The Credit Market Today and Its Impact on Real Estate - Chris Litzler: Ep #461

Full Episode Transcript

With Your Host

Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps

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Welcome to the Dentist Freedom Blueprint, a podcast about freedom—freedom from expectations of society and the traditional path to success that has been ingrained in us from our early years, I'm joined by mavericks, renegades, and non-conformers to discuss an anti-traditional path to financial freedom, freedom of time, relationships, health, and ultimately freedom of purpose. My name is Dr. David Phelps. Let's get started.

David Phelps: On this week's podcast. I thought I would share with you a conversation that I had just a few weeks ago at one of our Freedom Founders' large member events.

This conversation is with somebody I've had on the podcast before. So, if you like what you hear and want some more information about Mr. Chris Litzler, Chris is a senior vice president of the capital markets for Marcus & Millichap in their Cleveland office.

Chris is a standout in his knowledge of the commercial real estate space.

And as we all know, the commercial real estate space is undergoing some massive upheaval right now, just this week with the bankruptcy of WeWork, which starts the pendulum moving in a place where I believe that we're going to see more and more fallout.

To get some insights into the capital markets, here's my conversation with Mr. Chris Litzler. Enjoy.

My good friend Chris Litzler came down from Cleveland, the office of Marcus & Millichap. I introduced him this morning a little bit, gave you some of this background.

Alright. Chris, well, your position and your understanding of the markets is particularly relevant right now.

And I talked to you a little bit this morning, but was asking you just for people's understanding, who is it that you talk to and interact on a daily basis? Who are the players in your marketplace that you would be having conversations with?

Chris Litzler: Sure. Big picture, what I do all day long is I arrange capital for all types of commercial real estate deals. So, office buildings, industrial, self-storage, retail, multifamily with all different types of capital.

So, life insurance companies, Wall Street money, pension funds, government agencies, banks, credit unions.

So, I'm having conversations with capital sources and I'm having conversations with borrowers of money or sponsors. So, we see both perspectives, we see what's going on on the capital markets and we see what's going on with the underlying assets.

David Phelps: So, Chris, what's going on with the money side, the capital markets side? I know there’s different trances of that but give us kind of an outlay of who has money, who is wanting to get it invested, and who's tightening things down.

Chris Litzler: Sure. So, for the first time in a long time, there is a way to get a good yield without taking any risk. The federal funds rate is at five and a quarter compared to zero two years ago.

So, to put money out in a real estate deal, we need to make some sort of spread to take the risk. So, there is money abundantly available. The government agencies, Fannie Mae, Freddie Mac, are mandated to provide that liquidity for housing.

There's tons of money in CMBS, the life insurance companies are very well capitalized, but the cost of that money to borrow it has gone up.

So, the only folks that are borrowing that money are folks that really need it. Or in some maturity situation or the equity is requiring to be repaid.

The folks that don't have much money to lend are the banks. It's not that they don't have the money, it's they're trying to maintain the cash balances because in the event that they were to have more withdrawals.

David Phelps: And they certainly had some withdrawals, haven't they this year for various reasons? I mean, there was a lot of fear back in March with the banks that went in there, had to be salvaged.

And then as you said, the risk-free treasuries, it sucked a lot of money out that they normally would have. So, that's tightened up their box.

I even read the other day that JP Morgan was having to securitize more of their debt to get capital infusion back into the bank.

So, the Fed's got certain requirements and has the Fed not increased those requirements since the summer capital reserves for the banks at different sizes?

Chris Litzler: That's right. And there's much more scrutiny of it. And they have tiers of banks too. For a while, the smaller banks didn't have as much scrutiny. But everybody today is paying a bunch more attention to it.

The challenge that they have is that they put a lot of loans out, construction loans or even refinances that they expected to be repaid when these loans were made.

And every loan is being extended or held to the life of the loan because they were issued at rates that were much cheaper than what could otherwise be achieved today. So, they're not getting the repayments that they would've anticipated.

So, they're not putting out as much new money because they don't have as much cash as they would have.

David Phelps: So, how long do you think the extension for those that have loans that come to maturity, they need to refinance and they can't, so the bank lender doesn't necessarily want the property at this point?

How long do you think they extend? Is there a point where enough's enough and the lender's going to say, “We're done. You can't pay us back. We're going to take the property.”

Chris Litzler: There will become that time, and I think it's important to note that you could refinance today.

There's abundant liquidity out there. You would be able to refinance the performing real estate today. You just may not be able to get enough leverage to repay the entire first mortgage balance.

