COMMERCIAL REAL ESTATE LENDING TRENDS 2017

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NATIONAL ASSOCIATION OF REALTORS®
2017 OFFICERS

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INTRODUCTION

Commercial real estate found itself at the intersection of major global changes during 2016. Activity remained moderate in the world’s economies, with further monetary easing continuing on several continents, according to the Expectations & Market Realities in Real Estate 2017: Intersection of Global Change report, released by Deloitte, the National Association of REALTORS®, and Situs RERC. The same year of the Rio Summer Olympics and record highs for United States (U.S.) financial markets, saw global central banks drop interest rates into negative territory, and several South American economies battling recessions, in addition to geopolitical turmoil in the Middle East. In addition, Europe faced the surprising outcome of the United Kingdom’s referendum to exit the European Union (Brexit), while the U.S. awoke to an unexpected winner in the Presidential election.

While global economies moderated in 2016, U.S. gross domestic product (GDP) maintained its moderate upward trajectory, as employment growth maintained momentum, and housing prices reached new heights. Highlighting improved confidence, the Federal Reserve signaled a shift in its monetary policy by raising its target funds rate for the second time in a decade in December of 2016, followed by an additional 25 basis point increase in March of 2017, and the expectation of additional hikes.

Commercial investments mirrored the global uncertainty in 2016, with a 16 percent decline year-over-year, on total volume of $826 billion, according to Real Capital Analytics (RCA). Commercial investments in large capitalization U.S. markets totaled $489 billion, representing an 11 percent drop from the prior year. Amid a low-yield environment, investors continued seeking higher returns, even as the available inventory continued shrinking. This search brought investors to secondary and tertiary U.S. markets, which offered strengthening economies, rising employment and solid fundamentals.

With rising demand across all property types, vacancies continued on a downward path. As an exception, apartment properties experienced upward pressure on vacancies as rising new supply came on the market during the year. Commercial rents advanced for all property sectors, with industrial posting record gains during the year.

In contrast to the large cap commercial market reported by RCA, most REALTORS® who specialize in commercial real estate managed transactions averaging less than $2.5 million per deal, frequently located in secondary and tertiary markets. The 2017 Commercial Real Estate Lending Trends shines the spotlight on this significant segment of the economy.
Lending conditions in REALTOR® markets were impacted by increasing regulatory oversight of commercial real estate allocations on banks’ balance sheets. As commercial asset prices reached new highs in large cap markets, federal regulators voiced concerns about the trend’s sustainability and overall sector performance. Even as market fundamentals advanced, boosting cash flow growth, lending conditions tightened for the second consecutive year. The main sources of capital for REALTORS®’ commercial real estate clients remained local and regional banks, which made up 58 percent of funding in 2016.

The incidence of failed transactions, due to lack of financing reached a new low. REALTORS® cited regulatory uncertainty for financial institutions as the most relevant cause of bank capital shortage for CRE.
ECONOMIC OVERVIEW
ECONOMIC OVERVIEW

Gross Domestic Product

Economic output in the U.S. continued advancing during 2016, but at a slower pace. Gross domestic product (GDP) rose at 1.6 percent, on par with the pace set in 2011. The gain marked the seventh year of post-recession economic growth. In the context of the global economic landscape—especially given broader weakness—the U.S. economy constituted a relatively brighter landscape.

Gross domestic product had a slow start in the first quarter of the year, with a slight 0.8 percent increase. Economic activity picked up in the second and third quarters. However, financial markets’ uncertainty—spurred by the summer United Kingdom’s (U.K.) Brexit results and the acerbic U.S. election—led to slowing momentum in the fourth quarter.

Consumers maintained their role as the engine of economic growth in 2016, with consumer spending comprising 69 percent of real GDP. Boosted by rising employment, consumer expenditures rose during each quarter of the year, closing the year 2.7 percent higher on an annual basis. On balance, consumers spent more on both goods and services in 2016. Purchases of durable goods—cars and light trucks, furniture and appliances, and recreational goods and vehicles—increased by 5.8 percent on an annual basis. Nondurable goods spending rose by 2.5 percent. Consumers also spent more during the year on health care, recreation, as well as hotels and restaurants.

Business investments, which typically make up 13 – 15 percent of GDP, displayed a more downbeat performance. Spending by companies declined 3.4 percent in the first quarter of 2016 and the subsequent recoveries were not enough to overcome the initial hurdle, closing the year with a 0.5 percent slide. Companies cut back on commercial construction and equipment spending.
Investments in intellectual property products rose at a 4.7 annual rate, boosted by double-digit increase in software expenditures.

