

FALL
2024

HOW INVESTORS CAN TAKE ADVANTAGE **OF THE BANK FINANCING GAP**

... now is an ideal time for investors to explore these opportunities and position themselves for future growth in a shifting market.



Susan Mello
Walker & Dunlop



Mitchell Resnick
Walker & Dunlop

The current landscape for financing commercial real estate (CRE) presents a unique opportunity for investors as traditional banks tighten their lending standards and are less active in the market. Until the recent Federal Reserve cut, the federal funds rate had risen to more than 5%—marking a 17-year high. Market uncertainty and significant bank collapses in 2023 enabled nonbank lenders such as life insurance companies and debt funds to step in to fill the void. These alternative financing sources offer more flexible options, particularly for projects with uncertain time lines or higher-risk profiles, such as construction. Investors can capitalize on compelling risk-adjusted yields in the CRE debt market, especially in the multifamily sector, which continues to show strong fundamentals despite broader economic challenges. As banks focus on managing risk, now is an ideal time for investors to explore these opportunities and position themselves for future growth in a shifting market.

Key Market Dynamics Favoring Investors

- 1. Bank Retreat:** Approximately 45% of total outstanding CRE loans currently sit on bank balance sheets. As banks tighten their lending standards, a significant financing gap has emerged. This presents an opportunity for private capital to fill the void by providing funding for projects that may not meet bank underwriting standards.
- 2. Maturity Wave:** Over the next five years, more than \$2.6 trillion of total CRE loans are set to mature, creating a potential wave of refinancing needs. In particular, many multifamily loans are expected to face challenges refinancing at current interest rates, leading to increased demand for alternative financing solutions.
- 3. Attractive Risk-Adjusted Yields:** In the current environment, CRE debt offers compelling risk-adjusted yields while providing investors with a more secure position within the capital stack. This was particularly advantageous during periods of market volatility triggered by the Federal Reserve's unprecedented rate hikes in 2022 and 2023 and continues today, despite the recent Federal Reserve rate cut.

Opportunities in Debt Funds

National, regional, and local banks have long been key sources of financing for both residential and commercial real estate. There are a variety of reasons for this, but a key advantage is their ability to provide lower-cost financing because banks have access to cheap capital sources in the form of customer deposits. This was especially true after the great financial crisis and accelerated

through the COVID-19 pandemic as the federal funds rate was cut to zero. Anyone who deposited money in a bank saw negligible interest earnings.

Once the Federal Reserve started its rate hiking cycle in 2022, alternative, but still safe, investment options emerged to compete with bank products, such as money market funds and Treasury bills, which were much quicker to offer higher-paying interest rates. Depositors, especially those with large cash balances, started to withdraw their bank deposits and transfer the funds to these alternative options. Banks were also facing other headwinds, among them, a decrease in the value of the securities held on their balance sheets, the specter of increased capital reserve requirements under Basel III, and slower payoffs on their existing loan books as

With less competition from cheaper bank loan financing, debt funds have an opportunity to deploy capital at rates that are attractive for investors.

borrowers struggled to refinance or sell properties in the higher interest rate environment.

Combined, these factors caused many banks starting at the end of 2022 to substantially curtail their lending activity and tighten their terms and underwriting, resulting in lower debt proceeds and higher rates while also asking for substantial deposits from their borrowers. Data from the Mortgage Bankers Association show that in 2023, lending by depositories (banks) decreased by 63% over 2022 volumes. This has continued into 2024, with 2Q24 lending by depositories down by 26% compared with 2Q23 and overall 2024 lending through June 30 down by 34% compared with 1H23, although there was a pickup in quarter-over-quarter lending in 2Q24 over 1Q24.

In this environment, borrowers have had to turn to alternative lending sources. There has been substantial

demand for capital stack solutions that allow borrowers to refinance existing projects, finance new construction, and acquire new investments as the transaction market ramps back up. Demand has primarily focused on shorter-term bridge debt, as well as gap financing in the form of preferred equity and mezzanine debt.

With less from cheaper bank loan financing, debt funds have an opportunity to deploy capital at rates that are attractive for investors. Commercial real estate remains an essential asset allocation in many investors' portfolios, and given the equity-like returns that can be achieved, debt products are the investment vehicle of choice as common equity struggles to adjust to rapidly changing valuations.

Attractive CRE Sectors for Investment

Multifamily

The multifamily rental sector continues to be a strong option for both debt and equity investments, supported by long-term demand driven by factors such as population growth and declining home affordability. Recent data indicate that multifamily values have decreased approximately 20% from their peak in 2022, primarily because of rising interest rates rather than declining long-term fundamentals, although we note that increased deliveries in 2023 and 2024 and projected to continue into 2025 have weighed on operating fundamentals. However, as supply constraints are projected to become more pronounced in 2026 and beyond, investors that position themselves now stand to benefit significantly. The supply cliff, combined with persistent institutional demand for multifamily assets, creates a compelling case for investment in this sector that presents a unique opportunity for investors who can take a long-term view and navigate current market conditions.

