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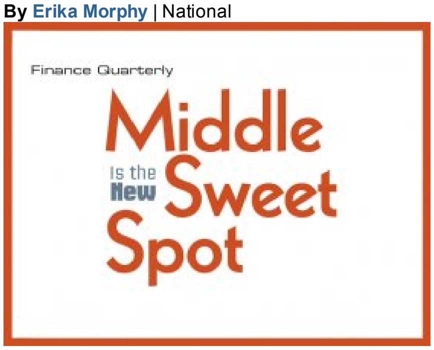
Middle Is the New Sweet Spot

By Erika Morphy | National



*This is an **HTML version** of an article that ran in **Real Estate Forum**. To see the story in its original format, **click here**.*

It took the McLean, VA-based GSE Freddie Mac about 11 months since the launch of its small balance multifamily loan origination platform in October 2014 to reach $1 billion in originations.

That doesn't seem like that big of an achievement until you realize that the program didn't start actively securitizing these loans until August of 2015, at $100 million a pop. One very short month later it made its grand announcement that the $1-billion mark had been reached.

For Stephen Johnson, Freddie Mac senior director of multifamily production for small balance loans, the program's momentum couldn't happen fast enough. Not because he was concerned it wouldn't take off—based on extensive market feedback before launching the program, he knew that it would.

Rather, he was eager to see the program's larger goal—introducing liquidity into a parched small and middle market multifamily lending environment —be realized.

"This program provides a secondary outlet for these loans," he says. "It gives the lenders in this sector more liquidity, which also furthers affordability."

There are other reasons to be excited about Freddie Mac's efforts to build out small loan financing. The debt financing market for small properties will benefit from the standardization, leading to more consistency, competition and, hopefully, transparency across the industry. Subsequently, appetite for these securities on the part of investors should also increase.

Freddie's small loan securitization platform is, without a doubt, a great development for middle-market commercial real estate borrowers.

But Freddie Mac isn't the only driver steering this particular bus. Over the past year or so, there have been a number of developments that are adding liquidity in this segment of the market and it is not just limited to the multifamily sector. New players are entering the middle-market commercial lending sector, while longstanding lenders that provide related products such as bridge loans are expanding their platforms. In many cases, these activities are being funded with institutional capital. Banks, too, are stepping up their game, often acquiring other banks to stay competitive.

The reason for the push? The same one that drives investors in all deals, across all asset classes. There is both demand for middle market commercial real estate finance and opportunity for investors to achieve a bit of yield.

This dynamic can be seen even at the individual product level, such as the ubiquitous bridge loan. "There is greater demand for bridge debt today than there was 12 or 24 months ago," says Al Moczul, senior vice president and regional director of Berkadia, in Jacksonville, FL.

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This seems to be especially true for the multifamily sector, he continues, as cap rates for stabilized assets have been driven down so low that investors are looking more toward value-add opportunities where they can manufacture yield. "By nature, these assets will utilize more bridge debt than stabilized ones."

Institutional appetite for middle market opportunities has also hit a global level.

At the start of October 2015, a Bethesda, MD-based boutique finance house, MidCap Financial, announced it had acquired some $3.6 billion in corporate and real estate middle-market loans in the US and Europe from Mubadala GE Capital. Abu Dhabi-based Mubadala GE Capital is a joint venture between Abu Dhabi state fund Mubadala and General Electric's finance business. The sale of its middle-market loan portfolio was part of General Electric's initiative to sell off most of its assets in GE Capital, including its real estate loans, announced earlier this year.

In a prepared statement, MidCap Financial CEO Steve Curwin said the deal furthers the firm's goal of being a "significant player" in the middle market lending space. "The opportunity to add a highly diversified portfolio of this quality to our platform is unique," he added.

Curwin has not spoken much to reporters since the deal was announced, nor have officials at Mubadala GE Capital released further information. The latter's website is not very revealing; rather, it shows a number of current positions it has in investments but it is unclear whether these are part of the portfolio that is trading to MidCap.

NVCapital Advisors provided $12 million in equity to develop Emblem at Christiana, a 245-unit luxury rental home community in Delaware.

What is clear, however, is MidCap's appetite for this piece of the market—and its firepower. The company was acquired by New York City-based Apollo Global Management in November of 2013, some five years after MidCap was founded.

MidCap Financial's roots are in the healthcare sector, as a provider of senior secured debt, including asset-based loans, revolving credit facilities, and other senior secured facilities. Apollo tends to use other credit vehicles to originate subordinated and opportunistic credit.

In February of this year, the companies rolled out a direct origination offering after having concluded that, as a result of the secular shifts in the traditional middle-market lending arena, "direct origination is one of the most compelling opportunities in credit today," Apollo co-founder and managing director Marc Rowan said at the time.

Capital One, a regional bank in McLean, VA, and its acquisition of Bethesda, MD-based Beech Street Capital in 2013, is another example of the middle market benefiting from an acquisition even though its clients range from middle-market to institutional-sized companies.