Exhibit 2.4: Real GDP Business Investments (% Annual Chg.)

While international trade continued as a mainstay in the U.S. economy, 2016 witnessed a domestic trade sector impacted by the strengthening dollar. U.S. exports rose at a modest 0.4 percent during the year, while imports—a negative contributor to GDP—advanced at a 1.2 percent annual rate, keeping the balance of trade at a negative $563 billion for the year. The gain in export activity boosted demand for industrial space, especially along the East coast, as ports welcomed the opening of the Panama Canal expansion.

Exhibit 2.5: Real Net Exports (SAAR, Bil. Chn. 2009$)

Government spending—another major GDP component—posted a modest 0.8 percent annual gain during 2016. Higher spending by state and local governments contributed the bulk of the increase, as rising property values added to local tax revenues. The federal government increased its spending by 0.6 percent over the year, as nondefense spending outweighed defense cuts.

Exhibit 2.6: Real Government Expenditures & Investments (% Annual Chg.)

Source: Bureau of Economic Analysis

Exhibit 2.7: Real GDP Business Investments (% Annual Chg.)

Source: Bureau of Economic Analysis
Employment

Payroll employment closed the year on a positive note, with 2.2 million net new jobs. The sectors with the largest gains were in the Education & Health, Professional & Business Services, and Leisure & Hospitality industries. Retail trade and financial activities also experienced solid gains. As employers in these sectors expanded their payrolls, demand for commercial properties increased, leading to lower vacancies and higher cash flows. The unemployment rate declined from 4.9 percent in the first quarter of 2016 to 4.7 percent by the close of the year. The average duration of unemployment declined from 29 weeks in the first quarter to 26 weeks by the end of 2016.

The labor force participation rate (LFPR) declined from 62.9 percent in the first quarter of the year to 62.7 by the end of December 2016. However, on balance, the 2016 LFPR was a notch higher than that recorded in 2015, and based on first quarter 2017 data, the momentum seems to be moving in an upward direction.
Housing

The U.S. population has grown about nine percent during the past decade, reaching 324 million in 2016. Historically, population growth has translated into 1.3 million new households each year. During the 2008-09 recession, household formation averaged a mere 265,000 new household. The figure rebounded in the ensuing years, with the average over the 2010-16 period reaching 874,000.

While demand for housing has been on a rebound toward long-term trends, housing supply has not matched it. The historical average for housing starts hovered around 1.4 million per year. During the 2008-09 span housing starts dropped to an average of 529,000 units. Since 2010, housing starts have averaged about 600,000 new units per year, falling short of the number of new households.

Compounding the housing shortage, the inventory of existing homes, which runs at six months’ supply during a balanced market, has been on the decline. In 2016, it reached an average of four months, with the December figure dropping to a low of 3.6 months, one of the thinnest levels of inventory recorded in the past 15 years.

Exhibit 2.9: Completions & Household Formation

New Housing Completions ('000s)
Household Formation ('000s)

In response to the tight housing inventory, home prices have been rising at a fast pace over the past few years. The annual median price of existing homes reached $233,800 in 2016, a record high. The price appreciation has boosted homeowners’ wealth, with the aggregate U.S. household wealth tied to real estate reaching $23.1 trillion in the fourth quarter of 2016. The figure represents a new high, surpassing its prior peak from the second quarter of 2006, during the last housing boom.

Concurrently, the rising cost of housing has broadened the divide between homeowners and renters. For consumers who participate in real estate markets, the recovery has been positive, leading to an improved outlook. However, for consumers—especially young professionals and first-time buyers—wage growth has not kept pace with housing costs, leading to an increasing share of household budgets allocated to housing costs.
Monetary Policy

The Federal Reserve took a measured approach to its monetary policy during 2016. The Federal Open Market Committee (FOMC) used the early part of the year to monitor labor markets and inflation trends, employing its forward guidance mechanism to inform markets about its view on the economy and likely rate adjustments. Consequently, its December 2016 increase in the funds target rate of 25 basis points did not come as a surprise. The FOMC Chairwoman, Janet Yellen, underscored the bank’s optimistic outlook when she mentioned that several rate adjustments were expected in 2017. The FOMC followed up on those statements in March of 2017, with another 25 basis-point rate increase.