Transitional Properties

Investors should also consider bridge lending for transitional business plans, including lease-ups, property repositioning, and light value-added acquisitions. As banks have become more selective in their lending practices, opportunities in this space are becoming increasingly attractive for those willing to take on higher-



risk, higher-reward projects. We have also seen demand for shorter-term financing simply as a result of timing—owners waiting for a better macro environment in which to refinance into permanent financing or sell assets. In addition to construction loans, banks have favored shorter-term loans.

Construction Projects: Completing the Development Capital Stack Requires Creativity and Strong Relationships

Many commercial construction projects face uncertain time lines or market conditions, which require more flexible financing options. Despite the media attention that banks are pulling back on construction loans, financing is still available. The difference today is in proceeds and spreads. Prior to 2023, banks often offered senior loans at 60% to 65% loan-to-cost (LTC), with no or partial recourse that burned down on completion. More recently, proceeds for non- and partial-recourse loans are generally at 50% to 55%. Spreads are also wider. It is more expensive today to complete the capital stack because lenders providing stretch senior and/or gap financing demand higher returns than historical bank-financed loans. Different lender types are stepping in to fill the void and seize the opportunity to build or be part of a creative capital stack that meets the needs of developers and investors to get projects underway.

Life insurance companies, in particular, have expanded their offerings to cater to the changing market. Since the start of 2023, life insurance companies have creatively expanded their product offerings to capitalize on the opportunity in the market created by banks that have tightened their

credit standards. Although they are not loosening credit standards, life insurance companies view the current market environment as an opportunity to establish new relationships with sponsors on high-quality assets. In the past, many financed construction only if it was combined with permanent financing post-completion.

We now see many life insurance companies offering products with favorable terms for the most in-demand assets, such as multifamily and industrial projects. Loan terms include maturities matched to construction completion and stabilization (i.e., dropping the “permanent” piece of the construction-to-permanent loan), floating rates, and flexible prepay, terms that have traditionally been sought and offered

We now see many life insurance companies offering products with favorable terms for the most in-demand assets, such as multifamily and industrial projects.

on ground-up development projects. Spreads are in the mid-300s, with LTCs generally in the 55% range for a nonrecourse loan.

Banks have not cut off their financing completely but have shifted their current construction lending to focus on higher-quality sponsorships on lower-leverage multifamily assets and still achieve low –300 credit spreads. Many still want some level of recourse or will offer nonrecourse at lower leverage levels. We see the most activity coming from regional and local banks.

Debt funds also are active in construction lending, taking advantage of the opportunity to be paid to go higher in the capital stack. Depending on the profile of the project, spreads can range from mid-400s to mid-500s, but leverage levels are 70% to 75% (and in some cases as high as 80%) without recourse.

Gap Financing: Preferred Equity and Subordinated Debt

The market dynamics driving the opportunity for debt funds are also creating a burgeoning market for preferred equity and other gap-financing solutions. Investors seeking safety but also additional yield can capitalize on lower senior-debt proceeds and depressed property values by providing subordinated financing to projects. Rates can range from 10% to 13%, with detachment points between 75% and 85%. Walker & Dunlop Investment Partners (WDIP), Walker & Dunlop’s investment arm, is capitalizing on this opportunity and recently expanded a joint venture to invest an additional \$250 million in this strategy.

Bottom Line

The withdrawal of banks from CRE lending has created a unique set of opportunities for investors. While traditional funding sources have become less accessible, nonbank lenders and alternative financing options are stepping in to fill the gap. Walker & Dunlop Investment Partners manages capital on behalf of endowments, foundations, pension plans, private funds, insurance companies, family offices, and high-net-worth individuals. It has invested more than \$9.2 billion through credit financing across 366 properties since 2017.

While traditional funding sources have become less accessible, nonbank lenders and alternative financing options are stepping in to fill the gap. As the market adapts, now is an ideal time for investors to position themselves for future growth and success. ■

Susan Mello is Executive Vice President and Group Head, Capital Markets, at Walker & Dunlop, and Mitchell Resnick is the President of Walker & Dunlop Investment Partners, a wholly owned subsidiary of Walker & Dunlop.

Data are as of June 30, 2024, and inclusive of WDIP’s lending activity on multifamily, industrial, retail, self-storage, and office property types since 2017 for both advisory and non-advisory programs. All investments involve risk of loss; past performance does not guarantee future results. Nothing herein is an offer to sell any security of fund interest.