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THE WEEKLY UPDATE ON REAL ESTATE FINANCE AND SECURITIZATION

Nonbanks Seen Boosting Construction Loans

Nonbank lenders plan to step up the origination of construction loans this year, attracted by higher returns and reduced competition from commercial banks.

Banks continue to dominate the sector, but their appetite has waned since higher capital charges were imposed on construction debt in early 2015. That has opened the door for debt funds, mortgage REITs, private-equity shops and other nonbanks, which have been gradually increasing construction lending as a supplement to their core focus on bridge loans backed by transitional properties, as well as mezzanine debt.

The growing list of nontraditional construction lenders includes Acore Capital, Apollo Commercial Real Estate, Blackstone Mortgage, KKR Real Estate, Mack Real Estate, Madison Realty Capital, Mesa West Capital, Starwood Property and TPG Real Estate Finance. Also active are two investment platforms backed by third-party capital but managed by banks: J.P. Morgan Asset Management and Goldman Sachs' Broad Street Real Estate Credit Partners fund series.

Executives at nonbanks generally declined to specify origination targets for this year. But speaking privately, many said they expect to increase their activity.

The higher potential returns that construction loans offer relative to bridge mortgages make them appealing.

"With construction, we are getting paid two or three times as much spread as we are on a straight transitional property that's 70% occupied and just needs some lease-up," said one seasoned lender at a big nonbank. "Transitional loans are inside of 300 bp [over Libor] — maybe 275 over. But construction is 550 or 600 over. Sometimes, depending on the project, it might be 1,000 over."

Acore Capital co-founder **Boyd Fellows** noted that his shop has originated more than $1 billion of construction loans over the past two years. "We have enough committed capital that we can continue to keep up that pace or exceed it" if there are suitable opportunities, he said.

Blackstone Mortgage chief executive Stephen Plavin has cited construction loans as "a very attractive opportunity . . . as the banks continue to struggle with regulatory challenges and capital constraints." In a presentation to stock analysts in October, he noted that his REIT had originated two construction loans totaling $284 million in the third quarter. The loans had a 54% loan-to-value ratio and were pegged to Libor plus 515 bp. Douglas Armer, the REIT's capital-markets chief, added that factoring in leverage, the loans will produce a low-double-digit return.

The origination of construction loans by banks peaked in 2006 at $243 billion, according to estimates by Trepp. Lending pretty much dried up after the financial crisis and then started to rebound, but hasn't approached the pre-crash levels. Trepp estimates that the tally was $135 billion last year, roughly flat with 2016. (Aggregate figures for construction lending by nonbanks were unavailable.)

In 2015, regulators significantly increased the amount of capital that banks must hold in reserve against "high volatility commercial real estate" debt. Construction loans fall in that category unless the leverage is 80% or less, the borrower's up-front capital contribution is at least 15% of the project's estimated value upon completion, and that equity remains tied up in the project for the life of the loan. The regulation has increased the costs associated with many construction loans, dampening banks' interest.

Those constraints have clearly been a boon for nonbanks. Josh Zegen, a co-founder and managing principal of Madison Realty, said nonbanks don't face the same leverage and customer-concentration limits that banks do, giving them more flexibility to take on loans that they find attractive.

Mesa West principal Jeff Friedman cited another competitive advantage: Nonbanks generally are willing to originate on a nonrecourse basis, while banks typically demand recourse.

At the same time, nonbanks are facing heightened competition for bridge loans from an influx of new players. Spreads on bridge loans to good sponsors have compressed by 50-100 bp over the past 12-18 months. That has spurred some nonbanks to turn to construction lending in pursuit of higher yields.

"It's hard to pin it down to just one thing," said one longtime lender. "The borrower demand has to be there, and the relative value has to be there. But yes, spread compression on transitional loans has made that product a lot less appealing. There's not much blood left in that stone."

But expanding into construction lending requires a skill set that some bridge lenders don't have. "Construction lending is a different animal from lighter transitional lending," said Peter Sotoloff, the lending chief of Mack Real Estate. "It's more complicated. There's a distinction between lenders who understand construction and those who don't. A lender who truly understands construction, and how to effectively monitor a project against its business plan, is well-positioned to work with borrowers as problems arise and ultimately to protect its position."

Sotoloff noted that Congress is considering legislation that would ease the elevated capital requirements for banks on construction loans. The Senate passed the measure this month. If the legislation is enacted, it could reduce a competitive advantage of nonbanks, he said. ❖