Exhibit 2.11: FOMC Fed Funds Target Rate (%)

While longer-dated bond yields spent the better part of 2016 below 2.0 percent, they registered an increase after the Presidential election, with the 10-year Treasury note closing the year at 2.5 percent. By April of 2017, the 10-year Treasury note yield had declined to 2.3 percent. For commercial real estate investors, the spread between the 10-year Treasury note yields and cap rates remained at over 400 basis points. However, the Federal Reserve, along with the other major bank regulating agencies, expressed in public comments concerns about the high levels of pricing in commercial markets. The comments ushered increased examiner scrutiny of banks’ balance sheets and their allocations to commercial loans.

Exhibit 2.12: Spread Between 10-Year Treasury Yield and Cap Rates

During 2016, inflation continued its ascent breaking the 2.0-percent threshold for both headline and core components. With the cost of housing components—rent and Owners’ Equivalent Rent—comprising about 30 percent of the Consumer Price Index, and prices on the rise, inflation is projected to continue above 2.0 percent in 2017.
Monetary Policy

Outlook

The economic outlook for 2017 calls for moderately positive expansion, with GDP projected to close the year 2.3 percent higher on an annual rate. Payroll employment is projected to advance at an annual rate of 1.7 percent, driving the unemployment rate to 4.6 percent by the end of the year. With the Federal Reserve expected to continue increasing the funds target rate, U.S. inflation is expected to reach 2.6 percent in 2017.

Exhibit 2.13: U.S. Economic Outlook—April 2017

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<td>Consumer Confidence</td>
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<tr>
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Source: National Association of REALTORS®
COMMERCIAL REAL ESTATE
COMMERCIAL REAL ESTATE

Fundamentals

Commercial market fundamentals marched to a steadier beat during 2016 compared with the investment environment. Demand for properties remained solid throughout the year, leading to declining vacancies and rising rents. There were, however, variations in each property sector.

As professional and business services contributed the highest number of net new jobs in 2016, office-using industries drove demand for office space. Office net absorption totaled 26.9 million square feet in the first three quarters of the year, complemented by another 13.0 million square feet in the last quarter, based on data from CBRE. Even with 37.1 million square feet of new supply, office vacancy declined to 12.9 percent by year-end, the lowest level in eight years. In a twist from the past few years’ trend, suburban office rebounded strongly, driving the vacancy declines. Rents for office properties rose 6.0 percent during the year, the fastest annual pace since 2007, reaching $31.6 per square foot by the fourth quarter.

Riding the winds of rising imports and growing online commerce, industrial properties maintained a sustained pace in 2016. Net absorption totaled 251.3 million square feet during the year, based on data from CBRE. Construction of industrial space, while accelerating, did not keep up with demand—completions totaled 178.7 million square feet. National vacancies for industrial buildings dropped to 4.7 percent by the fourth quarter, resulting in surging rent growth. Net asking rents increased 6.3 percent over the year, to $6.6 per square foot by year-end, the highest change since 2007.

Retail fundamentals benefitted from growing consumer spending and confidence, posting declining vacancies and rising rents. Net absorption for retail properties totaled 74.8 million square feet in 2016, outpacing by a wide margin the 51.5 million square feet of new completions, according to CBRE. The retail availability rate declined slightly during the first two quarters, but flattened out in the latter half of the year, at 7.1 percent. A significant number of department store closures coupled with struggling class B and C power centers and malls proved a noticeable driver of the slowdown in the downward trajectory of retail vacancies. National retail rents continued advancing in 2016, marking 12 consecutive quarters of growth. The net asking rents reached $16.6 per square foot by the end of the year.

Household formation gains kept demand for multifamily properties on an upward path in 2016. However, accelerating supply of new apartment units began to add downward pressure on rents during the year. Multifamily net absorption reached 201,000 units by the end of the year, a 4.9 percent increase from 2015, according to data from CBRE. Completions picked up the pace, jumping by a sharp 21.4 percent from the prior year, to a total of 242,800 units. With supply outpacing demand, vacancies rose to 4.9 percent by the fourth quarter of 2016, a 30 basis-point upward change. Multifamily rents inched up slightly, rising 0.2 percent for the year.
Large Cap Investments

Commercial real estate investment trends mirrored the global economic slowdown and broader uncertainty in 2016. Sales of global large capitalization (cap) transactions—over $2.5M—declined 15 percent year-over-year, with volume totaling $826 billion, based on data from Real Capital Analytics (RCA). Investors took a pause from the strong pace of investments recorded in 2015, ascertaining the impact of economic and geopolitical changes upon markets. Commercial investments in the U.S. echoed the global trends, with sales volume in large cap markets closing the year at $489 billion, an 11 percent decline on a yearly basis.

