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STEP INTO THE LIGHT

Nonbanks have a bright future that can benefit a variety of commercial real estate projects

One of the biggest success stories in the real estate and mortgage industries since the financial crisis is the rise of nonbank lenders all over the country. Sometimes called private-money lenders or hard money lenders, these companies perform the same basic functions as a bank that makes loans to real estate investors and developers. ✿ Nonbank lenders, however, do not take deposits, and investments in nonbank lenders are not insured by the Federal Deposit Insurance Corp. As a result, nonbank lenders are regulated much more lightly than banks. For commercial mortgage brokers and their clients, this is good news, as these companies are able to make decisions quickly and lend without a "check-the-box" mentality. ➤

Photo illustration by Karen Steichen

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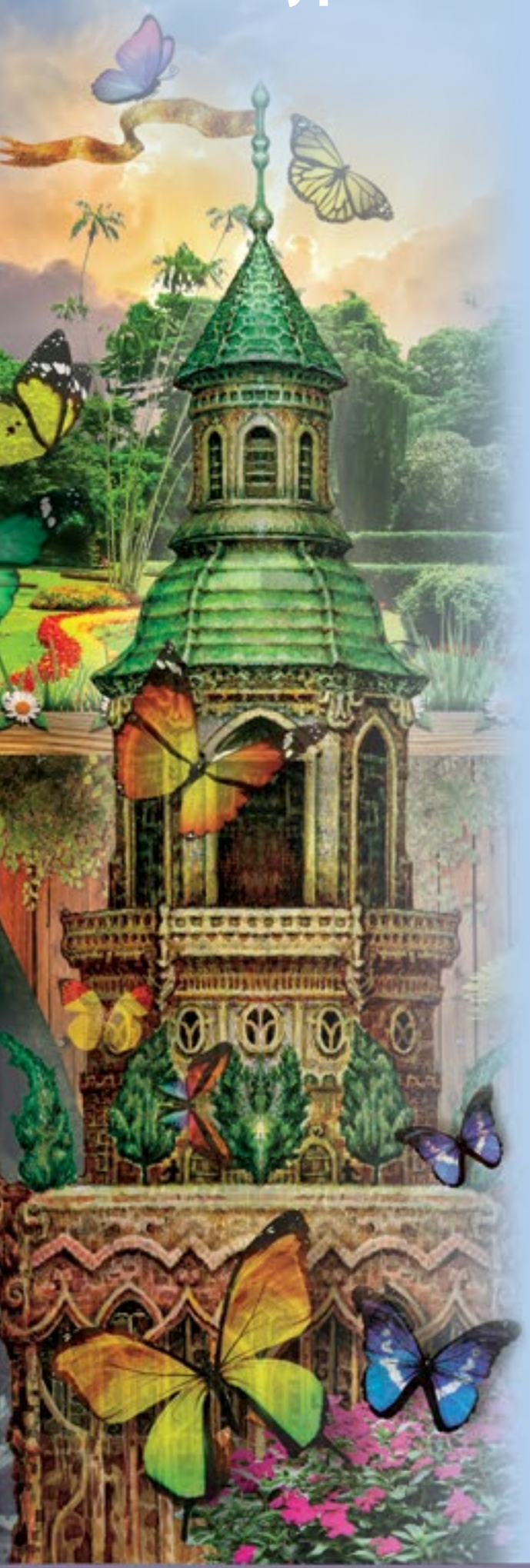

Private or hard money lenders can lend to a borrower who doesn't have steady income, as long as the property securing the loan has sufficient equity, and the borrower has a business plan that is realistic and makes sense. Fix-and-flip investors — those who buy, renovate and resell single-family homes for a profit — are a perfect example of who nonbanks commonly lend to.

These borrowers may have a profitable business. The owners of such businesses, however, often do not meet all the criteria that conventional banks require in order to extend a loan.

Mortgage brokers and borrowers should be aware of what is likely to happen in the future of nonbank lending. These potential trends can be divided into three segments: near term (the next 12 months), medium term (one to five years) and long term (five to 10 years).

The next 12 months

First off, it is a fair bet that increasingly more capital will flow into nonbank lending institutions over the next year. Interest rates are rising, which makes bonds a risky investment for income-oriented investors. Nonbank loans offer investors high yields, compared with most bonds, as well as short maturity periods (frequently one or two years for bridge loans).

Short maturities mean less interest rate risk. In other words, the value of the investment isn't reduced much by a rise in interest rates, in contrast to most bonds, which often lose substantial value when rates rise. Also, a number of nonbank real estate lending platforms have been sold in recent years to strategic and financial investors intent on doubling or tripling origination volume. Competition is likely to continue intensifying.

Second, the same forces that have increased competition also have reduced lending standards within the nonbank industry. A second short-term prediction is that the chickens will soon come home to roost, with default rates rising in the coming year. Some lenders have been attempting to "buy" a larger market share by offering high-leverage loans. In the fix-and-flip lending market, there are a number of lenders offering leverage of 90 percent of the purchase price or 100 percent of the renovation costs, subject to the after-repair value being sufficient to support the loan.

