Multifamily Borrowers Should Have No Problem Extending Loans. But What Comes Next?

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The U.S. multifamily market has its own spike of debt maturities looming in the fall, but without the existential doubt of the office sector, borrowers are in a totally different position.

Whereas office buildings face enough oversupply to render millions of square feet obsolete (https://www.bisnow.com/national/news/office/330m-sf-of-us-office-will-be-obsolete-by-2030-cushman-wakefield-predicts-117813), long-term demand for multifamily is among the surest things in real estate (https://www.bisnow.com/national/news/multifamily/no-vacancy-apartments-see-record-occupancy-nationwide-111421). Yet with rent growth slowing to a crawl (https://www.bisnow.com/national/news/multifamily/bargaining-power-is-shifting-toward-tenants-as-rent-growth-dissipates-119367), operational expenses continuing to rise (https://www.bisnow.com/national/news/multifamily/multifamily-insurance-costs-up-nearly-30-since-last-year-119259) and a hostile financing environment, multifamily owners with maturing loans have little choice but to negotiate extensions and hope better times arrive before they end.

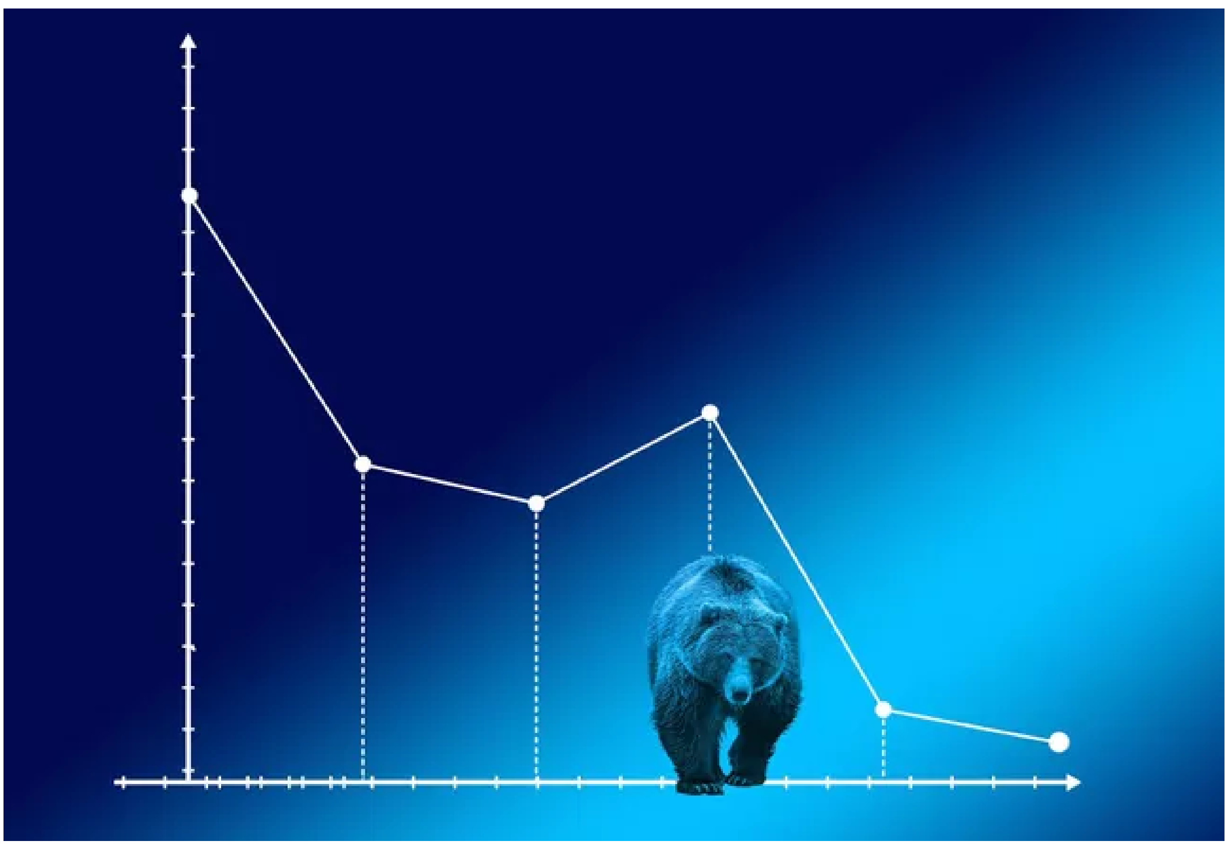
“In office, we’re witnessing a fundamental sector shift, whereas with multifamily, we’re not seeing a lot of performance stress,” Morningstar (https://www.bisnow.com/tags/morningstar) Credit head of CRE Analytics David Putro told *Bisnow*. “But if you’re talking about financing a loan at 150-180 basis points higher than how your current loan is priced, it builds risk into the refinancing equation.”

Despite its strong long-term fundamentals, multifamily is still vulnerable to the macroeconomic conditions challenging every form of commercial real estate. Any loan extensions are bets that conditions for refinancing or selling will improve, and if they don’t do so before the bill comes due, some borrowers may be in a worse position than they are now — and with a lender more willing to foreclose.

“I’ve heard people say that maybe we’ve kind of seen the worst of ‘it,’ but I don’t really know if we’ve seen ‘it’ yet at all,” CohnReznick (https://www.bisnow.com/tags/cohnreznick) Debt Restructuring and Dispute Resolution Managing Director Debra Morgan said. “I know that banks are doing whatever they can to get real estate off their books ... There are debt buyers for yield and debt buyers for real estate, but there are definitely buyers out there.”