The silver lining for U.S. commercial properties came from the comparative strength of the U.S. economy and higher yields of U.S. assets. With global economies slowing in 2016, U.S. property markets remained a favorite destination for cross-border investors. While top-tier markets in gateway cities continued as major targets of investor activity, the higher yields and advancing economies of secondary and tertiary markets offered viable alternatives to investors looking for stronger returns.

Pricing reflected investor uncertainty, with U.S. cap rates moving sideways during 2016 at 6.8 percent. With tight inventory in major markets, investors remained willing to pay higher prices for commercial assets. Based on RCA’s Commercial Property Price Index, commercial prices rose 9.0 percent in 2016 compared with the previous year. For apartments and office properties in central business districts, pricing levels reached new records.
Small Cap Investments

In comparison to the high-end deals, 83 percent of REALTORS® who specialize in commercial investments reported transactions below the $2.0 million threshold in 2016. Although many REALTORS® participate in transactions above $2.0 million per deal, they serve a segment of the commercial real estate market for which data are generally not as widely reported—small cap investments.

Based on National Association of REALTORS® (NAR) data, commercial real estate in small cap markets continued on a divergent path, with sales volume accelerating during 2016. REALTORS® reported continued improvement in fundamentals and investment sales. Following on the first and second quarters’ above-8.0 percent advances in sales volume, and the third quarter’s 11.0 percent gain, the last quarter of the year witnessed sales volume rising 12.9 percent compared with the same period in 2015.

As domestic and international investors across the value spectrum broadened their search for yield into secondary and tertiary markets, the shortage of available inventory remained the number one concern for commercial REALTORS®. Prices for small cap commercial properties increased at an average of 5.9 percent during the year. The data underscore an important point about the recovery and growth in small cap markets. The rebound in smaller markets lagged by three years that of large cap markets, providing investors in these markets opportunities for continued growth.

Exhibit 3.3: REALTOR® Commercial Real Estate Markets (YoY % Chg)

Source: National Association of REALTORS®
Capital Markets

U.S. capital markets had a banner year in 2016, even accounting for volatility. The U.K.’s Brexit provided an unexpected shock mid-year for equity markets. However, as investors absorbed the fact that the process would unfold over a longer period, and that many of the details—Article 50 of the Lisbon Treaty, multilateral trade agreements, immigration etc.—were uncertain, the markets rebounded. Equity markets experienced another short-lived bout of volatility related to the U.S. presidential election. However, the post-election environment was marked by major stock indices reaching record highs—the DJIA Index surpassed the 20,000 mark, the S&P 500 Index closed in on a 2,400 high, and the Nasdaq Composite came within 88 points of a 6,000 record value.

The events left their imprint on bonds as well, with 10-year Treasury rates riding a roller-coaster pattern during 2016. The early part of the year witnessed Treasury rates around 2.1 percent. In the wake of Brexit, Treasury rates plummeted to a low of 1.37 percent, as markets reacted to the shock of the referendum outcome. Rates rebounded through the third quarter, reaching around 1.8 percent by early November. Post-election, Treasury rates registered a noticeable jump, closing 2016 at 2.5 percent. The rate movement moderated in the first quarter of 2017, hovering in a 2.3 – 2.5 percent range.

With the volatility in financial markets, commercial real estate offered solid performance and steady returns. Based on Situs RERC’s institutional investment survey data, investors continued to lean toward commercial real estate over alternative investments in 2016, for the sixth consecutive year. The investment environment for commercial markets remained well-diversified, totaling $6.6 trillion in 2016. Debt investments accounted for 57 percent of total, with equity comprising the rest.

On the debt side, chartered depository institutions (banks) accounted for the bulk of capital providers, with a little over half of total market holdings, based on data from the Federal Reserve. The second largest share of debt holders was comprised of government sponsored enterprises (Fannie, Freddie), which accounted for 18 percent of debt investments, dominating the multifamily
Capital Markets

Life insurance companies held 11 percent of commercial real estate debt, followed by securitized debt holders—commercial mortgage backed securities (CMBS), collateralized debt obligations (CDOs), and other asset backed securities (ABS)—making up 10 percent of total. U.S. offices of foreign banks accounted for two percent of total debt holders.

On the equity side of commercial real estate financing, where equity investors held $2.9 trillion in assets, private equity accounted for 55 percent of capital, followed by listed and non-listed REITs, which made up 31 percent of financing in 2016, according to Situs RERC. Pension funds, both domestic and cross-border were the third largest capital provider group, representing 5 percent of the equity market. The remainder was distributed between groups comprised of life insurance companies, commercial banks, corporations, foreign investors and others.

