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ALTERNATIVE LENDERS MOVE INTO THE MAINSTREAM

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Alternative, or non-bank lenders, a staple in the commercial real estate industry for decades, have come into their own. They're filling in gaps in the mortgage world where they find them, whether it be the result of increasing capital requirements for banks, consolidation in the banking sector, or a pullback by CMBS lenders. And they're not going away any time soon, given the vast sums of capital they've raised.

Last year alone, the five largest players in the sector – Blackstone Group, Mesa West Capital, Starwood Capital Group, TPG Capital and Mack Real Estate Credit Strategies – collectively funded some $20 billion of interim loans. Each focuses on providing relatively big-ticket mortgages that generally have initial terms of two to three years to allow sponsors to complete upgrades or stabilization efforts.

Dozens of others play in the field just below them, providing loans against properties that could be classified as middle-market, in that they have total capitalizations of about $10 million to $100 million.

While alternative lenders are getting more attention, they're still relatively small players in the massive arena that's the commercial real estate lending world. According to a tally from the Mortgage Bankers Association, they held 3.1% of the nearly $3 trillion of outstanding mortgages last year. How does that compare to other lending source?

- Banks held a 40.4% share, up from 38.6% in 2015

- The housing finance agencies—Freddie Mac and Fannie Mae—came in with a 17.6% stake
- CMBS seized a 15.5% share
- Life insurance companies held a 14.2% stake.

The relatively heavy exposure of banks to commercial real estate has piqued regulators' concerns. As such, they're pulling back, creating an opening for alternative lenders.

According to the Federal Reserve's recent Senior Loan Officer Opinion Survey, banks reported that they tightened their lending standards over the past year. They increased loan spreads for all commercial mortgages and a significant percentage of banks had reduced their required loan-to-value ratios on construction, land development and multifamily loans. In most cases, banks had cited the uncertain outlook for commercial real estate and increased concerns about the effects of regulatory changes.

Banks Are 'Rationing' Loans

"It's not that banks aren't lending," explained Stephen Theobald, Chief Financial Officer of Walker & Dunlop. They're effectively rationing their credit by not providing too much financing to any one developer, sector or geographic area. That's prompted some developers to quickly pay off their construction loans, well before their projects reach stabilization, in order to be able to line up new financing for their subsequent projects. As a result, developers will often turn to alternative lenders for interim loans that would take a project from construction completion to stabilization.

"Once upon a time, banks were the real estate lenders," explained Joshua Stein, a New York attorney who has specialized in the sector for more than three decades. But growing regulatory oversight "has made it difficult for them to do business. They've become very conservative."

Thorofare Capital, a Los Angeles lender that focuses squarely on the middle market, pointed to that pullback, particularly by community banks, which were the meat-and-potatoes lender to relatively small and mid-sized development projects throughout the country. They were also the traditional lenders to properties undergoing redevelopment or renovations.

"Before the downturn, they were doing deals for the real estate, not for the banking relationships," explained Felix Gutnikov, EVP of Originations for Thorofare. They're typically reluctant to lend now, he said, unless they're able to generate additional business from their clients. That's created pockets of opportunity for Thorofare, which originated $345 million of loans last year and expects volume to increase substantially this year, given the 70% increase in volume it saw during the first quarter.

Meanwhile, outside of the Trump Administration's efforts to reduce regulations there's no move among developers and others to push for a reduction in regulations on banks. So, "the space is wide open" for alternative lenders, according to Boyd Fellows, who led a team that formed ACORE Capital two years ago after developing and running the conduit-lending operation for Starwood Property Trust.

Dozens of other investment managers have raised capital to lend on a relatively short-term basis. Some have been in the debt space for years, while others traditionally invested in properties. Arden Group, an opportunistic investment manager from Philadelphia, recently launched an effort to raise a fund that it would use to provide bridge and mezzanine loans against properties undergoing renovations.

It's found that banks are no longer willing to provide more than 65% leverage against properties after their repositioning. That often puts a crimp in developers' plans, so Arden hopes that they'll turn to companies like itself for alternative financing. Meanwhile, the company continues to make opportunistic investments and finds itself borrowing from other alternative lenders.

That makes sense since many alternative lenders got their chops in the industry by investing in properties themselves. So they're familiar with how redevelopments work and the challenges investors might face.

The information provided is based on information generally available to the public from sources believed to be reliable.

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