TREND report

CRE Finance Trends in 2018

Matthew Thrasher • published in the January 2018 issue

This past year began with cautious optimism in the commercial real estate sector. Coming off a tumultuous election year, the desire for relatively safe investments was extremely robust. Nonetheless, the real estate market in 2017 benefited from inexpensive financing and a significant supply of equity capital. Although the coming year will be met with critical factors including new tax reform, 2018 is anticipated to be steady for commercial real estate.

The debt financing landscape for commercial real estate has evolved nearly 10 years out of the Great Recession. Banks continue to lend for commercial real estate projects with lending surpassing pre-recession levels. The boost in commercial lending activity is likely due to lower interest rates, foreign investors' strong interest for U.S. property, and growing renter demand that has led to an apartment development boom. Traditional lenders have become more strategic, ensuring they do not allocate too much of their credit to any one developer or geographic area, making CRE exposure far less risky than a decade ago.

Alternative lending and crowdfunding are stepping in and filling any void left by traditional lenders for CRE projects. As more parties are finding real value in alternative methods of gaining access to capital, alternative lending is no longer the black sheep of the debt financing market. RealtyMogul, a popular crowdfunding marketplace, currently offers both recourse and non-recourse bridge loans as well as mezzanine debt, giving borrowers additional options when selecting the right source of capital for their projects. Sites like Patch of Land, which act as matchmaker between lender and borrower, focus on investors seeking high yield short term ventures with an emphasis on using the latest technology, data and process efficiency to more accurately assign risk profiles and project viability, while reducing time and cost of loan underwriting. We should expect the upward trend of adoption of these alternative methods of financing to continue in 2018.

The past year also saw a critical change with the initial phase out of LIBOR. The underlying market that LIBOR seeks to measure, the unsecured wholesale interbank lending market, has become significantly less active, motivating the FCA to eliminate LIBOR. The phase out will have far-reaching implications across the credit markets as many derivative contracts, corporate bonds, syndicated loans, mortgages, and securitizations reference this benchmark. As part of an orderly transition, the FCA announced that it had secured the voluntary agreement of all 20 LIBOR panel banks to continue submitting contributions until the end of 2021. The FCA now expects focus to turn towards developing alternative rates and working towards a transition that can be executed smoothly.

The Federal Reserve raised the key interest rate for the third time this year, lifting its short-term rate by a quarter-point from 1.25% to 1.5%. Commercial real estate professionals overwhelmingly predicted this move, citing strong economic growth, gross domestic product expansion, and the tight labor market as reasons for the Fed to continue tightening monetary policy. Three additional rate increases are expected in 2018, as the job market and economy to continue to boost next year.

The CMBS market strengthened in the second half of 2017. CMBS loans amounted to $66.6 billion at the end of the third quarter of 2017, a significant increase from $49.9 billion during the same time a year prior. The biggest change in the CMBS market following the implementation of the new risk retention rules, which require originators to hold 5% of the loans they issue as opposed to selling them off as bonds. This change moves towards more conservative underwriting. As these lenders are now pricing their deals with risk built-in, the cost of the capital has slightly increased, but not by upwards of 25 basis points, as was predicted.

Commercial real estate is likely to benefit from the recently-passed Tax Cuts and Jobs Act. Beginning in 2018, owners and developers of commercial real estate stand to gain from a new tax break for pass-through entities. The Act provides for up to 20% deduction for these pass-through entities, which are responsible for 61% of investment in U.S. commercial real estate. The intent behind the deduction is to encourage corporations to create jobs. However, it also applies to invested capital, which opens the door for real estate investors to benefit from that deduction.

It remains to be seen whether changes to tax treatment could influence how real estate ownership entities are structured going forward. The corporate tax rate will drop significantly from 35% to 21%. In comparison, an investor that qualifies for the full deduction on income from a pass-through entity will effectively see the tax rate drop from 39.6% to 29.6%. This raises the issue as to whether taxpayers should consider forming a corporation rather than a partnership entity, and whether the new tax rates will make it more desirable to convert from a corporation to a partnership or vice versa.

While the Act preserves the mortgage interest deduction for all homeowners with existing mortgages, the home mortgage interest deduction for homeowners with new mortgages will be lowered from $1 million to $750,000. Another tax change is the elimination of the interest deduction on new and existing home equity loans. On top of making modifications to the mortgage interest deduction, the bill limits the deductibility of property taxes and state and local income taxes to a combined $10,000.

As 2017 proved to be steadier than expected, real estate finance in 2018 is met with fundamental elements affecting investment practices. Both the interest rate policy and the Tax Cuts and Jobs Act create uncertainty in 2018. Nevertheless, commercial real estate should continue to provide a relatively attractive balance of risk and reward.

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