INVESTCORE COMMERCIAL

BOOTS ON THE GROUND

How many times have you been asked about cap rates and when they'll begin to rise again? In order to answer that question, it's important to understand what's happening with interest rates. As of today, the 10-Year Treasury is 2.90% up fifty basis points from December 2017. In December as Janet Yellen's term as Federal Reserve Board Chair neared its end, the central bank's Federal Open Market Committee voted after a two-day meeting to increase the federal funds rate by twenty-five basis points, to a range of 1.25% to 1.50%. Two and a half months later, we're seeing and feeling those effects.

In January the Fed voted to leave the interest rate unchanged setting the stage for another rate hike in March when the board meets again under the new Board Chair, Jerome Powell. Powell, who has supported the policies of the Yellen Fed, is expected to continue the gradual rise of interest rates throughout 2018.

As interest rates continue to rise, buyers who plan on using leverage will ultimately have to adjust their purchase parameters and seek higher cap rates in order to attain positive cash flow. This will cause lower cap rate inventory to accumulate eventually forcing sellers to reduce pricing. As the pool of all-cash buyers thins, pricing will slowly adjust to compensate for the higher interest rates. We are already seeing the effects of this with the reduction in pricing of assets in secondary and tertiary markets. Well-located assets in primary markets will be the last to feel the pressure and until interest rates increase enough to give investors an alternative, expect these investments to be in demand.

In order to get a better handle on what financing will look like for the remainder of 2018, we sat down with Cody Charfauros, Vice President, Commercial Mortgage Banking from Barry Slatt Mortgage.

ICC: Cody, you are fresh off the 2018 Mortgage Bankers Association - Commercial Real Estate Financing Conference (MBACREF) which took place here in San Diego. Can you give us some of your biggest take-aways?

JUST SOLD

Starbucks | Englewood, CO
$2,740,000 (4.93%)

JUST SOLD

Red Wings Shoes | Houston MSA, TX
$1,100,000 (6.49%)

UNDER CONTRACT

Starbucks | San Diego, CA
Asking Price: $3,350,835 (3.75%)

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Cody: The number one biggest takeaway is that we're in a highly-liquid market. Banks and Credit Unions are very active on the short side of debt in the 3-7 year fixed range, and those that are backed by larger institutions such as life insurance companies are being particularly aggressive with their loan spreads. On the longer side for terms north of 7 years, life companies and conduit lenders are competing on very low spreads over US Treasuries or Swaps which is helping keep real interest rates lower on quality properties. As you stated, real interest rates are increasing, and the net effect is most immediately felt on older-quality properties in secondary markets.

ICC: What is the general sentiment in the lending community and will this high liquidity continue?

Cody: Sentiments are very high and most of our lenders have increased their allocations for real estate lending above their record production levels in 2016 and 2017. That said, all of the lenders we surveyed feel that there will be a slow-down in the number of loan requests as the so-called wall of maturities (the period where a large number of 7 and 10 year balloon loans were originated in '05-'07) passes us and they are anticipating having to compete more aggressively for the non-peak refinances and new sales business. That is forcing them all to lower their spreads to remain competitive.

ICC: Does that mean loan underwriting guidelines will shift back to more aggressive pre-recession norms?

Cody: We don't think so since regulation and, really, attitude forced a fundamental shift in the way typical deals are underwritten. Couple that with a general concern over cap rates and some shifts in asset type positioning (read: rural regional mall-style retail) mean lenders are hardly pulling the wool over their eyes right now just to make loans happen. Loan delinquency is at all-time lows and the feeling is that isn't likely to change even if there is some sort of market disruption. They're happy to continue doing what has been working.

ICC: You mentioned malls as being problematic; does that attitude extend to other types of retail?

