Multifamily borrowers enter the fourth quarter of 2008 with a great deal of uncertainty. The real estate markets have been in a state of turmoil and disarray since spring 2007 due to external capital markets forces. As Peter Linneman, professor of real estate at the University of Pennsylvania, noted at a recent ULI capital markets seminar, “Capital is on strike.” Borrowers have learned over the past 18 months that the execution of real estate financings has become slower, more unpredictable, and more unreliable than ever before.

Multifamily housing, long considered the safest asset class with its diversified income stream and predictable expense ratios, is now being painted with the same brush as retail, office, and industrial property relative to concerns over rent stagnation and decline, oversupply, and value erosion. Whereas a call to a local bank or delegated underwriting and servicing (DUS) lender once was enough to get a nonrecourse, 80 percent-of-value fixed-rate financing with no uncertainty, multifamily borrowers have found that their lenders are taking a very conservative view of the future of multifamily assets and tightening the flow of debt capital into the sector, forcing borrowers to seek new sources and structures to meet their financing needs.

Crisis of Confidence
Borrowers, lenders, and market observers alike agree that the current capital markets situation is not an anomaly, but rather an inevitable phase of the real estate cycle. The capital crunch began in spring 2007 with the commercial mortgage–backed securities (CMBS) lending sector and ultimately spread to banks, life insurance companies, and the government-sponsored agencies. Further, the impact of the credit crunch on other sectors of the economy has altered the fundamentals of for-rent multifamily real estate.


Conservative loan-to-value ratios and debt-service-coverage ratios are back in vogue.
However, there were dark ramifications lurking behind this exuberance. Artificially low interest rates, a seemingly insatiable and endless supply of B-piece buyers, and a rating agency system that prized volume rather than caution led the banks to increase the size and frequency of their loan securitizations. This increase could only be accommodated by looser underwriting standards and less attention to detail.

First mortgages were often written up to 90 percent of value at historically low interest rates—sometimes interest only and almost always on a nonrecourse basis. In addition, CMBS lenders began underwriting future, unrealized income to capture the business of assets in transition—assets that were once the bread and butter of recourse commercial banks and high-priced credit companies.

In spring 2007, investors began to analyze more closely the risk inherent in these aggressive CMBS loans after significant delinquencies and defaults were observed in residential mortgage–backed securities (RMBS). After evaluating the underwriting of these loans, bond buyers lost confidence that CMBSs were risk rated and priced appropriately. As a result, bond buyers devalued these securities, driving CMBS and collateralized debt obligation (CDO) yields to astronomical levels, subsequently leading to rapid inflation of the cost of capital for borrowers. These lenders have been virtually out of the permanent lending market since the credit crunch began in early 2007.

With the CMBS lenders out of the market, many expected the life companies and depository banks to step into the void to provide desperately needed liquidity to borrowers. However, this did not happen.

Life companies, which are generally allocated funds relative to the annuities they receive, maintain a predictable and marginal growth in loan originations year over year. Due to their infrastructure, administration, and framework, these organizations were simply unable to fill any gap left by the CMBS lending community.

Bank lenders, which use their balance sheets to originate new commercial real estate loans, were flooded with new loan requests upon the collapse of the CMBS lending market, but, for the most part, they lacked the resources to efficiently process them. Furthermore, the very same flight of capital that caused the CMBS lending operations to exit the market decimated the ability of banks to syndicate their large loans. Large loans immediately were either tabled or killed at middle-market and even national banking organizations.

**Current State of Affairs**

While the capital markets quickly became largely fragmented and extremely volatile, many market observers pointed to the multifamily asset class and the government-sponsored entities Fannie Mae and Freddie Mac as a safe haven for real estate investors.

CMBS lenders are still out of the market. Currently, pricing for a ten-year, fixed-rate multifamily CMBS mortgage trades at a wide margin to Fannie Mae and Freddie Mac due to the lack of investor confidence in the underlying credit quality of CMBSs. Pricing remains extremely volatile, with dramatic shifts on a weekly basis.

Commercial banks are now only focusing on smaller short-term, floating-rate, recourse loans. With the CMBS lenders that historically provided nonrecourse loans now out of the market, banks are able to demand recourse guarantees on their 60 to 65 percent financing for stabilized assets.

With a contraction of capital and a plethora of lending opportunities, life companies have refocused on originating medium-sized to large loans on Class A, trophy, and institutional multifamily assets. Life companies can, and are, being even more selective in the origination of new loans.

Due to the liquidity crunch in the overall securitized markets, Fannie Mae and Freddie Mac have been flooded with financing requests and have substantially increased fixed-rate loan originations. “Despite increased restraint in overall underwriting standards, agency lenders continue to provide permanent debt liquidity to the multifamily asset class,” says David Tindall, senior vice president of acquisitions at NBS Real Estate Capital, an active multifamily investor based in Portland, Oregon.

**Back to the Basics**

“Everyone has returned back to underwriting fundamentals,” says Rex Bradley, division executive with Bank of America Commercial Real Estate Banking.