Exhibit 3.6: CRE Equity Investments

- Private Equity
- REITs
- Pension Funds
- Life Insurance Cos.
- Commercial Banks
- Corporations
- Foreign Investors
- Gov't, GSEs & Others

Sources: Situs RERC, NAREIT, PREA, AFIRE, Prequin, Real Capital
Large Cap Lending

Lending for commercial real estate mirrored a slowing investment environment in large cap markets. Lenders completed $491 billion of mortgage loans secured by U.S. commercial properties during 2016, according to the Mortgage Bankers Association. The figure represents a three percent decline from 2015, with the fourth quarter’s seven percent year-over-year drop in loan originations accelerating the year’s slide.

Based on RCA data, the financing landscape in large cap markets remained diverse during 2016. Government agencies (Fannie Mae and Freddie Mac) captured 22 percent of total lending during the year, a larger share than in 2015, positioning them as the most active lender. The change was not surprising considering that apartment properties accounted for the largest sales volume across all property types.

Exhibit 3.7: Real Capital Analytics Lending Sources ($2.5M+)

Regional and local banks comprised 20 percent of total lending during the year, an increase from the prior year. CMBS originators accounted for 13 percent of lending at the high end of the market, a marked shift considering that they were the dominant player in commercial financing for several years. Life insurance companies were the fourth most active lenders for commercial transactions, accounting for 12 percent of transactions during 2016, according to RCA. They were followed by financial companies, which captured eight percent of lending deals. Private lenders were a smaller part of the funding sources, comprising only two percent of financing transactions.

Banks ask for too much, i.e., large down payments, additional collateral, repeated reporting of buyers’ financial condition, some ask for reports every 6-12 months. Many investors have paid off loans in an effort to eliminate the lenders over-reaching requirements, which in turn could slow down the number of sales in the market. Banks called 100% performing loans in order to raise capital, which impacted the market values and flooded the market with too many properties to absorb. Banks packaged up loans to sell to vulture note buyers. Caution continues to hold the market back from full recovery.

- Texas

Dodd Frank has held back the economy. Too many hoops to jump through and then you don’t qualify. Appraisers are also a huge part of the problem with low appraisals.

- South Carolina

Appraisals down slightly, banks still very conservative on their lending standards, particularly with new construction.

- Pennsylvania

These days, most residential loan brokers do residential, commercial, SBA, etc. [...] Loan officers (LO) often don’t have any experience in commercial. They advertise, take the loan, find a lender and give them the file and wait at the mercy of the bank rep to tell them what they need [...] But if the LO is experienced, they can probably tell within 15 minutes if the file is eligible for the loan.

- California
Small Cap Lending

Based on NAR’s 2017 survey data, capital markets displayed a fundamentally different landscape. Local and community banks were the largest lending source in REALTORS®’ commercial markets during 2016, accounting for 32 percent of transactions. Local and community banks maintained their market share over the past several years. The second largest capital source in 2016 were regional banks, which captured 26 percent of REALTORS®’ commercial deals, on par with the previous year.

The lending survey highlights the marked differences between the large cap versus the small cap commercial markets. Debt financing represents a much-larger portion of capital in small cap markets, whereas large cap deals benefit from significant equity contributions.

I believe that Dodd-Frank and the CFPB have made banks skittish on lending, especially smaller local/regional banks. That said, they are still lending and seem to be somewhat flexible to get deals to close. One big problem we’ve experienced is that the big banks, (PNC, Santander, BB&T, etc.) are very rigid in their qualifications and will not budge to help overcome even minor obstacles. Furthermore, many of these larger banks will decide they don’t want certain loans anymore and thus make it very difficult to reset the loan when the term is up, forcing appraisal fees and other costs onto the borrower or forcing them to go to another lender which takes time/money to complete.

- Pennsylvania

Small banks need to have the regulatory mandates lifted then increased funding will occur. Small town Broker.

- Texas

Nonrecourse financing seems to only be available on larger deals—over $5MM—where the principal borrowers have substantial assets, which would make personal guaranties meaningful. That never seemed rational to me.

- Mississippi
Small Cap Lending, continued

For regional and community banks, which accounted for 58 percent of all capital in REALTOR® markets, compliance costs stemming from financial regulations have made a stronger impact on available capital for commercial deals. With higher costs of compliance and higher capital reserve requirements for commercial loans, compounding rising scrutiny from banking regulators, regional and community banks have been more cautious in their lending during 2016, resulting in tightening of capital. In 2016, 37 percent of REALTORS® reported tightening lending conditions, compared with 33 percent in 2015, 22 percent in 2014 and 28 percent in 2013.

