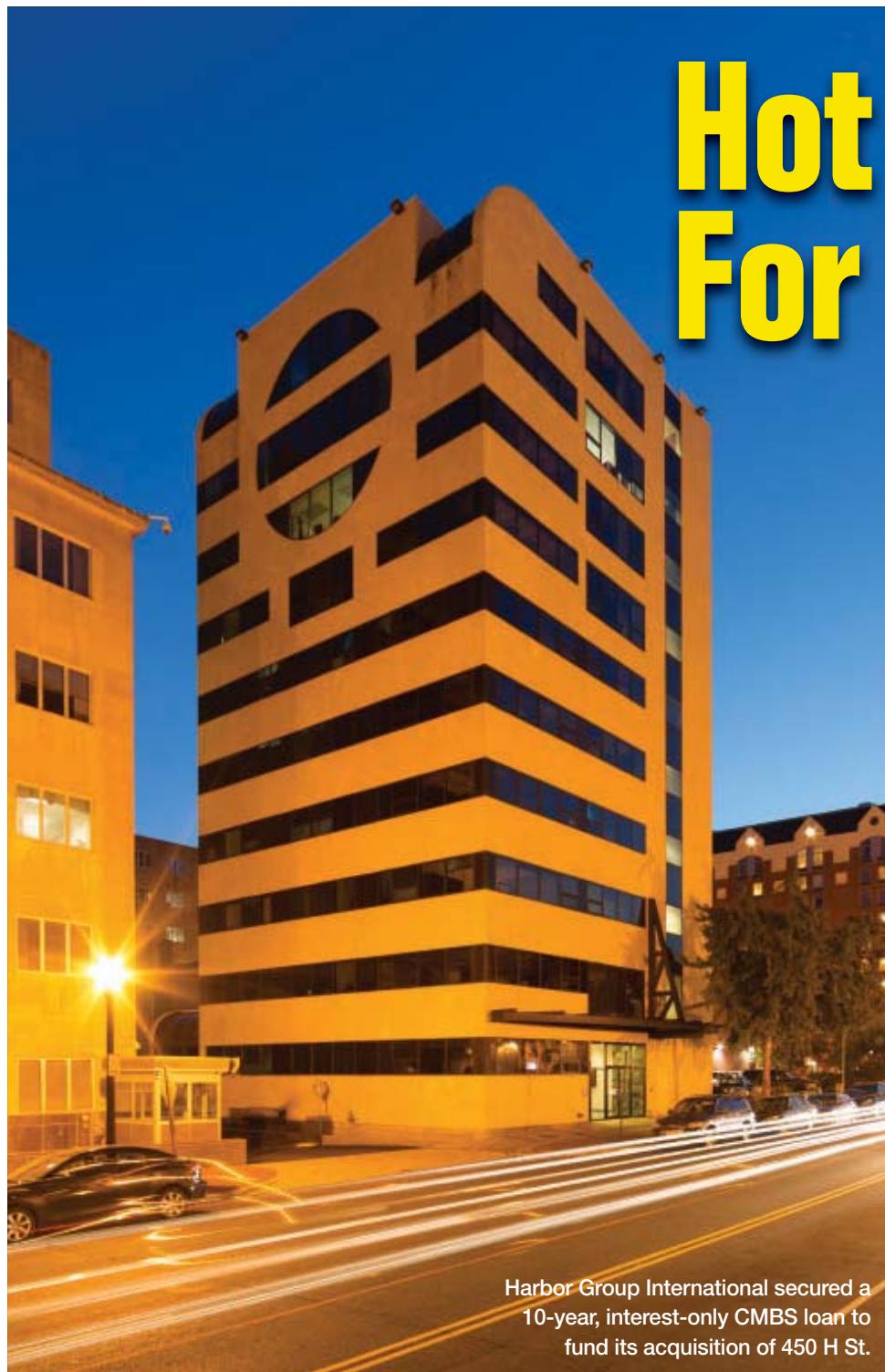


THE COMMERCIAL REAL ESTATE CAPITAL MARKETS ARE CERTAINLY BOOMING, BUT ARE THEY ROBUST ENOUGH TO HANDLING THE SCHEDULE OF UPCOMING DEBT MATURITIES OVER THE NEXT FEW YEARS?