Banks and life companies that have traditionally excelled at financing development are now questioning multifamily market vacancies and rent growth projections. Because thousands of unsold housing

continued on page 261
units are poised for quick conversion to for-
rent multifamily product, these lenders are
not relying on assumptions regarding rent
growth or higher vacancy factors, and are
using very conservative takeout assump-
tions. The bottom line is that developers
today can only borrow about 65 percent
of development cost from a traditional
construction lender, compared with two
years ago when loans covering 75 percent
of construction cost were easily obtainable.
“While apartments have not been overbuilt,
job creation has slowed and household
creation may decline,” Bradley explains.
“Until construction costs come down a bit,
investment in multifamily development may
slow down from both a debt and equity
perspective.”

On the other hand, Marcus & Millichap
Real Estate Investment Services observed
in a May 2008 research report that 1.5 mil-
lion additional renter households have been
added to the market as a result of a 110-basis-
point drop in the homeownership rate since
January 2007. While some in the market
suggest this added renter demand will miti-
gate a softening economy and concerns over
shadow supply, the lending community will
continue to be very cautious when making its
own forward-looking assumptions.

Emerging Trends
The debt markets, even for multifamily real
estate, will continue to be fragmented and
volatile for the foreseeable future. With ques-
tions of the liquidity, general long-term viabil-
ity, and recent government takeover of Freddie
Mac and Fannie Mae weighing on the minds
of both lenders and borrowers, multifamily
construction loans are becoming increasingly
difficult to obtain. Alternative multifamily
financing strategies will become a prominent
feature of the capital markets in the months
to come.

A notable alternative financing structure
currently emerging is the private loan fund.
Several major banks, along with a handful
of pension and real estate funds, are raising
these funds with a cost of capital margin-
ally lower than the rate at which they lend.
These groups plan to hold these loans on
their balance sheets until the fixed-income
market stabilizes and they can pool loans to sell to bond buyers.

With stabilized, bridge, and construction lenders all pulling back on leverage, a second strategy is to access mezzanine financing for additional debt capital. These lenders, while expensive, tend to also operate real estate and therefore can provide additional credit support and comfort to senior lenders.

This summer, the federal government announced that it was assuming control of Fannie Mae and Freddie Mac, a big step toward realignment of the financial markets amid the worst credit crunch since the Great Depression. After seeing heavy short selling and a complete lack of investor confidence, the U.S. Treasury realized it needed to shore up faith in the two government-sponsored enterprises (GSEs) and in agency mortgage-backed securities (MBS), now the primary channel for housing finance, accounting for over 70 percent of originations in recent months. Direct government intervention here and other actions of the past year, such as the Bear Stearns and AIG “bailouts,” should be viewed as temporary, emergency moves that will give way to a more transparent and, in all likelihood, more heavily regulated financial market as the credit squeeze slowly dissipates.

While federal intervention has provided the market with additional stability, further strategic decisions are yet to be seen. Some speculate that the Treasury may consolidate the two agencies to avoid the self-destructive, hypercompetitive lending environment that led to the lax underwriting standards used over the past several years. However, others see a more ominous future with no GSEs. These cynics have long argued that Fannie and Freddie were doomed from the start by their hybrid nature as semi-public/private organizations; they question the ability of any company to maximize shareholder wealth while pursuing the GSEs’ more altruistic goals of promoting affordable homeownership for Americans and keeping the mortgage market liquid.

The ultimate impacts of the recent, dramatic transformation of the 150-year-old investment banking business model
of Wall Street into a depository-based and highly regulated commercial banking model are yet to be seen. The next 18 months no doubt will constitute a dynamic and fluid environment for multifamily borrowers as the financial systems are rebuilt and reconfigured from the ground up.

**Final Thoughts**

From institutional equity to private syndication groups, multifamily investors are all seeking reliable and certain loan terms before committing to core asset acquisitions, repositionings, or developments. However, these loan commitments will continue to be increasingly difficult to obtain.

The capital markets are indeed more challenging and more conservative, even for multifamily borrowers. Lenders have tightened the flow of debt capital to new developments and value-added investments, and permanent lenders are pulling in their reins with respect to leverage on and pricing of stabilized assets. Underwriting has returned to the basics. Conservative loan-to-value ratios and conservative debt-service-coverage ratios are back in vogue. Lenders are singularly focused on financing real estate with the right borrower, of the right quality, and in the right location.

As Linneman observed, capital is on strike. It is no longer an acceptable strategy to rely on a Fannie Mae takeout or the relative safety of the multifamily asset class. Borrowers wishing to break the strike line must be equipped with an array of strategies to deal with the volatility, fragmentation, and uncertainty inherent in today’s capital markets.

**Mike Kingsella** is an associate in the global real estate practice at KPMG LLP. **Ramsey Daya** is a principal of Regency Capital Partners, based in San Francisco.

*(This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP or Regency Capital Partners.)*