Real Estate Finance & Investment

REFI Breakfast: Alternative capital replace banks as construction capital provider

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With Basel III categorizing construction loans as high volatility commercial real estate, banks are increasingly squeezed out of the role as capital provider for development projects, according to panelists at REFI's latest breakfast briefing.

"At this point, I am not seeing any [of the institutional banks providing] construction loans for condos, except maybe HSBC and Wells [Fargo], other than some outlying cases with very strong sponsor like Related," commented Stephen Schweiger, a director in the real estate group at law firm Goulston & Storrs. He added that development projects are considered more risky in a city like Manhattan where land price is so high.

Indeed, with land prices having increased dramatically, developers are extremely cautious. Most prefer to stick to gateway cities, including New York, Boston, South Florida, Chicago and Los Angeles, with the exception of apartment projects in secondary and tertiary cities.

"Land prices in Brooklyn are rising more steeply than Manhattan on a percentage basis," pointed out Nick Werner, a co-founder at Largo Investments, a private real estate investment and development firm targeting multifamily real estate. He recalled having purchased land in Williamsburg, a popular neighborhood in Northern Brooklyn, for $250 per square foot three years ago. The price tag for land in that submarket has risen significantly, ranging from $600 to $700 per square foot. "There's no budging, if you want to be there and buy something, you have to pay the price. We have adjusted to being more selective," he said.

On the bright side, with plenty of capital and alternative debt platforms, borrowers are able to secure affordable financing if the basis of a development project is sound. "If you have a developer willing to sign a repayment guarantee, you can go to banks to borrow cheaply, in the 2% range for apartments and 3-4% for condo," said Ari Hirt, managing director of the debt and equity finance group at Mission Capital Advisors.

Hirt added that if a developer does not want to sign a repayment guarantee, other options include public real estate investment trusts or debt funds. Mortgage REITs typically ask for a minimum of 20% equity and the loan is sized at 60% to 70% of projected sellout value.

Debt funds can take down the entire capital stack and split the loan into senior and mezzanine tranches post closing, selling the senior debt to banks who need a 3% to 4% return and holding the mezzanine piece at a high interest rate. “Even though it could be cheaper to go directly to a senior lender and a mezzanine lender, many developers prefer a one-stop shop, as one of the biggest cost overruns in a development deal is time. In choosing two separate lenders, you will need time to work on the inter-creditor agreement and deal with multiple set of attorneys and requirements, which could extend the closing timeline,” Hirt explained.

Indeed, developers wishing to limit their personal liabilities often seek non-recourse, or sans repayment guarantee, debt. But with Basle III regulations altering the composition of the capital stack, specifically the 15% equity requirement from borrowers, banks are finding it increasingly challenging to compete with non-traditional lenders. “Banks can buy a piece of deal originated by another [debt] fund, but that’s not common. [The new regulation] is almost like they are advocating demise of the banks, limiting the banks’ ability to originate,” commented Schweiger.

Banks are responding in varying degrees to Basel III, and most of them asks for subordinate debt in the form of preferred equity and not mezzanine. “In today’s changing environment of risk, an originator at a bank will quote you based on what he thinks will be approved. Most banks don’t want [mezzanine debt] behind them. [The banks] definitely want to make sure you have enough money in the game,” said Hirt, adding that every construction loan has to be in balance.

All in all, panelists agreed that fundamentals remain strong across all real estate classes with tremendous capital, domestic and international, willing to lend. New York market continues to see robust demand for housing. Supply is tight and rental vacancy is at 3.45%, according to a 2014survey from NYC Housing Preservation & Development. Opportunities include The Bronx, Bushwick (an up-and-coming Brooklyn submarket) and Long Island, according to panelists, “Anywhere in New York with a close commute to Manhattan.”

But when it comes to discovering the next “emerging market,” Werner cautioned against overpaying. “The problem with emerging market is an emerging market [that] wants a non-emerging market price.”

Background

The difference between a repayment guarantee and a completion guarantee is that the former provides full repayment of the loan amount if the borrower defaulted whereas latter promises a one- time, lien-free completion that expires when the building receives a certificate of occupancy. In contrast, a repayment guarantee not only guarantees construction completion, it also safeguards the lender in the case where an asset fails to sell.