Cody: Generally, no. Lenders have followed the recent investor sentiment with a larger emphasis on "experiential" retail such as gyms, restaurants, entertainment, etc., but really what it comes down to is future-proof retail. It's hard to imagine the dollar stores, fast food and the kind of neighborhood-oriented retail strip centers (nail salon, sandwich shop, donut shop, massage) from being moved to an Amazon Prime delivery kind of world. It also helps that in-fill retail tends to occupy fundamentally good real estate (access to arterials, hard corners, signage, etc) which lenders like to see as well.

ICC: What surprising thing did you hear at the conference?

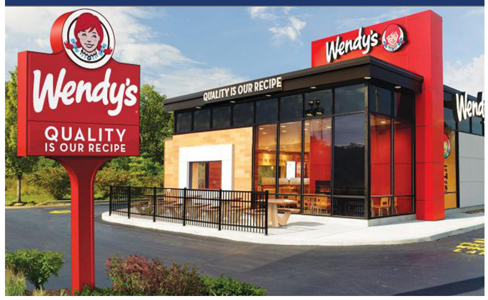
Cody: Medical office is in vogue, such as the branded Davita/Fresenius in or near traditional retail locations are look at very favorably. This is something of a surprise since just a few years ago the concept was fairly new to the broader lending community.

ICC: What would you say is a key factor for every real estate investor to keep in mind right now?

Cody: Lenders are in a time of transition adjusting to many things including higher US Treasuries, a maturing real estate cycle, the second year of President Trump's economic policies and the proposed changes to the tax system, all of which affect the macroeconomic climate and lenders' shifting appetites for lending. There was a time when you could have one go-to lender that would lend on nearly all your properties including homes and investment real estate all under one roof together with your deposits and business lines and credit cards. That sort of savings and loan or community banking model has been in decline for decades but because of the fundamental shifts in the market during the downturn, those days are pretty well over. Real estate investors must now cast a wider net to remain competitive and the loan structure remains a key component in an investment's profitability.

Recently funded by Barry Slatt Mortgage:

Wendy's



Mt. Orab, Ohio

- 5-year fixed, 10-year term, 25-year amortization.
- Very low-4% range, locked at application for 75 days.
- Declining prepay 4-3-2-1-0…0%
- Recourse to the entity only.

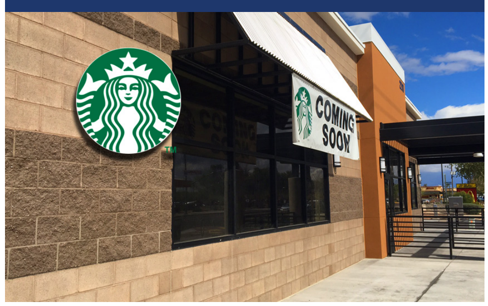
Habit Burger + Sleep Number

Millenia Plaza –Orlando, Florida

- 10-year fixed, 30-year amortization.
- Very low-4% range, locked at application for 60 days.
- Declining Prepay 3-3-2-2-1%
- Limited-recourse to 25%

**Barry Slatt Mortgage is servicing the loan.*

Starbucks



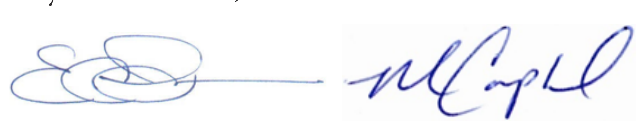
Mesa, Arizona

- 10-year fixed, 30-year amortization.
- Very low-4% range, locked at application for 75 days.
- Declining Prepay 3-2-1…1%
- Non-recourse.

If you would like to contact Cody directly he can be reached at (858) 257-2110 or codyc@slatt.com. To visit Barry Slatt Mortgage online, www.slatt.com.

The takeaway: Interest rates are rising, but cap rates will remain steady until investor demand shifts. Lenders are ready to compete for your business and have increased their allocation above record production levels. Amazon resistant tenants are in demand, medical office is finding footing within the quasi-retail niche.

See you next month,



Eddie & Mike

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