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Owners of Stabilized Properties Increasingly Turning to Floating-Rate Loans

Commercial Real Estate Direct Staff Report

Some property owners are increasingly turning to short-term loans against even stabilized properties, despite long-term interest rates remaining at near historic lows.

The odd trend is being driven by institutional investors in general, and investment funds with relatively short remaining lives, in particular. They might own a property that's fully stabilized through a fund that may only have a couple of years of life left.

Instead of locking in a 10-year loan with a coupon of say 4.75 percent, they're choosing a bridge loan that might have a higher coupon, but that includes prepayment flexibility. Property owners generally don't want an asset encumbered with long-term debt when it comes time to sell in order to attract the largest number of possible buyers. Many REITs can borrow on an unsecured basis, so they might be turned off by a property that is leveraged with long-term mortgage debt.

"The rationale for stabilized property owners seeking short-term facilities seems to be driven by a desire for optionality," explained Daniel Mee, executive director of Tremont Realty Capital, a Boston-area lender and mortgage bank. He said borrowers choosing a short-term loan "may want to consider a sale of the asset within the next 24 months and do not want to incur breakage fees on fixed-rate debt."

Long-term holders of properties, however, are generally sticking with long-term loans.

The phenomenon might have a salutary impact on loan origination volumes in the coming years. Given that relatively few loans, from all lender types, were written in 2008 and 2009, the thinking has been that refinance activity in 2018 and 2019 would be minimal. The short-term loans that are being written today might be refinance opportunities in those years.

"There's something going on in the psyche of borrowers that's actually causing them to actually pay higher rates for shorter terms because they're viewing the prepayment option as much more valuable," noted Brian Harris, chief executive of Ladder Capital Corp., which funds both fixed- and floating-rate loans. "We've seen an unusual amount of loans with financing for two years instead of five or 10 years," and their collateral properties are stabilized. "They're occupied. They're full," he added. Harris was speaking on a conference call with analysts last week.

HFF, among the country's most active mortgage intermediaries, is seeing much the same thing. While that typically would be an unusual phenomenon, given low current long-term rates, it's not surprising.

"Because there's a lot more institutional ownership of properties, there's a lot more need for flexible debt," explained Gerard Sansosti, executive managing director, who said 40 percent of the company's 2016 loan volume was comprised of floating-rate financing. While that volume included construction loans and loans against transitional properties, a "significant" volume was written against stabilized properties, Sansosti said.

Long-term, fixed-rate loans generally include prepayment restrictions, so a borrower can't simply pay off the loan before it's due without facing a penalty. Most are structured with a yield-maintenance penalty, which would ensure that the lender generates the yield that was expected for the loan's life. They also can be defeased, a complex and often costly process that involves replacing a loan's collateral with government securities, ensuring that expected cash flows to the lender are uninterrupted.

But yield-maintenance penalties can be extremely costly, particularly if Treasury rates are low relative to a loan's coupon. They typically are calculated as the difference between the loan coupon and prevailing Treasury rate for the remainder of a loan's life, discounted to its net present value.

Borrowers sometimes can negotiate fixed prepayment penalties, as opposed to yield maintenance, providing them more certainty. But lenders often will require a 10 to 20 basis-point increase in loan spread.

"A major concern for many borrowers now is the prepayment penalties," concurred Robert Slatt, a principal with Newmark Realty Capital Inc., a San Francisco mortgage bank that specializes in the middle market.

He noted that a number of lenders - A10 Capital and LStar Capital to name two - have developed programs that provide greater prepayment flexibility.

In addition, certain credit unions will offer flexible prepayment options, but they'll usually limit their loans to $10 million or less. And some life insurance companies could be willing to structure certain prepayment flexibilities in their loans. They can, for instance, include a yield-maintenance penalty for the first few years of a loan, then fix that penalty as a percentage of the loan's balance that would decline as the loan ages.

The expectation is that demand for loans with greater prepayment flexibility should remain healthy, as institutional investors and funds have accounted for just more than 25 percent of all property transactions over the past three years, according to Real Capital Analytics. In 2007, they accounted for 42 percent of that year's $571.2 billion of transactions.

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