Harbor Group International secured a 10-year, interest-only CMBS loan to fund its acquisition of 450 H St.

## Hot For Enough You?

**S**teven McCraney, CEO of McCraney Property Co. in West Palm Beach, FL, is feeling supremely confident as negotiations for financing the company's latest industrial development in Orlando enter into their final weeks. For starters, the firm recently signed a 200,000-square-foot prelease for one of the facilities it will develop. It also has a solid, longstanding relationship with its usual equity provider, Clarion Partners, with whom it has completed a number of satisfying deals.

And then there is this: good deals are so scarce that financiers are oftentimes willing to incorporate construction lending in a package. That

**By Erika Morphy**

is what Clarion did for McCraney for its 250,000-square-foot project in John Young Business Park in southwest Orlando, he says. "They partnered with us and not only provided the equity but also became our lender for the construction loan."

Today's market is so robust, McCraney says, that even without the company's good friend Clarion Partners, and even without that 200,000-square-foot prelease, he would have found construction financing one way or another, at least for Phase 1. (The project calls for two buildings: a 500,000-foot cross-dock facility and a 200,000-foot front-loaded facility).

"The plan right now is to do the transaction with Clarion Partners out of Dallas," he says. "But I know if we took it to the market—and brokers have come to us about this—there

would easily be half a dozen suitors asking to do the transaction."

This is not to say that all deals in all markets by all sponsors will be automatically and generously underwritten. Lenders are not as short on memory as some might suggest; the lessons of 2008 still burn fresh and if institutions are inclined to put them in the past, regulators certainly are not.

But a chief question on many borrowers' minds these days is not what can or cannot get done right now. Rather, it is what will be able to get done in the next few years when the looming schedule of debt maturities comes due in 2016, 2017 and 2018.

The real estate industry has faced down this question before, notes John R. Mallin, a Hartford, CT-based commercial real estate partner at McCarter & English who represents developers on a variety of real estate finance issues. "We see this scenario on occasion, as earlier transactional and refinance activity, and the terms of the CMBS debt that drove it, create significant debt maturing around the same time," he says.

The simple fact is there's never an easy answer to this question of how borrower-friendly the refinance landscape will be in X number of years, he continues. "It's a number line—not an absolute—with some factors working in favor of borrowers and some against them. But the bottom line is that lenders have two choices: refinance or take back the collateral. Given the way the markets are working, there's no real appetite among lenders, and hasn't been for some time, to take back properties." It's a strong argument in favor of most borrowers being able to refinance their maturing CMBS debt.

Mallin ticks off a few reasons for his thinking: the cost of money is near zero and liquidity is relatively high. As McCraney notes, there's still a lot of money on the sidelines with fewer deals for prospective lenders to deploy the money to generate returns. There are also new and returning lenders entering the market on a regular basis. (To give one example, in April multifamily lender Berkeley Point Capital LLC announced it was providing financing options for all commercial property types, including office, retail, hospitality, industrial, mixed-use, self-storage and non-agency multifamily properties. It also said it would offer a broader set of financing solutions through CMBS and bridge loans, in addition to Fannie Mae, Freddie Mac, and FHA financing.)

Mallin has his sympathies, though, for borrowers nervous about their future prospects. "The biggest factor arguing for some difficulty in refinancing is the great unknown. The Fed can't and won't keep interest rates this low forever, so we have to wonder whether rates will creep up or skyrocket when they start to move, and when that will be."

In addition, he says there are some sectors that don't look all that healthy, and it wouldn't be shocking to see industry realignments, which could hurt confidence among lenders, both in their overall willingness to lend and in how they underwrite loans. This economy isn't in a recession, but it's not growing quickly either, Mallin points out—and likewise for most property valuations.

"A number of factors—economic, banking-industry specific and other—have caused lenders to forbear on non-performing or borderline debt, rather than take the collateral." At some point, the mood among lenders could change, he says, and lenders may decide that the risk outweighs the reward. Then "they will either tighten the spigot, underwrite even more stringently or start

being more aggressive about taking back properties."

Mallin's parting words of cold comfort are this: who wins and who loses, if there are losers, in the refinancing wave of the next three years will likely come down to timing. "In the refi market, sometimes if you miss by a month, you might as well have missed by a mile."