Loan originations have tailed off dramatically, with commercial mortgage-backed securities volume down 73% year-over-year as of mid-June and collateralized loan obligation volume down about 90% in the same interval, according to Commercial Mortgage Alert research published in a June 28 report (https://www.yardimatrix.com/publications/download/file/4068-MatrixMultifamilyNationalOutlook-Summer2023?eml=matt.rothstein%40bisnow.com&frm=4&key=B905CA689FFD56C12C0558F7D(by Yardi Matrix (https://www.bisnow.com/tags/yardi-matrix). Despite a lack of new loans, the steady relationship between multifamily CMBS delinquencies (https://www.bisnow.com/tags/cmbs-delinquencies) and special servicing (https://www.bisnow.com/tags/special-servicing) transfers in data from the Commercial Real Estate Finance Council (https://www.bisnow.com/tags/commercial-real-estate-finance-council) suggests that extension deals are happening with minimal friction, Putro said.

“If a property is performing relatively well, has good sponsorship and is in a decent market, I’d be very surprised if loans are not extended until there’s a more favorable rate environment,” he said.



A combined $8B in CMBS (https://www.bisnow.com/tags/cmbs) loans backed by multifamily properties is scheduled to mature (https://www.bisnow.com/national/news/multifamily/wall-of-multifamily-maturities-dead-ahead-more-than-4b-in-october-alone-119584) between October and November alone, according to a research report by Gray Capital. In general, the loans have 10-year terms, meaning that billions of dollars' worth of short-term loans originated by private lenders during the investment feeding frenzy from 2019 to 2021 is also likely to come due in the next few months, said Peter Lewis, Wharton Equity Partners (https://www.bisnow.com/tags/wharton-equity-partners) founder and chair.

Any borrowers with short-term loans coming due will have an especially difficult time refinancing, with additional equity infusions (https://www.bisnow.com/national/news/multifamily/tides-equities-multifamily-floating-rate-debt-119597) all but guaranteed to be needed, Morgan said. Multifamily property values are down 15%-20% from their peak and likely to fall further, Yardi research found.

Rent growth may have fallen off faster than borrowers projected, while insurance premiums (https://www.bisnow.com/national/news/multifamily/multifamily-insurance-costs-up-nearly-30-since-last-year-119259) and interest rates (https://www.bisnow.com/national/news/economy/possibly-the-last-rate-hike-for-now-but-its-cold-comfort-for-cre-118788) have risen faster than virtually everyone expected, Morgan said. Many in real estate hold out hope that interest rates will begin falling again next year, but there is little reason to believe insurance rates will do the same.

Meanwhile, new multifamily deliveries this year are expected to exceed last year's total by 15% and increase even more next year, per Yardi research.

As surely as the market is set to be challenged this year and next, deliveries are expected to tail off (https://www.bisnow.com/philadelphia/news/multifamily/developers-pausing-land-banking-119025) not long after, as construction loans are at least as difficult to land as refinancing deals, Lewis and Conti Capital founder and CEO Carlos Vaz said. High mortgage rates and persistent undersupply in the single-family home market are likely to keep many households from transitioning from renting to owning.

"What the data is telling us is that if we're able to hold assets for one or two years, they're going to be fine," Vaz said. "Construction costs (https://www.bisnow.com/tags/construction-costs) are not coming down, you're still struggling to get labor and there are still zoning issues across the U.S."

The existence of government-sponsored entities Fannie Mae (https://www.bisnow.com/tags/fannie-mae) and Freddie Mac (https://www.bisnow.com/tags/freddie-mac) represents a security blanket for multifamily lenders that doesn't exist for any other asset class, Lewis and Morgan said. Though their underwriting standards becoming more strict has added to the difficulty and cost of refinancing, the two agencies represent a direct way for the federal government to intervene should anything threaten the sector on the whole.

Reaching an extension deal may not be a challenge, but what happens at the end of an extension depends on more than multifamily fundamentals or the health of the economy. Regional banks, a key source of construction and acquisition loans for decades, are not just avoiding making new loans but actively reducing their commercial real estate exposure.

"Behind the scenes right now, there are a lot of loans being sold and getting off banks' balance sheets," Lewis said.

Over 760 U.S. banks had exposure to CRE and construction loans in excess of federal guidelines in May, according to Trepp data reported by Reuters (https://www.reuters.com/business/finance/overexposed-us-regional-banks-could-sell-commercial-property-loans-2023-05-17/). Many banks will use extension negotiations as opportunities to adjust terms or establish liability clauses to make loans more appealing to potential buyers, Morgan said. In the current environment, that likely means debt funds (https://www.bisnow.com/national/news/capital-markets/shadow-lenders-step-in-as-regional-banks-back-away-from-cre-118526).

"Some buyers work out repayment over a certain number of years, and that's the yield from their investment," Morgan said. "But there are other funds with ideas out there to buy these loans, because then they could get the real estate."

As has been the case since the pandemic began, there are likely far more investors looking to capitalize on owners not having the cash to weather short-term challenges than there are deals that fit the bill, Lewis said. Banks won't eat deep losses on assets with long-term value just because of overexposure to real estate, unless regulators crack down.

"The big wild card is that the government has a tendency to have knee-jerk reactions with regulation," Lewis said. "If, for some reason, they want to really crack down on regional banks' capital, then banks will have no choice but to do something with their loans."

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See Also: Texas Legislature Reaches Property Tax Deal With Some Relief For CRE (/houston/news/commercial-real-estate/texas-legislature-reaches-property-tax-deal-with-at-least-some-commercial-property-relief-119744)

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