Powered by

Hunting for Revenue

By Denise Kalette

Jul 1, 2008 12:00 PM

With commercial property sales hurtling into an abyss, mortgage bankers and direct lenders are taking bold steps to find new revenue streams. The strategies range from adding loan-servicing portfolios to hiring entire teams from rival firms to gobbling up smaller companies.

How great is the sense of urgency? Consider that in the retail sector the volume of property sales plunged 75% in the first quarter of this year compared with the same period in 2007. In the office sector, the drop-off has been even more dramatic, with property transactions down 82% in the first quarter of 2008 compared with first-quarter 2007.

So it's no surprise that loan originations plunged 53% in the first quarter year over year, according to a closely watched index compiled by the Mortgage Bankers Association (MBA). Conduit lending tumbled 96% over the same period, and originations by life insurance companies and commercial banks fell at least 25%.

"Everybody is looking for alternative revenue sources," says Clay Sublett, senior vice president at Cleveland-based KeyBank Real Estate Capital. For example, many firms are trying to become Delegated Underwriting and Servicing (DUS) lenders for Fannie Mae, but the competition is tough.

"Mortgage banking firms are definitely [wondering], 'Can we play the sales brokerage role? Can we sell real estate? Can we do syndications? What ancillary areas are there that can be used to generate revenue?'" says Sublett. KeyBank itself has a tough act to follow. The lender provided $21.9 billion in commercial real estate financing in 2007.

"If you haven't changed, you're in big trouble because the market is clearly a challenging market," warns William Hughes, senior vice president of financial intermediary Marcus & Millichap Capital Corp. based in Irvine, Calif. The company arranged $1.5 billion in loans in 2007 and expects to arrange $2 billion this year.

What accounts for the projected increase in a down market? Marcus & Millichap plans to hire debt originators and acquire firms that offer entrée into new markets. It has replaced conduit-lending sources with commercial and local banks.

Conduit lending played a key role in the commercial real estate sector in recent years because of favorable pricing and loan terms. Domestic issuance of commercial mortgage-backed securities (CMBS) rose from $92.9 billion in 2004 to $230.3 billion in 2007.

During a stretch from January through early June 2007 — the height of the market — domestic CMBS issuance reached $137.1 billion. But in the same period this year, volume sank to a scant $12.1 billion, according to industry newsletter *Commercial Mortgage Alert*.

In the brave new post-conduit world, recourse lending is back on the table. Lenders also have dramatically changed the rules of the game by establishing more conservative underwriting terms. "If you go to a life company, getting a loan over 50% or 60% [loan-to-value] is a real challenge," Hughes says. "There are no 100% deals out there."

Tumbling with a parachute

Smaller companies are perhaps the most vulnerable in this volatile lending climate. David Cronheim Mortgage Corp., a 111-year-old correspondent for life insurance companies based in Chatham, N.J., arranged about $1 billion in loan volume in 2007, but has taken a bath in 2008, admits CEO Andrew Stewart. "Our revenue is probably down by 60%."

Stewart, who has run the company since late 1999, wisely anticipated the drought in loan originations and socked away money, cutting back on advertising, laying off six of his 23 employees, and slicing his own executive pay. The company arranges loans

across property types, ranging from neighborhood shopping centers to office buildings, warehouses and multifamily structures.

As CMBS lenders halted their operations, leaving many conduit borrowers stranded, Stewart saw a chance to help the borrowers and his own company, too. "It has opened the door for us to reintroduce ourselves to real estate developers who are lacking competitive capital sources," Stewart says, and many are glad to find an originator who services their loan throughout its term.

Within the past year, Red Mortgage Capital, a Columbus, Ohio-based Fannie Mae DUS lender that provided $2.2 billion of commercial real estate financing in 2007, acquired a small Philadelphia portfolio that services loans backed by the U.S. Department of Housing and Urban Development.

"It's a good time to be an agency lender," says Kenneth Bowen, senior managing director at Red Mortgage. "We've already done over $2 billion this year in Fannie Mae financing, which is more than we've ever done in an entire year."

Red Mortgage retrained its CMBS specialists to pursue multifamily loan underwriting with Fannie Mae. Currently 100% of the firm's loans target multifamily or seniors housing, up from 90% a year ago.

The Washington, D.C.-based Mortgage Bankers Association reports that in the first quarter of this year, the level of multifamily mortgage debt outstanding grew substantially to $856 billion, a boost of $18.5 billion, or 2.2%, from the fourth quarter.

Fishing close to home

Jones Lang LaSalle's investment banking practice found potential revenue through a loan sale advisory service. The company now facilitates the sale of "mispriced" loans, a mix of performing, non-performing and under-performing loans that investment banks want to remove from their balance sheets.

In some cases, the borrower has made mortgage payments, but the properties are located in economically depressed areas and the value of the underlying assets is no longer as high as the loan amount. "We've done billions of dollars worth of loan sales, but we've never focused on it as a business," says Noble Carpenter, program director.

"We are placing mortgages on hotels and office buildings and multifamily and industrial properties. We're still closing them. But volume is way down because the acquisition financing is not there." Consequently, the focus has switched to refinancing and a handful of new deals, Carpenter says.