## TRANSPOSING TODAY'S MARKETS ON TOMORROW

That said, there are enough signs in the current debt and equity markets to give an inkling as to how things will play out. Consider the thinking of Josh Zegen, co-founder and managing member of New York City-based Madison Realty Capital, an institutionally backed real estate private equity firm and asset manager.

He recently announced the sale of a four-building multifamily property, located on West 111th Street in Northern Manhattan, for \$24.25 million to Acuity Capital Partners. The building and its recent history was a classic, textbook private-equity play.

Madison initially purchased distressed loans on the four adjacent buildings, located at 136, 140, 144 and 148 W. 111th St., respectively, for \$11.75 million in May 2011. After navigating through the bankruptcy and foreclosure process, it acquired the property title at auction in July 2011. It then renovated and repositioned the assets.

None of this, except for the eventual sale of the building, would happen today, Zegen says—and he has his doubts it could happen in future cycles, at least not any time soon.

"The difference is, at that time, the borrower had no equity. Today borrowers do have a seat at the table because they have equity," Zegen says this forces—or at least nudges—lenders into agreeing to recapitalize a deal with, for example, a bridge loan.

Indeed, bridge lenders see opportunities for their particular flavor of financing in both the current and future markets. "The capital markets are doing a lot better today and there is more liquidity available than there was two years ago," says Chuck Taylor, principal and EVP with A10 Capital LLC, a Boise, ID-based firm specializing in non-recourse financing for value-add properties. "That said, we still find there are places where there are fewer lending options available, and that is our sweet spot. Maybe there's a vacancy issue or another story."

For example, the firm recently provided a \$5.2-million non-recourse bridge loan to fund the acquisition of a suburban office building in the Virginia Beach-Norfolk, VA metro area. The property was only 35% occupied at the time of the transaction, Taylor says. "There are a lot of traditional financial vehicles that can't or won't finance that deal today and definitely won't be in a position to finance when the re-fi wave comes."

## THE OLD STANDBY OF CMBS

When Harbor Group International purchased a building in Washington, DC earlier this year—a 31,340-square-foot office fully occupied by the District of Columbia's Department of Youth Rehabilitation Services—the company turned to the CMBS market for financing and secured a 10-year, interest-only loan.

The company was, of course, happy to have the option. After the housing crash, the conduit market retreated to lick its wounds for several frightening months.

However, HGI's thinking about CMBS and what it can and cannot do point to the limitations of this option, even though it's the backbone of commercial real estate finance. "We're not exclu-



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**JOHN R. MALLIN**  
McCarter & English



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*Bloomberg Markets, 2013*

<b>\$120,000,000</b> CMBS Multifamily 116 John New York, NY	<b>\$45,000,000</b> CMBS Hotel Residence Inn Philadelphia, PA	<b>\$9,300,000</b> CMBS Multifamily Hampton Apartments Anderson, SC
<b>\$40,400,000</b> CMBS Retail Westland Portfolio Los Angeles Area	<b>\$27,000,000</b> CMBS Office 940 Ridgebrook Sparks, MD	<b>\$130,000,000</b> Interim Retail Potomac Town Center Woodbridge, VA
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sively a CMBS borrower because it can be a fairly structured process," says T. Richard Litton, Jr., president of HGI.

CMBS is not the ideal financing source if the borrower expects it will want to prepay a loan—that is, it doesn't work for buildings that will have a quick turnaround. "We use CMBS in situations where the holding period will match up closely to the term of the debt and where there can be an attractive cash flow at a fixed rate," Litton says.

Also, CMBS has become more conservative in its underwriting in this cycle. It is possible, even likely, that some properties may still not meet CMBS' criteria for a refinance even if they have gained in value.

"Underwriting standards in this cycle are stricter with more focus on the sponsor and more focus on actual in-place cash flow," Litton says. "There is no credit for pro forma rent increases, for example, although in some markets like New York City, lenders are giving credit for contractual in place lease bumps."

Still, Litton is of the mind that borrowers seeking refinance in 2015 onward will be able to squeak by. "A few years ago, we envisioned fire sales and distressed opportunities. But some sectors, especially apartments, have greatly improved."

## A PUBLIC PLAY

The state of the CMBS market is also of lesser importance in the public markets.