In addition, 51 percent of REALTORS® reported that insufficient bank capital remains an obstacle to commercial sales in small cap markets. Regulatory uncertainty for financial institutions was the main reason for the banks’ restrictive approach to commercial lending, followed by proposed legislative and regulatory initiatives. With the change in the U.S. administration and Congress, investors and lenders have been weighing the likely changes to the financial framework, from adjustments to the Dodd-Frank legislation to tax reform.

Exhibit 3.9: Change in Lending Conditions over Past Year

Exhibit 3.10: Causes of Insufficient Bank Capital for CRE Lending:

I have encountered that National Banks will not touch lot/land loans, more local or family owned banks will finance at 40 to 50% down for 5 years. They will take a chance if buyer is a bank customer and great credit references.

- Texas

Banks need to lend and not just meet requirements for regulation.

- Arizona

FDIC regulations make it difficult for local lenders in smaller markets.

- Texas
SURVEY HIGHLIGHTS

4
SURVEY RESULTS: Highlights

• 69% of respondents closed deals in 2016

• REALTORS® closed an average of 5 commercial transactions

• 93% of sales were valued at or below $5 million

• Cash comprised 30% of all transactions

• Sales composition:
  - Office CBD: 9%
  - Office Suburban: 12%
  - Industrial Warehouse: 15%
  - Industrial Flex: 8%
  - Multi-family: 13%
  - Retail Strip Center: 12%
  - Retail Mall: 2%
  - Land: 19%
  - Hotel: 2%
  - Other: 7%

• Lending conditions tightened in 37% of respondents’ markets, an increase from last year’s 33%

• Top sources of capital:
  - Local/community banks: 32%
  - Regional banks: 26%
  - Private investors: 10%
  - National banks (“Big four”): 8%
  - Small Business Administration: 6%
  - Credit unions: 6%
  - Life insurance companies: 3%
  - REITs: 2%
  - CMBS: 1%
  - Gov’t Sponsored Enterprises: 1%
  - International banks: 1%
  - Public companies: 0.5%

• 16% used the Small Business Administration refinance program

• 35% of respondents reported failed sales due to lack of financing, compared with 40% in 2015
  - Loan underwriting standards caused 59% of financing failures
  - 15% caused by appraisals/valuation
  - 14% due to financing availability

• 14% of deals failed to secure re-financing

• 51% of respondents find insufficient CRE bank capital due to:
  - Financial regulatory uncertainty: 28%
  - Legislative/regulatory initiatives: 26%
  - Reduced NOI, values & equity: 16%
  - U.S. Economic uncertainty: 11%
  - Global economic uncertainty: 4%
  - Pooling/packaging of CMBS: 4%
  - Disposition of distressed assets: 3%

• 16% of respondents reported transaction failures due solely to appraised values, with principal causes being:
  - Net Operating Income (NOI): 39%
  - Economic obsolescence: 14%
  - Deteriorated property financials: 13%

• Net operating income (NOI) of sold/leased properties increased in 67% of respondents’ markets over the past year

• Banks’ approach to determining commercial loan amounts varied:
  - 62% used loan-to-value (LTV)
  - 23% employed debt service coverage ratios (DSCR)
  - 16% chose the lower amount between LTV and DSCR

• Median DSCR in 2016 was 1.25

• 67% of transactions had financing with LTV higher than 70%

• 79% of respondents reported average interest rates for debt financing at or below 5%

• The median loan term was 10 years, with international banks offering shorter terms and the Small Business Administration offering longer terms
SURVEY RESULTS
SURVEY RESULTS

Market Environment

During 2016, 69 percent of REALTORS® who responded to the survey completed a commercial real estate sale. The figure represents an increase from the prior year’s 61 percent. Respondents reported that they closed an average of five sale transactions during the year. The majority of REALTORS®—93 percent—reported average transaction values below $5.0 million, with 83 percent indicating deal values below $2.0 million.

The survey data indicate that 19 percent of sales comprised land transactions, the largest share of all property types. Industrial transactions outpaced multifamily sales, moving into the number two spot, with 15 percent of investment sales. Multifamily properties were the third most transacted property type, accounting for 13 percent of all deals. Suburban offices and retail strip centers made up an equal share of transactions—12 percent.

REALTORS® reported that net operating income for properties on the market advanced, with 67 percent of respondents indicating gains of 1% - 25% on a yearly basis.