Furthermore, brokers and borrowers should consider that many of these lenders never see some of the properties they are lending on. Recall that many properties dropped in value by 30 percent to 50 percent or more in the wake of the Great Recession. If a lender offers 90 percent of the purchase price and the property later winds up in foreclosure, the lender would be lucky to get all of its money back even if the market stays flat, after taking foreclosure costs and brokerage fees into account.

Medium-term trends

Today, there are many nonbanks offering loans for commercial properties. In 2020 and beyond, we may begin to see some of these platforms fail due to loan defaults. Many of today's lending platforms were built for growth but, like Countrywide Financial, lenders that are too aggressive and lead the pack in growth are often the same ones that don't make it when the going gets tough.

Many of today's nonbank lenders have never seen or had to deal with a large wave of defaults. In the small-balance arena in particular, many staffers are younger professionals who were in college or high school during the last financial crisis. Even a small number of defaults will test these platforms and, in many cases, investors may lose confidence in senior management if they realize that growth was achieved at the expense of loan-portfolio quality.

In the next few years, borrowers may wake up to the importance of the quality of their lender. As lending standards have loosened, some borrowers have been feasting on high leverage and low rates. If something seems too good to be true, however, it probably isn't sustainable. Recall that Corus Bank funded many condominium towers in South Florida prior to the financial crisis. When Corus was taken over by federal regulators in 2009, more than half of its $3.9 billion in condo-construction loans were in default.

The important point here is what happened to the bank's other borrowers who performed flawlessly. Instead of dealing with a lender that would live up to construction-loan agreements, they were left dealing with regulators. Many projects that might otherwise have survived were frozen in a half-built purgatory because the lender could not fund construction draws in a timely manner.

Lastly, financial technology (or fintech) in commercial real estate will likely shake out in the next few years. Venture capitalists have been flush with money and willing to bet big on all sorts of ideas, including some real estate debt-related ventures. It remains to be seen which companies have a strong fintech-related business model. In the meantime, non-fintech lenders are likely to build the technology that is valued by their clients. Expect to see a convergence of nonbank lenders in this area, much like E-Trade and Charles Schwab started in different places but ended up in similar ones, offering multiple on-ramps to their services.

Long-range predictions

It appears likely that, in the coming decade, nonbank lending will scale up. Banks are often poorly suited to deal with today's real estate investors. They move slowly and have many layers of requirements before they can provide reliable solutions.

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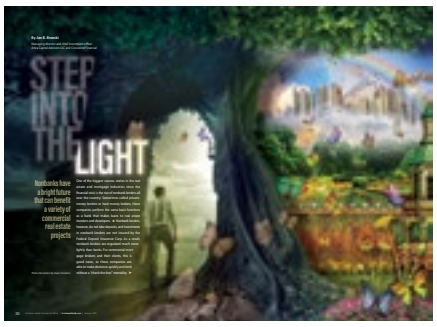

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The pricing advantage of banks also has fallen steadily in recent years. Today, for example, some construction loans for spec homes in Southern California are priced by regional banks at rates above 7 percent, given their spreads above Libor and the rise in 12-month Libor rates. Meanwhile, some nonbank lenders are pricing similar loans in the 8 percent range. As fixed-income investors become more eager to put money into real estate investment loans, expect the pricing gap with banks to narrow even further.

Mortgage brokers should begin to anticipate seeing a handful of branded nonbank lenders with higher visibility in each major metropolitan area. Real estate investing is widespread, with about one third of the nation's single-family housing stock operated as rental properties, not to mention every apartment building and the bulk of commercial real estate assets.

> **"Terms like the 'shadow-banking system' may not be as relevant as nonbanks become fully integrated into their communities."**

Although there is no definitive data, estimates of the number of investors who directly own real estate range from about 2 million to 10 million. Banks do not typically court real estate investors, other than select banks that focus on the largest investors. This means nonbank lenders have a very large market to serve and some of them will see the benefits of building higher visibility in the communities they serve.

Eventually, banks and nonbanks may coexist as parallel systems, each with its own separate focus. Terms like the "shadow-banking system" may not be as relevant as nonbanks become fully integrated into their communities, just as banks are today.

A final long-term prediction is that investment loans with smaller balances and shorter durations will largely be originated by nonbank lenders. Processing a loan today usually takes much more effort on the part of a bank, compared to a nonbank. For a larger loan or a long-term loan, investors who qualify for bank loans will pursue this option to save roughly 1 percentage point to 4 percentage points per year on interest charges. For smaller or short-term loans, however, an investor will often choose a nonbank lender.

The extra effort to obtain a bank loan is often costlier. An investor may spend many hours doing tasks that are outside of their routine, or tracking down documents that seem irrelevant to the loan application. Many investors would rather spend those hours finding their next acquisition. They can make more money doing so, versus saving a few percentage points on interest with a bank loan.

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In summary, the development of the nonbank-lending industry is good news for real estate investors and industry professionals. The coming years will see bumps in the road as the industry matures but, long term, these companies will prove to be a valuable and substantial part of the commercial real estate finance landscape. ■