REITs, for example, don't consider it a high-priority funding source, although it is important to them as they sell assets to buyers who need the financing. REITs, though, have been experiencing their own set of nuanced issues as they approach the capital markets. By and large, they are securing the capital they want, although the amount they're raising has leveled off a bit from 2013.

Charlottesville, VA-based SNL Financial recently reported that US equity REITs raised a total of \$13.33 billion in capital year-to-date as of April 4, compared to \$19.45 billion raised during the same period in 2013.

The capital raised via common equity amounted to \$3.31 billion, senior debt offerings generated \$9.42 billion and \$602.5 million came from preferred equity offerings through April 4. During the same period in 2013, REITs had raised \$9.33 billion from common equity offerings, \$7.08 billion from senior debt issuances and \$3.04 billion from preferred equity offerings.

Some of this shift is due to the expectation that interest rates will rise soon, James Mathieu, a senior analyst in the firm's Real Estate Research office, explains. That is, senior debt issuances were up in 2014 compared to 2013 because issuers wanted to lock in low rates.

He provides a more interesting and nuanced analysis of why fewer REITs have tapped the equity markets this year. Mathieu notes that NAV premiums have been flat or even trading at a discount this year for US REITs. "Companies would rather raise equity when it is trading at a premium when they can get more cash for their shares," he says.

Unraveling the question of why NAV valuations are flat is a bit harder, but one answer can be found in the decreasing equity prices of US REITs last year. These were a large driver of the increases in NAV discounts throughout 2013, Mathieu says.

Last year, the SNL US Equity REIT index price change was nearly 30 percentage points below the S&P 500. Year-to-date in 2014, though, an 8.5% increase in US REIT equity prices has

helped to bring the premium to NAV calculation closer to equilibrium, as NAV estimates have remained fairly stable on average for REITs throughout the year, he says.

"However, due to the fact that US REITs have traded at a discount to NAV for much of 2014, REITs may be swayed toward raising capital through 'cheap debt' as opposed to selling stock at a discount," Mathieu says. "As of April 15, the average coupon rate for debt raised in 2014 by US REITs was just 4.16%, a rate that has continued to decline since the 2009 average rate of 7.19%."



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**CHUCK TAYLOR**  
A10 Capital LLC

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## THE ART OF THE DEAL

In the end, though, when the refi requests start to come in, the dominant factor won't be whether the company in question is a public or private one, but just how well it can read the environment and the lender—and then close the deal either with new or restructured capital.

Consider the sophisticated play made by Parkway Properties when it acquired One Orlando Center, a class A office building in Orlando, and simultaneously restructured the existing first mortgage.

First some background: One Orlando Center is a 19-story, 356,000-square-foot office tower in the recovering Orlando CBD. The property is 81.3% occupied and is expected to generate an initial full-year cash net operating income yield of 7.0%. Parkway really wanted this asset as it's accumulating a significant footprint in Orlando.

Onto the deal. Parkway made an \$8-million equity investment that will be held in lender reserve accounts to fund the leasing and repositioning of the asset. At the same time as the equity investment, the existing \$68.3-million first mortgage note was restructured into a new \$54-million first mortgage and \$16.4-million B-note, which is subordinated to Parkway's equity investment.

Upon the sale or recapitalization of the property, proceeds are to be distributed first to the lender up to the amount of outstanding principal of the first mortgage note; second, to Parkway up to its equity investment; third, to Parkway until it receives a 12% annual return on its equity investment; fourth, 60% to Parkway and 40% to the lender until the subordinated B-Note is repaid in full; and fifth to Parkway at 100%. Parkway's equity investment will provide for 100% ownership and management of the asset.

It's a deal that could have been doable a year ago or two years ago, says Jason Bates, senior vice president and head of transactions at Parkway, although an asset of a lesser quality might not have made the cut.

Also, the 81.3% occupancy rate would have made it harder for some buyers to structure, he says. However, "this wasn't exactly applicable on this deal since the property debt was restructured as opposed to new debt being obtained."

Ditto the full-year cash net operating yield of 7% that the property is expected to generate. Pro forma estimates and projections tend to receive careful scrutiny. Did the lenders accept Parkway's projection or require more paperwork to make sure it was accurate? Says Bates: "This isn't applicable on this deal since the property debt was restructured as opposed to new debt being obtained." ◆

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