So, that shortfall would need to be some sort of rescue capital equity infusion. But there is an abundance of vehicles to refinance these deals.

So, only until such time that the lender feels like values are deteriorating in such a way that there isn't a clear path to a

refinance, would they put the pressure on to force a sale or ask to be repaid?

And you'll start to see that when these maturities really start to come in a wave. A lot of the acquisitions that happened over the last couple of years were put out with shorter term financing, three-year deals, floating rate loans.

And those have started to mature and will continue to mature at least at the end of that initial three-year term, some part of this year, and into next year.

Most of those loans have extension options, they're expensive. The hedge that you purchase, the interest rate cap hedge, on a lot of these loans is expensive right now.

So, lenders have been willing to extend and there really haven't been many trades to determine value. Because the only sales that are happening are stuff that's forced to.

So, if you don't have to sell, not a lot of folks are selling right now. But once a lot of those trades start to happen and lenders can determine value, they may be less friendly.

David Phelps: Maybe a little bit like what Ted was talking about this morning. When things start to break or contract, it kind of happens slowly at first. Little bits pieces, little bit outliers here and there.

And then once it starts to roll, it's like it happens very, very quickly. And you just don't know when that's going to happen. But when it goes, it can go.

I mean, the financial markets very much that way. I mean, when the markets start to turn, it's just, it's very emotional. Same thing

can happen not as quite as quickly, but in real estate, more illiquid. But still, it can start to happen.

And as there's more activity, more trades, you said, then we start to establish a potentially a downward trend. And that's where everybody starts saying, “Well, wait a minute. What now?”

I think you were talking earlier today when we had a conversation that a lot of the short-term variable rate loans that syndicators and operators took out, because that was easy money back in 2020, ‘21, it's relatively cheap money.

And the market was such that they knew they could get in and typically get out during that period of time with typically a three-year term with two-year, one-year extensions. So, basically a five-year run.

And those that got invested in 2018, 2019, got some equity runup, and if they're good operators could get through, could refinance where they needed to do, probably in most cases, those would be okay.

But those that got in a little bit later, 2020, ‘21 and bought at a higher price point and rents have been softening. And so, the NOI goes down and now, they don't have the ability to refinance as they propose to do. Is that essentially what's happening?

Chris Litzler: Those are the types of loans that would have the most risk today. Because if you had bought the same property in 2020 or 2021 with long-term, non-recourse, long amortization, no covenant, those loans would be totally fine right now.

There's the underlying real estate is performing, there's no maturity event. There would be cashflow to support the loan and there would be no challenges.

The challenge comes in only upon maturity. So, those are the properties that are most at risk. That's on the multifamily side.

Storage had a lot of bridge deals, but the asset class that's in the most trouble is office.

I mean, even if you had bought an office building with permanent financing, rents are soft, occupancy is soft, there are major headwinds in office that you may not be able to support an office building, even if it was on permanent finance.

David Phelps: Let's do a lot of capital out in the marketplace looking for yield, looking for investments. And so, you have an operator who is facing maturity event and needs an equity infusion, as you said, because you've got to get back down to a loan to value that the lenders will take the risk on.

What’s the appetite today as you're trying to help some of these operators do a work through … I don't call a workout, but it's a work through, I guess, process.

What's their ability in general? What have you seen to bring in more capital to allow them to do that? Is that happening okay? Is it depending on the operator, their track record, their credibility factor?

What are some of the things that you're seeing that makes that either work or not work?

Chris Litzler: Yeah, the biggest thing is the capital calls are tough. A lot of the guys that bought property over the last several years didn't have the deepest pockets, didn't have most experience.

David Phelps: You mean like the ones that Brian was talking about where they put a hundred dollars in?

Chris Litzler: That's right.

David Phelps: No pocket.

Chris Litzler: And this typical of every market cycle. At the end of every market cycle, leverage is abundant, newer folks get into the business.

So, those folks are having challenges because they can't write the check themselves and the investors don't feel comfortable writing that check.

But the more experienced sponsors, the folks that are able to write that check themselves, that's the way around it.

There is capital out there to rescue these deals. We arrange a first mortgage, we put some preferred equity on top of it, but it's very expensive.

So, if these properties aren't performing and we put on this type of debt, it's not going to service the interest expense.

David Phelps: That's what guys like Van Horn do. They're out there, they're bringing that private credit to the market, charge exorbitant interest rates. No, you charged with the market bear, it's based on the risk. I know, but there's capital out there.

But they're going to have to meet certain metrics and underwriting that, again, just someone like a Dave Van Horn would look at if he was going to make that kind of a private credit loan.

