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Another banner year for commercial lenders

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A local commercial banker was worrying earlier this summer that his mortgage banker friends were spending all their time at closings and missing out on an entire season on the golf course.

But his friends aren't complaining - at least not on the record - as the commercial mortgage pipelines keep humming along at or near record levels in the Twin Cities.

All that business has been stimulated by the still very low 10-year Treasury rates, the lack of a better investment alternative and a flat yield curve, which makes permanent mortgages all that much more attractive, priced at just a slight premium to shorter-term bank loans.

And the result is a second consecutive year in which local and national mortgage records may tumble.

Collateral Mortgage's 3-year-old Twin Cities office had already matched its 2004 level of a little over $100 million by July. The local L.J. Melody shop is on track to add between $100 million and $200 million to its record year-ago volume of $307 million, and every other local broker is predicting a year-end finish well above last year, when mortgage bankers set a national record for commercial volume.

Investment acquisitions are one of the drivers behind the strength of that business, pushed by a broad-based appetite for real estate. Buyers range from traditional pension funds to international investors, from REITs to the fast-growing TIC investment groups. That appetite continues, despite a competitive market that has driven prices up and cap rates down at a time when many quality properties already have been gobbled up.

But that demand has also drawn additional deals to the trading block, according to Dave Rasmussen, vice president at Collateral's Minneapolis office. "We've been seeing clients who are normally long-term holders who think the pricing is so crazy now that it's time to take advantage of it and put more of their properties on the market."

New projects are also coming to market, and their developers are pushing to stabilize and lock in their low-rate permanent mortgages as quickly as they can. The hottest of those projects are retail centers, which remain popular with investors and developers.

But beyond that, the pace of new commercial development remains subdued.

Bankers are still being "pretty conservative" on funding new construction in other property types, said Mike Meents, president of Towle Financial, a subsidiary of Wells Fargo Commercial Mortgage.

"They're beginning to show some interest in industrial," Meents said. But he added that banks are still shying away from offices and apartments, especially with single-family home construction remaining so strong.

But if the demand for new office and apartment construction is slow, the demand for cheap mortgages is making up for it. Borrowers with existing loans that are nearing maturity are scurrying to lock in new mortgages that are 200 basis points or more below their current deals.

Those margins have also prompted many borrowers to refinance before their loans mature, taking prepayment penalties in order to lock in favorable long-term rates before those rates begin to climb again - a turnaround that every broker and mortgage lender had expected to be well under way by now.

The pool of mortgage holders that are getting ready to refinance also appears to be growing, according to Meents and Rasmussen. They said a large cohort of mortgages was originated between 1995 and 1998, the result of a real estate market that was bouncing out of its early '90s trough and the simultaneous development of the CMBS product - a lower-cost securitized mortgage funding tool.

All those mortgage holders are now trying to guess when to refinance - whether to take a substantial penalty to lock in favorable rates, or to wait until their loans get closer to maturity, risking that the long-anticipated rate hike will beat them to closing.

A brief spike in rates actually spurred the refinance market into a couple sprints during the first half of the year, said Tony Navarro, vice president at GMAC Commercial Mortgage's Minnetonka office.

"Interest rates had bumped up in April (to 4.47 percent after lingering at 4 percent or below for months), and people jumped in and finished deals out of concern that the rates were going up," he said.

That pattern was repeated recently, helping to keep volume "very, very strong," Navarro said.

Borrowers are also benefiting from very low spreads - the margins that lenders negotiate over the comparable Treasury note index. Those have been pushed down by competitive lenders who have expanded real estate positions, and by record-setting sales of CMBS issues, adding to the lending capital in the first half of the year.

Those narrowed spreads are one of the factors that prompted a shift in L.J. Melody's local strategy, according to Doug Seylar, managing director in Melody's Minneapolis office.

"Straight refinance is becoming a commodity, and that's why the fee compression is occurring," Seylar said, noting his team has focused its efforts instead on finding larger transactions where more complicated structured financing packages can give added value to clients - and higher returns.

"That may involve things like raising more equity, using higher leverage or adding another layer of debt on top of a CMBS loan," he said.

So far the results look good, with average loan size increasing in 2005, contributing to volume growth that should be at least 35 percent and possibly much higher, he said.