The market for Industrial type properties in San Fernando Valley, and Los Angeles County in general is extremely tight.

- California

I manage 3 offices that practice in both residential and commercial real estate. We are noticing an increase in commercial sales. I would say lending in our area is available but still a little tight. There is concern about the future of the 1031 exchange.

- Maine

The compressed cap rates on quality NNN leases is limiting first time investors in getting into the market.

- Minnesota
Market Environment

In the current market situation, I feel there is a lot more money chasing deals. Banks have the money to lend and are being creative in financing good properties.

- Texas

Cap rates are getting dangerously low. Putting values at the upper extreme while vacancies are rising.

- Texas

Unfortunately the current economic environment has not produced opportunities for commercial sales in this small town.

- Virginia

I have been in the commercial brokerage business for 30 yrs. As rates start to rise, the money is going to get easier. Our biggest issue is that government is the biggest user of debt and until that shifts to society’s needs, it will remain suppressed for the rest of the market. As an example our prices for industrial building, whether it’s rental or sales in the center of metro Phoenix have been rolled back to the 1980’s -1990’s prices... No risk here for overheated market in the near term.

- Arizona

I am working on new listing and reducing the price on present listing. I am getting hits on my internet listings, and had two hits but were rejected due to very low offers. Banks are still holding copious REO properties. Appraisal values have dropped by 20%, still lots of cherry picking. I am working with my sellers to reduce the price of current lists.

- Mississippi

More borrowers I work with are using private capital as construction loan. Banks are less willing to do so.

- Missouri

Bankers need to keep up with the marketplace. Appraisers, also, it hurts business and economic growth.

- Georgia

I believe it would be beneficial in my area to relax or modify lending practices for commercial.

- Missouri

Commercial lending is creating huge over-building and over-development in metro Atlanta! It’s way out of reason because such development is overloading our roads, both surface streets as well as our expressways, causing very dangerous driving conditions. It’s also creating more crime in and around the metro area. Residential properties are also over-developed with standing inventory everywhere! People are not making the wages to support all of this out-of-control development. [...]

- Georgia

The credit quality of the buyer shouldn’t be as important as the cash flow and appraisal of the building.

- Florida

Lenders are OK with owner-occupied, even with excess rentable available. However, most are not seeking investor purchased properties.

- Nebraska
Debt financing comprised 63 percent of REALTORS®’ commercial transactions in 2016. Cash comprised 30 percent of all deals, a slightly larger proportion than in 2015, and on par with historical trends.

Bank financing was an important source of capital for commercial transactions in REALTORS®’ markets, comprising 68 percent of responses. Local and community banks continued as a main finance providers, with 32 percent of the market, followed by regional banks, at 26 percent. National and international banks accounted for a combined nine percent of capital sources.

Over 60 percent of REALTORS® indicated that banks determined loan amounts using loan-to-value (LTV). A smaller share—16 percent—mentioned that banks employed the debt service coverage ratio (DSCR) to calculate loan amounts, while slightly over one in five respondents mentioned that banks were calculating loan amounts by taking the smaller amount between LTV and DSCR. Survey respondents answered that the majority of LTVs were in the 70% - 80% range during 2016. The median DSCR for REALTORS®’ transactions was 1.25.

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**The banks are too conservative when there vacancies in a sale, even when the buyer is an experienced operator. This caused a last minute increase to a down payment of 100K after the deal had gone hard and deposit after deposit had passed through. Buyer had no choice but to “bite the bullet.”**

- **California**

**Vacant land equity requirements at 35% are absurd and an obstacle to moving that market forward. Secondly, blanket mortgages or cross collateral or additional collateral terms have changed significantly for the worst. Now you must re-finance the additional collateral and extract the cash to apply to the target property, creating a huge obstacle.**

- **Delaware**
The interest rate environment remained favorable for commercial real estate transactions in 2016. Based on REALTORS®' answers, close to 80 percent of respondents indicated that interest rates were 5.0 percent and lower. The median loan term for commercial deals was 10 years. The only exceptions were international banks—with six year loans—and the Small Business Administration (SBA), which offered longer termed loans—20 years.

REALTORS® reported that clients took advantage of the SBA lending programs. The two main types of loans employed were the 7(a)—aimed at small businesses, and offering a loan cap of $5 million—as well as CDC/504—loans designed for small enterprises seeking to purchase real estate and equipment.