Beech Street was an originator and servicer of GSE and FHA multifamily loans. Capital One recognized the synergies it had with its own platform and acquired it to be able to offer bridge financing and CMBS executions.

Some two years later the combined institution has generated over $1.2 billion in incremental business, a great deal of it in the middle market, according to Grace Huebscher, president of Capital One Multifamily Finance. Typical transactions can be found on both coasts: in June 2015, for example, Capital One Multifamily originators provided a $35.1-million balance sheet construction loan to build the Martin, a six-story apartment complex in San Francisco's Dogpatch neighborhood. One month later, its balance sheet lenders originated a $14.5-million fixed-rate Fannie Mae loan out of the Washington, DC office to refinance Fields of Arlington, a midrise affordable housing complex in Arlington, VA.

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The combined, one-two punch of the respective platforms has much to do with these originations, she says, but the institution's willingness to listen to borrowers and craft solutions that meet their needs also played a part. Sometimes these solutions are put together on the fly.

Huebscher tells of one client that had an agency deal in progress, but because of backup at the GSE, it didn't look like it would close on time. Capital One provided financing for the transaction until the agency loan came through. "We are not so much product driven but rather focused on listening to our clients' needs," she says.

Another company eager to tap the opportunity in middle-market CRE lending is Los Angeles-based DoubleLine Capital. It formed a partnership with local CRE lender Thorofare Capital to originate, underwrite and service middle-market commercial real estate bridge loans for DoubleLine Opportunistic CRE Debt Strategy clients.

"There is greater demand for bridge debt today than there was 12 or 24 months ago, especially in multifamily, where cap rates for stabilized assets have been driven down low." ***—Al Moczul, Berkadia***

DoubleLine will buy longer-term loans that Thorofare will originate under the platform, complementing its existing array of shorter-term, higher-rate financing products, according to Thorofare CEO Kevin Miller. The goal is to originate as much as DoubleLine can eat.

Boise, ID-based A10 Capital is another middle-market loan provider that received a recent infusion from an institutional investor, in this case its pre-existing backers BlackRock and THL Credit, which provided a significant follow-on investment recently. The amount, which was not revealed, will be used to grow A10's loan origination platform and on-balance sheet loan portfolio.

A10 is a balance sheet lender; to post significant growth it would need this additional investment or, at least, access to secondary markets. As it happens, there are a surprising number of bridge lenders that do have their own CMBS platforms—a very helpful component to their operations, especially as appetite for CMBS in general continues to grow post recession.

New York City-based Cantor Fitzgerald is one example. In 2011, as the industry was struggling back from the abyss after the market's crash, it issued $634.5 million in commercial mortgage pass-through securities, backed by loans originated by Cantor Commercial Real Estate. It was the first time in almost a decade that a new entrant in the US CMBS market had originated, securitized and lead-managed its own deal, the company crowed in a press release at that time. More significantly, these were almost all middle-market loans. That first mortgage pool was collateralized by 38 fixed-rate loans secured by 67 properties in 22 states.

Cantor provides loans of $5 million to $175 million under its fixed rate-lending program. Its floating-rate program targets larger amounts starting at $35 million and going up to $200 million.

Whether they have their own CMBS platform or not, most lenders in this space do underwrite to an eventual CMBS takeout, Berkadia's Moczul says.

They have to, if they want to remain competitive.

Yes, even here in the small and middle market, competition for good deals is fierce. That may come as a surprise to some as the space has traditionally been (until recently) under-served and over-regulated (that has not changed).

"We have been getting a lot more inquiries in recent months in large part because of the market volatility. Oftentimes they are borrowers abandoned by their previous lenders late in the game." ***—Jerry Dunn, A10 Capital***

But today the landscape is almost unrecognizable, Moczul observes. "Not only has the demand for bridge debt increased, the supply has increased as well," he says. "In fact, there is more available capital than deals to lend on."

Loan amounts on value-add plays have increased to nearly 80%, up from 75% a year ago, according to Moczul. Going-in debt coverage requirements can be below 1.0, whereas in previous years it's been at or above 1.0, he says. And some lenders are willing to look at deals below $10 million, when not long ago $15 million to $20 million used to be the floor.

Having said all of that, Moczul concludes, middle-market lenders remain disciplined with their underwriting. "It's nothing like the go-go years of 2006 and 2007."

That's good, since middle-market borrowers are finding themselves buffeted as the market becomes more volatile, Jerry Dunn, the CEO of A10 Capital, says. "We have been getting a lot more inquiries in recent months in large part because of the volatility."

For example, he offers, A10 Capital has taken on a number of new clients who were abandoned by their previous lenders late in the game. "Typically they were under application with a lender and for whatever reason the lender decided it couldn't or wouldn't deliver. It had a change of heart, perhaps," he says. The volatility is also increasing the number of clients that want its fixed-rate offering, he adds.

