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COMMERCIAL REAL ESTATE

MATURITY MAYHEM

High rates cause challenges as loans are set to mature

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By Brian Bandell – Real Estate Editor, South Florida Business Journal
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A spike in interest rates has created challenges for many commercial real estate owners as their low-rate loans come due – and even South Florida's relatively strong real estate market won't be spared.

A recent report by Morgan Stanley laid out the challenge: Almost $1.5 trillion in commercial real estate loans are due before the end of 2025, creating significant "refinancing risks." New loans will be much more expensive due to higher interest rates.

And that's if property owners can even refinance at all, as more banks pull back on lending or underwriting due to the financial system's liquidity crisis and economic uncertainty.

Meanwhile, commercial real estate sales have dipped sharply this year as higher rates and tighter loan requirements discouraged buyers or prompted them to offer lower prices for real estate. That means it's going to be harder for property owners with maturing loans to sell, and purchase offers could come in lower than expected.

In South Florida, there are 310 commercial mortgage-backed securities loans set to mature this year, followed by 325 in 2024, according to New York-based Trepp. That excludes loans held by banks and private lenders. Many CMBS funds are working to extend loans, but that's a challenge in the office sector because of property appraisals' "shocking" decline in value, said Stephen Buschbom, Trepp's director of research.

"The challenges maturing CMBS loans will face this year with higher interest rates include increased borrowing costs, potentially lower valuations and a tighter lending environment – making it more difficult for borrowers to refinance their loans," Trepp research analyst Vivek Denkanikotte said. "There is a concern that higher interest rates could lead to lower debt service coverage ratios if the property's income does not increase proportionally, potentially indicating a higher risk of default for the borrower."

Banks hold about 51% of all commercial real estate loans nationwide, according to Trepp. And because they pay much higher rates to depositors now, banks are eager to rid their books of any loans paying low rates to help improve their cash flow.

"Every bank and credit union and mortgage lending company is freaking out because the debt service coverage on commercial real estate loans is out the window," said James Angleton, CEO of Miami-based United Police Federal Credit Union. "None of them can easily underwrite cash flows on these interest rates .... It's a tsunami coming."

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Angleton said many banks will ask borrowers to put more equity into the deal to extend a commercial real estate loan, which would reduce the amount of debt service, even at the higher interest rate. But if the borrowers refuse, this could mean trouble because other banks won't be eager to assume those loans, he added.

"General market forces are making folks more reluctant to lend, and there will be a massive supply and demand imbalance across commercial real estate," said Mukang Cho, CEO of Boca Raton-based Morning Calm Management, which owns office buildings. "There is a huge pocket of opportunity, and we're looking to fill that void."

Morning Calm recently formed a $500 million joint venture partnership with an unidentified global investment manager to finance Class A office in large markets across the U.S, including South Florida. The idea is to capitalize on the wave of debt maturities by providing mezzanine lines or preferred equity, Cho said. Both are secondary forms of financing that are junior to the first mortgage. His joint venture could also purchase mortgages and work with the borrowers.

Office building owners are under stress due to more tenants shifting to remote work and higher operating costs, including for insurance and tenant improvement construction, Cho said. Many of them will need secondary financing to buy more time.

“I don’t know if there is any sector that can escape the broader capital market’s challenges,” Cho said.

South Florida in better shape

Experts say South Florida’s real estate market will weather the maturity storm better than most regions because of the many companies and people relocating here.

Cities such as New York, Chicago and San Francisco have problems in the office market, with large blocks of empty space, but South Florida’s office market is very healthy, with available space being absorbed and rents growing – especially in Miami, said Brian Gale, vice chairman in the Miami office of Cushman & Wakefield. While there are tenants still downsizing because of remote work, they have largely been replaced by new or expanding companies.

South Florida office landlords looking to refinance must pay higher interest rates, yet they have more income from higher rents, so that will ease the burden, he said.

“Lenders are much more reluctant to look at ‘office’ outside of South Florida,” Gale said. “There are a few buildings in Miami now on the market, and they are getting an incredible amount of attention.”

South Florida’s market has performed very well, and borrowers have been able to absorb higher interest rates and other unexpected expenses, such as a spike in insurance premiums, said Calixto Garcia-Velez, president and CEO of Coral Gables-based Banesco USA. His bank is being more selective with office and construction loans, but he likes the fundamentals of the local market at a time when some national and regional banks are more reluctant to lend.

“While the larger lenders pull back in this space, we will find opportunities to do deals with loan sponsors we may not have had access to when things were roaring,” Garcia-Velez said. “The problems will be in the CMBS market, which doesn’t have the flexibility to support a client with a loan maturity.”