To make matters worse, some regional banks and life companies are selling their loans directly, cutting out intermediaries, Carpenter adds.

Contraction mode

The overall level of commercial and multifamily mortgage debt outstanding swelled to $3.4 trillion in the first quarter, a 1.8% quarterly increase, according to MBA. But many commercial real estate executives say the industry is shrinking to 2004 levels through layoffs and downsizing.

Jack Cohen, CEO of Chicago-based Cohen Financial, which arranged $3.4 billion in loans and serviced $6 billion in mortgages in 2007, says the commercial real estate industry is "de-leveraging," and companies are hoarding cash and repaying mortgage debt.

Cohen sold a majority share of his company in 2006 to Toronto-based FirstService Corp. As CEO, he has opened new U.S. offices and aggressively pursued direct lending in addition to the firm's role as loan intermediary. He wants Cohen Financial to strategically grow.

"We have capital. We are looking to acquire. We are looking to recruit. We just opened an office in Dallas. We brought a team over from [financial intermediary] HFF. The prior year we brought a team over from Marcus & Millichap in Phoenix," Cohen notes. He hopes to buy two new businesses to develop a new income stream by 2013.

So far, with slow deal volume, 2008 has been as difficult for Cohen as the third and fourth quarters of 2007. Still, it's his intent to make the company more recession-proof with the new offices and shift toward direct lending.

Meanwhile, Pittsburgh-based intermediary Holliday Fenoglio Fowler (HFF), from which Cohen lured away a financial team, has hired its own new team of seven capital market specialists from Staubach Capital Markets, now part of Chicago-based Jones Lang LaSalle. HFF's new hires will focus on investment sales and capital markets transactions in the retail property sector.

HFF could use the help. Its first-quarter revenue of $32.3 million is 42% less than the $55.5 million notched in the first quarter of 2007. A publicly traded company, HFF (NYSE: HF) arranged $26.4 billion in commercial real estate financing in 2007.

It doesn't help mortgage bankers and lenders that what started as a credit crunch last year snowballed into something much bigger. Anemic economic growth of 1% in the first quarter is expected to improve to 2.4% by the third quarter of this year and 2.6% by early 2009, predicts MBA. The national unemployment rate rose from 5% in April to 5.5% in May.

As layoffs continue, KeyBank's Sublett acknowledges that the commercial real estate industry is shrinking. “I don't think we will have tremendous consolidation,” however, he says. After the big shakeout, which firms and executives will emerge as the industry's new leaders? It's too soon to tell, say industry experts.

Many commercial real estate owners worry about the lack of liquidity and believe it's critical to have cash on hand in case of an urgent development as the economic slowdown drags on.

“We just did a deal with somebody who paid a $400,000 prepayment penalty to refinance their deal with us today because the borrower wanted to have a rainy day fund of $2 million,” explains William Walker, president and CEO of Bethesda, Md.-based intermediary Walker & Dunlop. The loan wasn't even due, Walker says. “He did the new deal just so he could have $2 million in his back pocket.”

In his shop, Walker had planned to launch a multifamily equity fund to acquire stable Class-B multifamily units, invest $5,000 to $10,000 per unit in upgrades, raise rents and realize projected returns of 13% to 15%. But the investors he contacted injected a dose of reality.

“Equity investors are really looking for vulture opportunities rather than stabilized asset returns,” Walker learned. They said 15% wouldn't do — they wanted returns on investment of at least 20%. “So we modified our fund from a straight-out equity fund to a mezzanine fund.”

Conduits test the water

While some CMBS lenders say the recovery of the securitized financing market is at hand, Sublett thinks that's premature since spreads haven't narrowed and stabilized enough to make the offerings attractive.

Despite the steep drop in conduit issuance, CMBS, collateralized debt obligations and similar issues hold nearly one-fourth of U.S. commercial and multifamily mortgages, or $777 billion, according to MBA.

Marcus & Millichap's Hughes agrees that the conduit market isn't yet ripe for a big rally, but he believes activity could pick up in the fourth quarter. Conduit lenders are already knocking on his door.

“Four or five of them have approached us,” Hughes says. But before conduits return to the market, their spreads have to improve. “If you could do a 10-year fixed-rate deal at less than 7%, that seems to be the entry point.”

Yield spreads on the safest AAA-rated CMBS widened from 150 to 160 basis points over interest rate swaps in late June, according to *Commercial Mortgage Alert*. (Those spreads are based on fixed-rate loans with an average life of 10 years). The widening spreads for AAA-rated CMBS were well above the 52-week average of 122 basis points.

Although intermediaries may be interested in conduit deals, lenders aren't stepping forward, Hughes concedes. “What's the old line, ‘Nobody wants to be the first to catch the falling knife?’”

Denise Kalette is senior associate editor.

Want to use this article? Click here for options!
© 2007 Penton Media, Inc.

Find this article at:
http://www.nreionline.com/industrynews/real_estate_hunting_revenue_0701/index.html

Check the box to include the list of links referenced in the article.

2008 Penton Media, Inc. All rights reserved.