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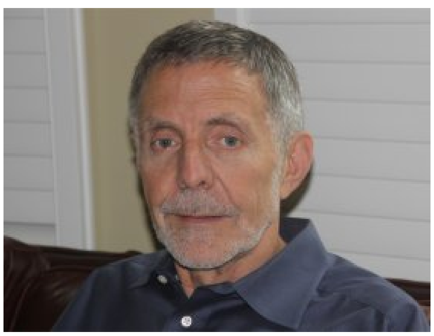
Then there is everyone else—that is, borrowers who come to him for, well, almost any reason and not just because times have suddenly become volatile. For instance, as more companies consolidate and reconfigure space in office buildings, building owners are finding their parking facilities are no longer sufficient to accommodate the increase in tenants. Their answer is a new parking lot funded via a bridge loan.

Indeed, bridge loan borrowers come to a lender's tables for all manner of reasons.



"I expect we will see more of these types of opportunities as developers move away from the larger cities." ***—Peter Lunt, NVCapital Advisors***

There was a borrower in the Midwest who owned two class B office buildings dating back to the 1980s in Schaumburg, IL and Milwaukee, WI. The buildings had common areas that needed immediate renovation, plus the sponsor apparently had a prospective tenant in the wings, since it needed additional capital for tenant improvements and leasing commissions immediately. The buildings averaged below 70% occupancy at closing in submarkets where the average occupancy was well above that level.

Bloomfield Capital in Birmingham, MD and Alpha Alternatives in Chicago put together an $8.5-million senior bridge loan, the proceeds of which were used to purchase the discounted note from the existing lender on the two buildings. The discounted note purchase came to $6.6 million with additional funds for interest and renovation reserves.

There was another borrower in Phoenix who needed to pay off a defaulted first mortgage on a multifamily property in bankruptcy.

The answer, as it turned out, was a $13.6-million first-mortgage bridge loan secured by not one but two apartment properties in Phoenix. The loan proceeds paid off the defaulted first mortgage on the property in bankruptcy, which was cross collateralized with a stable core asset in the borrower's portfolio. The lender, New York City-based Trevian Capital, spoke on behalf of the borrower in bankruptcy court to help it secure the discounted payoff.

Trevian launched in January 2013 to fill what it saw as an unmet need in this market. Today it expects that it will have originated $200 million in volume for 2015 alone. That number, incidentally, is not a hard cap, says founder Michael Hoffenberg. There is plenty of capacity for more.

"We are not so much product driven but, rather, focused on listening to our clients' needs." ***—Grace Huebscher, Capital One Multifamily Finance***

Many middle-market bridge loans, though, are made for far more benign reasons, such as renovations or construction financing. You can't get any more typical for this product than the $13.6-million first mortgage bridge loan made earlier this year by Boston-based UC Funds. The proceeds are being used to renovate an existing 112-key La Quinta Inn in Aberdeen, MD, into an 85-key La Quinta Inn and 92-key Hampton Inn. When they are done, the renovated properties will be the newest product in the market since a 2009 development by the same sponsor.

There is another type of borrower on the market that is very much a sign of the times: developers that have picked over opportunities in gateway cities such as Washington, DC or San Francisco and decided it was time to move on to secondary or even tertiary markets for the next wave of opportunities.

The developers often have relationships with local offices of national banks, but then find that these banks are not interested or cannot lend in, say, St. Louis, MO or Bear, DE, says Peter Lunt, chief investment officer of NVCapital Advisors in Vienna, VA. So they turn to other providers as they enter new markets, especially as their funding needs are not as great as they would be for a project in, say, the capital gateway city of Boston.

That is because land is so much cheaper, Lunt says. The total cost per unit to develop is about the same everywhere but luxury projects can be developed on relatively cheap tracts of land.

NVCapital, which ordinarily focuses on Washington, DC projects, has provided financing to such a project in Christiana, DE. Has it, too, come to believe that better opportunities are available elsewhere? No, asserts Lunt, although he does agree that it is getting more difficult to find such deals.

The transaction, one of the few it is funding outside of DC, is a joint venture between NVCapital Advisors and M-C Development, an affiliate of Leon N. Weiner & Associates, a Delaware homebuilder.

They are developing Emblem at Christiana, a 245-unit, nine-building luxury rental home community with a delivery date of 2016. PNC Bank is providing construction financing of $30 million and NVC and MCD have provided $12 million in equity.

“I expect we will see more of these opportunities as developers move away from the larger cities,” he said. The middle-market finance ecosystem will be an important source of support for this trend, especially if national lenders continue to limit their exposure to the Christianas of the US.

Not all, of course, will. If nothing else, national CRE lenders have learned they must go where the opportunities are. But enough will decide to bow out, attracting even more institutional investment to this segment.

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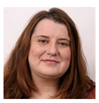

Washington, DC reporter Erika Morphy goes deep inside the DC power scene to explore the link between Capitol Hill and your assets. Erika Morphy has been a financial journalist for 20 years. She’s been covering the capital markets for ALM since 2004. Contact Erika Morphy.