So, I know you're not only a credit market analyst, but you're also an investor like everybody here. You don't just sit back and put your money in savings, you like to be in the game.

Give us through your eyes, how are you looking at the equity markets today? What would you consider as maybe some of the criteria you would use if you were considering something from somebody you knew and was bringing you a deal?

How have you changed your buy box criteria from last year or 18 months ago even, to today? What criteria are you looking at through your eyes?

Chris Litzler: Sure. I mean, I still think that the underlying real estate is still very, very strong. And if we look at apartment buildings for example, there's really no new construction starts happening right now.

There's really no new inventory that's going to come online in the next couple of years. It's starting today.

So, we have a leverage issue, we have a capital markets issue, but we don't have an underlying real estate problem. So, if no new supply comes on, then you're going to have rent growth.

So, I wouldn't change my investment thesis. I own well located B+, A- quality apartment buildings. I buy them myself personally. I have no investors in them. I use long-term financing.

Look, there's probably a much more efficient way to invest my money where I could get better returns, but I have a very long investment outlook. I don't think it's very risky. If I were to lose money, I'd only be losing my own money.

I also do make loans into my clients and my friends' projects, but I do it more based on the person. I'm sponsor first, deal second. And that's been a change for me is to really lean in on sponsorship and the operator of the real estate.

David Phelps: You spend a lot of time, like some of the rest of us in different groups, you get to know people. You're getting to do that here.

That's what Troy was talking about and what David and Bill were talking about is you get to have conversations directly with the person, with the sponsor and say, “Well, is this somebody that I even begin to believe has the ability to track record the culture?”

And then you do the deeper dive. You go deeper into the asset and if you don't know them that well, track record, et cetera.

I wanted to ask you a little bit about what your feeling is and what the lending environment is today for larger redevelopment projects or ground up today. What's the appetite there?

Because again, that has to be short-term financing. You can't get fixed rate long-term financing until you've got a stabilized project.

Do you want to maybe explain a little bit about that, so people understand how the process works, and how it's working, and where the headwinds are today, and what you see in terms of how much ground up redevelopment is going on today versus a couple years ago?

Chris Litzler: Virtually all of the construction financing in this country is done by banks. They're shorter duration loans, they're floating rate loans, and they're really just used to build the project. And

once built, they usually get refinanced into longer term non-recourse financing.

Virtually all construction projects have a full repayment guarantee. So, these are recourse loans.

So, the developer is buying a site, entitling it, permitting it, using the construction loan to build the project, and they're fully guaranteed repayment.

Two components of the construction loan that are making it very challenging today.

The first is construction costs haven't come down. So, it's equally costly to build these projects and the interest component is substantially up. So, construction loans are floating rate over the Fed funds, over SOFR, plus some spread.

So, Fed funds went from zero with a spread of 250. So, 2.5% interest rate on these construction loans to a five and a quarter SOFR, plus a 350 spread. So, the cost of the money has increased substantially.

Further, these projects take time. You buy a site, you get it entitled, you get it built, you get it leased up. I mean, this is a three-year process.

So, you really have to have some conviction on what the market's going to look like when this project delivers for me to take on that risk.

So, if you don't know where interest rates are going to be in three years from now, you're taking a lot of risk knowing am I going to be able to exit this project? So, that's why you've seen it stall out.

If the project wasn't fully entitled, loan was committed, those projects are still kind of moving forward, albeit slowly. But if you weren't at that level, pencils down.

David Phelps: So, the operator's taking risks and the lender was also taking risks. So, that's why those deals have slowed down.

Chris Litzler: I guess I didn't quite answer your question.

There is still plenty of money available for construction loans. Banks would be plenty willing to fund the construction loans, but there's much less leverage. We used to do construction as 85% loan to cost. Today, that might be at 50% loan to cost.

David Phelps: That's a huge difference.

Chris Litzler: It's a huge difference. So, that 50% is equity. So, A, not a lot of folks want to write that equity check and there's more risk.

So, it's not that there isn't capital for it, it's just the capital that's available isn't working for the deals today.

David Phelps: So, I think since we established this morning, not just this morning, but we've been talking about, but Ted kind of just really nailed it again, that we're in a probably a higher for longer situation with rates that the last year, earlier this year, all the Feds going to pivot. Rates are coming back down. We'll all be okay.

I think we've got to push that off a good while.

That being the case, how long does it take in the real estate markets commercial, let's say for … well, you said it a little bit earlier, so maybe I'm backtracking and reiterate what we talked about, but it takes time for the values that spread between bid

and ask, which has been huge because that's why no one's selling.