The lenders and the feds are imposing ridiculous requirements for loans. I don’t see the general economy getting better here in AZ. We are still digging out of a hole. […]

- Arizona

The CMBS loan assumption process created significant issues for us the past 12 months, with some assumption requirements that make it difficult, if not impossible to complete a transaction.

- Florida

DSCR seems to be the obstacle especially if management, reserves, vacancy and rent loss, are not included in the expenses despite single national tenants.

- Florida

Commercial lending has always been challenging for small to medium business enterprises in the MSA of Indianapolis at least for the last 42 years of my experience.

- Indiana
More relaxation in SBA loans for self-occupied properties could help. Also raising limits of 7A loans could be useful.

- Illinois

My investor clients have had no problem getting access to capital on commercially reasonable terms.

- Maine

Lack of financing for buyers of properties under $500,000 was prohibitive to the sale of such properties.

- Arizona
With property values continuing on an upward trend, appraisals for commercial transactions were less of a roadblock to closing deals in 2016. The incidence of failed sales due solely to appraised values declined from 22 percent in 2014 to 16 percent in 2016. In instances where appraisals came in lower than the sale price, the main reason was reduced net operating income (NOI), according to 39 percent of REALTORS®.

Economic obsolescence and deteriorating property finances were the second and third main reasons for appraisal issues, accounting for 14 percent and 13 percent of respondents, respectively. Location obsolescence and environmental conditions were reported as problems by 10 percent and six percent of respondents, respectively.

Stemming from these conditions, 27 percent of REALTORS® indicated that mezzanine debt was required during the year to cover gaps between purchase prices and appraised values.

- **Lenders have a hard time finding an appraiser willing to appraise a commercial property. They prefer easy residential properties with lots of comps. Commercial property appraisers are rare in Hawaii.**
  - Hawaii

- **Lenders are using out-of-town appraisers not familiar with the area.**
  - Illinois

- **Appraisers are so timid from the restrictions and burdens of Dodd-Frank as to seriously undervalue investment properties, negatively impacting the ability of investors to obtain financing.**
  - New York

- **Appraisers in commercial real estate are a key problem right now as to their accuracy and time it takes.**
  - Arizona
Appraisals

REALTORS® reported that appraisers’ familiarity with local markets and property types varies. In an improvement from the prior years, 25 percent of survey respondents indicated that appraisers are always familiar with the market. For 62 percent of REALTORS®, appraisers are “Sometimes” familiar with their local markets.

Familiarity with the property type was similar, with 26 percent of respondents stating that appraisers are “Always” familiar, and 62 percent reporting that appraisers are “Sometimes” familiar.

Market participants have expressed concerns over the past few years about banks’ approach to appraisals, with many reporting that lending institutions were mostly focused on reducing costs. Along those lines, 59 percent of REALTORS® reported that lenders generally seek quality appraisers who are familiar with the local market and property types. That left over 40 percent of survey respondents who experienced transactions appraised by someone not familiar with the market or the property type.

Appraisers should not dictate value, a willing buyer and willing seller should establish VALUE and PURCHASE PRICE. There is way too much disparity from one MAI appraiser to another. I’ve been a real estate broker for over 45 years in six western states and many of the MAI Appraisers have no clue about construction costs and reasonable comparables.

- Washington

Many appraisers out there take assignments to get a job—not because they are knowledgeable about the type of property they are appraising. Some appraisals are just a joke—i.e. unrelated properties as comps, dissimilar properties as comps. They should get disciplined for this, or lose their license. General appraisers should be categorized for the type of property they can actually appraise—not everything under the sun.

- Illinois
Methodology of NAR’s 2017 Commercial Real Estate Lending Survey

In March and April of 2017, NAR invited a random sample of 62,786 REALTORS® with an interest in commercial real estate to fill out an online survey. A total of 803 responses were received for an overall response rate of 1.3 percent.

The primary measure of central tendency used throughout the report is the median, the middle point in the distribution of responses to a particular question. The report also employs frequency distributions, to display the number of observations within a given interval.
The National Association of REALTORS®, “The Voice for Real Estate,” is America’s largest trade association, representing 1.2 million members, including NAR’s institutes, societies and councils, involved in all aspects of the real estate industry. NAR membership includes brokers, salespeople, property managers, appraisers, counselors and others engaged in both residential and commercial real estate. The term REALTOR® is a registered collective membership mark that identifies a real estate professional who is a member of the National Association of REALTORS® and subscribes to its strict Code of Ethics. Working for America’s property owners, the National Association provides a facility for professional development, research and exchange of information among its members and to the public and government for the purpose of preserving the free enterprise system and the right to own real property.

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