Lending Mood

How institutions are approaching real estate deals today

BY DAVID SHUBS

In 2008, credit markets tightened, the major North American stock markets lost up to 40 percent, investor confidence was at an all-time low and the market started a downturn not seen since the 1930s. Over the last 24 months we have been inundated by forecasters providing their opinions on the future state of real estate and the economy.

Ontario Home Builder took this opportunity to interview two of the leading lenders in the Canadian real estate industry. The goal was to learn from their experience and understand what they are seeing in the market. CIBC's real estate team comprising Rob Callander, Senior Director and Head of Real Estate, Peter Block, Senior Manager, Lindsay Brand, Associate, and National Bank Financial's Neil Carpenter, Senior Manager Commercial Lending.

Q: There are conflicting opinions on where real estate prices are heading. How do you see the market moving?

CIBC: In the past year real estate prices have enjoyed a strong upswing from the early 2009 lows. Recent data, however, gives us reason to believe that stabilizing forces are already at play and housing prices will climb very slowly moving forward. According to a recent report by Benjamin Tal, Senior Economist at CIBC, home prices are starting to respond, with price growth slowing as a result of increasing supply and moderating sales velocity.

NBF: Long-term interest rates will be heading higher and cap rates will follow suit. In the short-run, prices may move sideways, but longer term they will weaken somewhat. In the case of housing, personal incomes haven't kept pace with price increases and that can't continue indefinitely. If the incomes aren't there to maintain the affordability balance, prices will have to retreat.

Q: Interest rates are at near historic lows. How does that change/affect your lending rates?

CIBC: Over the latter part of 2008 and through 2009, loan spreads returned to more sustainable levels, not only in the real estate sector, but across the entire banking industry. Current spreads, although slightly higher than they were several years ago, coupled with the low prime rates, leave borrowing costs at historic lows.

NBF: Lending rates and spreads are largely dictated by market forces and competitive pressures. However, industry spreads remain wider than they were prior to the credit crisis. Low rates impact underwriting. Higher, "normalized" interest rates are employed to study rate rollover risk.

Q: What are the key criteria that you look for when lending?

CIBC: At a high level we look to the fundamentals of the project and the strength of the sponsors. *(Continued on page 60)*

(Continued from page 55) When you analyze a project, you need to know that there is a market for it so you look at the location, the success of nearby projects and local demographic trends; for residential projects, you look at the number of units that are pre-sold, or for commercial projects, the amount of space that has been pre-leased and to whom. We also look to the level of purchaser deposits, both as a source of funding and a demonstration of commitment by the buyer. Equity also is an important component; this demonstrates that the builder has the requisite financial resources and a strong commitment to the success of the project.

As for the sponsor, you need to know their reputation and track record within the industry, including a solid understanding of their past experience as a developer and an awareness of their active projects. From a lending perspective, it is important for us to know what exposure we have outstanding to the developer, their financial resources, including liquidity, and their ability to support the project to completion.

NBF: In order of priority...the three exit mechanisms of cash flow, collateral and covenant.

The quantity and quality of cash flow streams are of equal importance. The impairment in collateral value from an upward change in cap rates can be bad enough, but coupled with an unexpected loss of cash flow, the impairment can be devastating. If the repayment source must be collateral, there is the added wrinkle of liquidity. Finally, collecting on covenant, whether borrower or guarantor, will always be viewed as a last resort.

Where we're talking about condo construction, the amount of builder equity is key as it affects the level of pre-sales needed to repay the construction loan. Most lenders would prefer to see the pre-sales level sufficient to fully retire the loan. Other important factors include both the size and timing of collection of the various deposits, the qualification of buyers (i.e. confirming buyers' ability to close either with or without financing) and limits on buyers of multiple units.

Q: What is the time frame to get a deal done?

CIBC: The time frame varies for a range of reasons, mainly the size, complexity of the transaction and the timelines available. Our process begins with a general review of the project and preliminary analysis. If we believe that the bank can support the project, we will prepare and issue a discussion paper to the client within one and a half to two weeks. Provided that our agreed structure meets the borrower's needs, we move into our formal credit application and approval process, which takes roughly three weeks. Depending on the complexity of the deal, market conditions and timing, this step in can take longer. Following approval, you can expect a deal to close anywhere within two to six weeks. The whole process can, of course, be compressed where timelines are tight.

NBF: Typically, a month to six weeks from start to finish. Syndicated deals, involving multiple parties, will inevitably require longer. **OHB**

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