And if you're not in trouble, you don't have a maturity event and you're operating, you're just going to stay with it.

So, how long did it take for the values to start to equilibrate to interest rates? Do you see that happening later this year? Next year? Ongoing process?

Chris Litzler: Well, it's already happening. I mean, folks are trying to electively sell, and we have a brokerage side of our office that sells predominantly most of all the assets in the Midwest.

And they're telling guys the value that they could sell their properties for today and they just don't want to hear it.

So, that the values are already coming down. You're just not seeing the trade to substantiate. And once folks start to capitulate, then you'll see more trades. You'll start to see the distress sales. Only the folks that have to sell will sell.

There's very few left of the legacy folks that bought these properties in 2002, 2004, that didn't sell that now, would like to sell. Those are still out there, but those folks, if they didn't choose to sell in the runup, they aren't likely to sell now.

David Phelps: Could you give us a little bit of an insight into what we would term loan covenants? Most people think that, "Well, as long as I just meet the payment obligations under my note contract that everything's okay."

What are loan covenants and why are they playing potentially a bigger part today? Or are they at this point? What are you seeing? Because you underwrite and help place a lot of loans.

Chris Litzler: Loan covenants are a really sneaky, potentially large issue. They're predominantly in loan documents with banks. The banks say, "Well, basically the covenant is to stay in compliance. With the loan, you need to meet certain thresholds."

There's typically a net worth or liquidity covenant. So, in this loan every year, tested annually, the guarantors of this law need to maintain X amount of liquidity.

So, if you don't have that much liquidity, that would be a covenant breach.

David Phelps: So, even if my project is running fine and I'm not in default in any form or fashion, but they're going to want to see my balance sheet.

Chris Litzler: Absolutely.

David Phelps: And if my balance sheet is not so good, then that's a potential breach of a covenant and what can happen if-

Chris Litzler: I mean, it could go so far as being an event in default, could also require a pay down of the loan, to get the loan to a level that the bank feels more comfortable with, which is what would happen in the other form of the covenant. Which is typically a debt service coverage ratio requirement. So, 120 1.25 times.

Where if the property's underperforming, the bank can say, "You need to pay us down to a level where the NOI would cover that service at that level."

David Phelps: So, I bought a property, and I assumed that rents would keep going up. And I'm not really the best operator, I want to play the game of just get in, lipstick it, sell it.

And all of a sudden, I'm caught in this interest rate fluctuation, and now, my rents are coming down.

And or I'm this floppy operator and I've let management just dissipate and now, my DSDR is not being covered. And again, I have to come to the table with something to offset that.

Chris Litzler: That's right. And now, you have banks that want the money back. So, most of these covenants are with banks and you have banks that made these low interest rate loans, and they wouldn't mind if they got that money back.

So, now, all of a sudden, those covenant tests might be getting a little bit more scrutiny because A, they want their loans to be in compliance. But B, if you breach a covenant, might be an avenue for them to get repaid.

Now that's an important distinction. One thing that our borrowers often think about is the life insurance companies, Fannie Mae, Freddie, there are no covenants. On some of these permanent loans, there are no covenants. As long as you make your payments, then you're in good standing.

So, that's one of the key differentiators of a lot of types of loans. One reason that folks avoid banks or credit unions is to avoid the covenants.

David Phelps: So, part of my diligence as an investor is understanding what co financing my operator has on the project.

I mean, everybody clear, we've been talking about that this morning, this afternoon, but that's one of the things I want to look at. If I go into IRC, want to see what Bert and Larry have put there. These are the things that we need to be looking at.

Don't just say it's IRC approved and go, just go in and look at the documents and understand what we're talking about here. You all can do that. You all can discuss that on your fit calls. Really important.

Chris, what is the magnitude of difference in the amount of actual, let's just call it deals or loans funded this year versus a year ago? Just in your office.

Chris Litzler: Our office is probably down somewhere between 60 and 70% in terms of transaction volume. 2022, 2021 were crazy high years.

So, the levels that we're producing today are probably closer to in line with 2018, 2019 levels. So, still a lot of transactions, but not nearly as high as before.

David Phelps: So, we really in aberration is what I'm saying. You're down from the height, but the height was an aberration to begin with.

Chris Litzler: Correct, that's right. So, I'll tell you from my business specifically, 50% of my business has been acquisitions and 50% of my business has been refinances.

So, if you know that the sales volume is down 60%, well, I'm capturing 60% less sales.

