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THE FINANCIAL SERVICES AND REAL ESTATE WEEKLY FOR MASSACHUSETTS

FLEXIBLE FINANCING

A Misunderstood Source of Multifamily Lending

CMBS Loans Have Unconventional Characteristics

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November is here: the time of year when multifamily investors begin to think about how they will close all of their deals before they can enjoy their Thanksgiving dinner. As thoughts turn to whether there will be enough room at the crowded dinner table, investors should also consider making room for commercial mortgage-backed securities (CMBS) lenders at the multifamily table.

According to the National Multi Housing Council (NMHC), CMBS financed 17 percent of the multifamily housing market during its peak in 2007, and an average 10 percent of the market since 1995. In recent years, however, CMBS loans have accounted for only 7 percent as the field of willing lenders has grown more crowded, with Fannie and Freddie garnering the lion's share.

Why the decline? Relatively higher CMBS interest rates compared to other multifamily loan products, certainly, but the perpetuation of a few lingering myths is also at fault.

Myth One: CMBS loans are not negotiable and lack flexibility. The unique qualities of the CMBS business model often lend it to the commonly held belief that CMBS loans are non-negotiable or their lenders lack flexibility. However, one just needs to appreciate the acronym to understand that, by definition, securities look and feel differently than conventional real estate loans, and for good reason. CMBS loans need to satisfy the rating agencies and bond holders.

Nevertheless, amid the various, complex rules and regulations surrounding securities, there is much flexibility, and in some cases more than can be experienced with a balance sheet lender. The CMBS lender is in the business of moving loans to investors. To do so, it must check off certain securities market requirements. Once that is done, the CMBS lender is able to negotiate property substitutions, out parcel releases, cash management structure, reserve release provisions and subordinate financing to tailor to the borrower's needs. The conventional lender may have a more restrictive internal policy or a federal/state regulatory environment that hinders its ability to provide the same degree of flexibility. But the CMBS borrower should not be shy, rather he should express his needs at the commencement of the underwriting process.

Myth Two: CMBS lenders have no long-lasting relationships with borrowers and are lenders of last resort. This myth is belied by our experience. Many of our CMBS loans are with repeat borrowers. They show loyalty to CMBS lenders and their counsel when they demonstrate a smooth execution over several past transactions. Also, CMBS lenders win over loyal customers when they accommodate a borrower's request to show creativity in maximizing loan proceeds that conventional lenders are unable or unwilling to do.

Myth Three: The CMBS loan industry is not expected to survive. Although no longer accountable for nearly one-quarter of the $3.1 trillion commercial real estate market, CMBS loans have settled into an impressive yearly range of $90 billion. In this saturated market of lenders of all sizes and stripes, currently rising interest rates could result in CMBS lenders increasing their market share. Longer interest-only periods, higher loan-to-value ratios (i.e., more loan proceeds) and non-recourse provisions combined with the ability to lock in 10-year terms with a fixed rate will once again increase the attractiveness of CMBS loans.

It is also pertinent to recall one of the main reasons for the existence of the CMBS loan industry: to spread risk. CMBS has always been used as a tool to diversify portfolios, price loans appropriately to reflect risk and ultimately lower interest rates for borrowers.

Despite the benefits, CMBS is not for the uninitiated borrower, as there are several rules of the industry that must be mastered. It is critically important to work with an experienced and trustworthy CMBS lawyer to help avoid the commonly experienced pitfalls of CMBS and help make the CMBS lender a welcomed guest at the family table once again.

Ian T. Lane is a partner in Sherin and Lodgen's real estate department. He is experienced in all aspects of real estate law, with a specialty in complex financing transactions, including CMBS loans. **Gary M. Markoff** is former managing partner of Sherin and Lodgen and a member of the corporate and real estate departments. He works with clients primarily on business, corporate and real estate transactions and bank financings.