The value of industrial property here has nearly doubled in recent years and occupancy levels have been high, so refinancing at higher rates shouldn’t have a problem, said Edward Easton, chairman of Doral-based industrial real estate firm Easton Group. The only industrial properties that could face trouble are those bought in 2019 without much equity, he added.

Yet, Rafael Serrano, managing director of Miami-based Safe Harbor Equity, which buys distressed debt from lenders, expects a plethora of opportunities in South Florida. Local banks are heavily invested in commercial real estate loans, and many of those borrowers will struggle to refinance – especially those with adjustable-rate loans.

“It’s almost impossible for someone with a 3.5% rate to go to 7% and that not cause a problem with their ability to cover payments,” Serrano said. “Your payments just doubled.”

Most troubled sectors

South Florida’s office market isn’t immune to the interest rate spike because not all buildings have succeeded in attracting new tenants. Plus, lenders have recognized that the value of office has declined in most markets nationwide, so finding a bank to refinance them will be tough, experts say.

Enlarge Holly MacDonald-Korth, KDM Financial

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It used to be that office buildings with a large tenant were very desirable for a lender, but now it’s a potential liability because many larger office users are downsizing with remote work, said Holly MacDonald-Korth, CFO of KDM Financial, a Coral Gables-based commercial real estate lender holding over $500 million in loans. Another difficulty is that few offices have sold this year, so it’s hard to obtain a good appraisal to base a loan on.

“Certainly, office is the hardest thing to refinance now because they have the dual problems of everyone working from home and we don’t know what those buildings are worth,” she said. “It’s going to be an interesting 12 months or so with the multi-prong problem of high interest rates, a loan maturity wall and banks pulling back.”

Property owners with floating rate loans are already feeling the pain from higher interest rates, especially if they were construction loans or construction bridge financing, which tend to carry higher rates in general, MacDonald-Korth said. Many borrowers are trying to refinance because the higher rates have made their business plans unprofitable.

Apartment developers that started construction in 2020 or 2021 likely dealt with higher-than expected construction costs, more expensive insurance and movement in capitalization rates that reduced property values, said Ben Jacobson, a partner at Boynton Beach-based Forman Capital, which arranges multifamily loans. Rent growth has softened this year, so operating income may not be enough to make up the difference.

“Everyone thinks the big challenge is office, but there will be pockets of challenged loans for multifamily, especially on the construction side,” Jacobson said.

Bankruptcy attorney Joe Pack, of Miami-based Pack Law, said he’s heard from many developers running into problems with construction loans. These are typically projects in South Florida’s “B markets” as opposed to booming cities like Miami, he said.

“The bottom is starting to fall out in the lower-tier markets,” Pack said.

Lenders demand more equity

If property owners hope to refinance, they will likely need to cut a check and bring more equity to the table.

Many commercial real estate borrowers up for refinancing are faced with a rate 3 or 5 percentage points higher than their current rate, so they don’t have the debt service coverage to comfortably make those payments, KDM Financial’s MacDonald-Korth said. The solution is the borrower contributing more equity into the property.

“If you want a $10 million loan, I can only really give you $8.5 million now,” she said.

Many investors are lining up with “rescue capital” to help commercial property owners refinance with lower loan balances, said Eric Hochman, chief investment officer of Boca Raton-based office and retail property owner Pebb Enterprises. As lenders demand more equity, borrowers can tap mezzanine financing or preferred equity deals to obtain those funds at refinancing, he said.

Paying higher interest rates at refinancing will be challenging for many property owners, said Charles Foschini, senior managing director in the Miami office of commercial loan broker Berkadia. It’s harder to obtain loans now because of the market volatility amid the rate hikes, but credit is still available.

“The cost of capital is going to be higher, and that will take a bite out of cash flow,” he said. “That doesn’t mean properties won’t be profitable; they will just be less profitable than if rates were lower.”

In some cases, a change of business plan could help a developer out of a tight spot.

Marlon Gomez, head of Gomez Development Group in Miami, said he recently converted his Aventura Eco office project from a rental to an office condo. That helped him refinance the construction loan to $15 million with Rok Lending as he ramps up construction on the 263,371-square-foot project.

By selling the office space as condos, Gomez can use the sales proceeds to reduce the loan balance over time, thereby reducing the total amount of interest payments on the project by about 75%. His prior loan was not due for 18 more months, but it had a floating interest rate.

“We don’t know where the future will be,” Gomez said, “and before you know it, there are five more rate hikes.”