Now, of the sales that are happening, maybe a third or a half of them are on loan assumptions. So, there's no new financing taking place on a loan or something. So, your singles financing opportunities are down a lot.

And then on the refinance side, not a lot of folks are electively refinancing. We put a lot of long-term loans in place at very cheap levels.

No one is going to refinance those deals to try to recoup a little bit of equity but increase the marginal cost of those proceeds significantly.

So, there's just not as many transactions happening. When you start to see some distress, there will be more transactions or when the market perpetuates and folks say, “Well, there may be further value deterioration to come and now might not be the worst time to sell.”

David Phelps: Just mentioned loan assumptions. It sounds great if I can buy a property and assume a loan that was from three years ago at under 3 or 3.5.

Are there any downsides to an operator taking on a loan assumption? Are there other guarantees or is there continued offsets? Is the original guarantor let off the hook? Or what happens to that? Just give us, in commercial space.

Chris Litzler: Loan assumptions are typically only available on permanent financing. So, with a life insurance company with CMBS, Fannie, Freddie hard. Because those lenders focus 80% of their attention on the underlying real estate and 20% on the borrower.

The borrower and those types of loans is really just to check the box for them.

So, if a new buyer comes in to assume that loan, so long as they check those boxes, they can take over the existing loan. At that point, the seller is off the hook. They're released from the carve-outs.

Just because you are assuming a loan at what I would suspect would be a lower interest rate today than what you might

otherwise get, really the only benefit to the buyer is the interest savings, the net present value of those interest savings over the life of the loan.

So, you can't just pay 2021 pricing because you have 2021 interest rates. Because the value of that is only the net present value of those savings. Because once the loan rolls, you'd be forced to refinance it at market.

The other thing to think about is most of those loans that are assumable have call protection. They have pretty punitive prepayment penalties in the event the reinvestment rate is lower than the face mortgage rate.

So, the reason that a lot of buyers didn't want to use that type of financing is because it could be difficult to get out of them.

So, in the event that interest rates did go down and they wanted to recapitalize, it could be expensive to do so.

David Phelps: Someone put a syndication deal across my desk in the last few months and they were selling it because we're assuming a loan that's 3.5%, and look what we got.

Well, but you have to look at the other considerations and where is the call provision? Where is a prepayment penalty? What other stipulations are they taking on?

Again, we as the investors, as the LPs, have to look at this because we're riding coattails with people who are managing our money. But if we don't understand what the other issues are, then we're stuck in the game with them, whether they were prudent or not.

And again, we can all look at this together, but these are important things to consider.

Alright, let's say we go into a heavy downside market correction the next couple quarters and Jay Powell waves the white flag and says, “Okay, okay, I'm going back. We're taking interest rates back down again. We're going to crank up the QE, we're going to flood the economy with trillions of dollars because we got the printing press, we can do it.”

How quickly does a falling market … I'm talking about real estate now, a falling market that's gone in this like crashing and of course the financial markets are too. How quickly can a real estate market come back up if Powell goes to that extreme and tries to juice it?

Chris Litzler: If the property problem is an interest rate problem, then pretty quickly. If your property is performing as the same NOI today with a 7% interest rate and all of a sudden you can borrow a 4%, that's solves the problem.

But if interest rates are down because the economy is having real challenges, which is the only way that he could take it down, then you might have more vacancy, you probably have lower rents, and you have a different problem.

Lower rates don't solve underlying real estate problems, poor performance, poor occupancy, not achieving rent growth, high operating expenses. So, really, it depends.

David Phelps: Well, I've about chewed up all the time here. I left time for like one question, I’m sorry. Who's got one like really good question? Coming out of your left blank, look live.

Speaker 3: So, what asset class do you think is going to have the most issues in the next we'll just say two years?

Chris Litzler: It's without a question, office. There's just too many fundamental challenges with work from home and there's just too much supply. I don't know what the solution is, but that's-

Speaker 3: Do you see that mostly in the larger cities where they have the high rises, or do you think some of the suburban areas are going to be a little safer?

Chris Litzler: Good sub-markets with good demographics, with good incomes, that suburban office is probably okay. Like the better quality stuff. But see quality, kind of crummy vintage stuff, I mean, it's obsolete unfortunately. I don't know what the repurposed use is.

We just have too much inventory. I mean, this stuff was built when everyone was going to the office five days a week. And that's just changed. Until that would return to normal, we have our oversupply issue.

David Phelps: Alright. Chris, really appreciate you coming all the way down from Cleveland to be with us yesterday, today. Mr. Chris Litzler.

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