The Risks and Cost of Borrowing Money Today - A Renewed Sense of Due Diligence – Chris Litzler: Ep #502

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Dr. David Phelps

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Chris Litzler: The cost to hedge was nothing and we didn't do it. In 2021 to buy a three year cap at one percent cost us nothing and we chose not to do it. And we didn't put on long term fixed rate loans because we thought we were going to be able to come in and flip it quickly. So there's definitely been a renewed sense of how do we de-risk these deals.

"David was of course a dentist, but he was a very sophisticated real estate investor. He had run with a circle of probably the most sophisticated housebuyer types in the country."

"David is a student of the game."

"I would never say this about most people. I would get in a foxhole with David."

"His knowledge is unreal. I mean, it's off the charts."

"This is not some person in front of you going, 'Yeah, just give me your money and I'm going to invst it in real estate.' It's way more elevated than that."

"The most common message I get, I want to thank you so much for introducing me to Dr. Phelps because my wife and I—we went to Freedom Founders. We're on a path. We're going to be financially free. We are going to retire sooner. We are going to be happier. This changed our life."

David Phelps: I recently spoke to a good friend of mine, Mr. Chris Litzler, who's a Senior Director for Loan Originations for Marcus Millichap, which is a commercial real estate financing corporation. Needless to say, Chris is well versed in the credit market cycles and is one of my barometers For credit shifts regarding real estate and how banks need to react and change to the current economy.

Chris gives great insight into the current credit markets, which affects how we invest in real estate today. And to find some terms investors need to know as they perform their own due diligence. On the back end, I'll share my thoughts on what it will take to be a long term investor. But for now, Here's my conversation with Mr. Chris Litzler.

With the Jackson Hole meeting that just happened with Federal Reserve and Powell, seems like he's flipped from, you know, being hawkish some months and quarters in the past when inflation was the thing that you gotta go fight the inflation, gotta beat this dragon down from a 9. 1, you know, what was 18 months ago and why the government stats were down into what, three?

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Their mandate is to get to two, but everybody feels like, well, wow, Federal Reserve, you're doing a great job. You're bringing that nasty inflation back down. And now Powell's kind of saying; Okay. Now we've got, you know, unemployment taking up, which is going to be the effect and kind of what they wanted to some degree, because inflation has been driving hard. So now we're seeing the uptick in unemployment and Powell recently said, okay, it looks like we're going to go ahead and do a rate cut. Didn't say how much, you know, in September, a lot of the market was expecting, as I remember back in December rate cuts, you know, coming back in March, well, March went by then May and then July, and now we're looking at September.

There's a lot we can talk about there, but what effect have you seen? Because you're in the mortgage business. Has there already been some countenance for what Powell's sensing in the market sensing is the 10 year treasury, which is what in your marketplace you guys peg where mortgage interest rates are or going.

What are you seeing there?

Chris Litzler: To your point about Powell's comments at Jackson Hole, I think the main line that people are focusing on is his comment that it's time to adjust policy. He's definitely signaling that rate cuts are on the horizon. We're sitting here at a fed funds rate of five 30, five and a quarter, which I think everybody believes with inflation coming down to the level that it is, that is now restrictive, right?

Cutting rates to some degree is not necessarily accommodative, right? But it's just becoming less restrictive. He's definitely identifying that we now need to consider the labor market when factoring in policy. He's got two mandates. First is inflation. Second is employment. Inflation is coming down. Is it steadily on the track to their 2 percent goal?

Maybe close enough, he may think now that he does have some softening in the labor markets. Definitely have cuts priced in. I think the market is pegging about a hundred basis points of cuts by the end of the year. That's the market. He's not saying that we don't know, but that's what the market is saying.

How does that impact commercial real estate and commercial real estate financing? That really only impacts the front end of the yield curve. So that's the Fed funds rate. That's SOFR. SOFR sits at 530 today. Every basis point cut in Fed funds rate reduces SOFR. So the cost of construction financing, the cost of bridge loans, the cost of bank loans that are priced over SOFR, that will dollar for dollar go down.

So that's pretty well telegraphed. But that's still very high relative to recent historical trends of rates, right? LIBOR was as low as-- was effectively zero two years ago. So this is still a, you know, 25 base point cut doesn't really move the needle too much.

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And then you have the long end of the curve. So the five, seven, 10 year treasuries, which are not necessarily impacted by his movement of the federal funds rate. Why is he moving the federal funds rate? Is the economy slowing down? Are we expecting there to be more or less long term inflation? Are we expecting growth rates to slow down? Those types of comments are what moves that market as well as of course, broader supply and demand trends.

David Phelps: I was looking at some data and some graphs, and you're probably familiar with this too. But I think in the last 70 years, going back to 1953, out of 15 times that the federal reserve cut rates, like we're anticipating they say next month, out of 15 times, 11, 15 times. The economy rolled right into a recession.

The Fed's always a day late, or a quarter late, or whatever you want to say. They're always late. They're always reactive. Is it too late? Are we rolling into a recession? There's lots of data there. You mentioned unemployment. We can look at consumer credit card debt today, which has just expanded tremendously.

What is the runway for the consumer? 70 percent of our GDP is driven by consumption. Everyday people out there can buy what they're spending money on. From that standpoint, is there a potential even with a rate cut of, you know, let's just say what, you know, the market's expecting a hundred basis points by the end of the year.

Okay. That's 25 percent down from 5. 3. That's relatively significant, but is that enough? Is it too late? And if it is too late, do we roll into a heavier recession, which. Is overall at least in asset classes. I'm going a lot of places here. So I'll let you just decipher what I said here in a minute. You can tell I'm thinking through my head the same time I'm trying to talk to you.

But that's how I do it. As you said, the federal funds rate SOFR doesn't really affect the longer end of the curve. Does that do much at all for house housing or your market, the commercial market? I guess I'll stop there picking that you want to and run with it. Okay.

Chris Litzler: What would impact the commercial real estate market all else equal would be lower borrowing rates, right?

So predominantly that would be five, seven and 10 year treasuries. Now, assuming that there's no breakdown in fundamentals of the underlying real estate, for example, if the reason the 10 year treasury is going down is because there's material softening in the labor market, well, that may put pressure on occupancy levels, collection levels, etc.

So, leaving that aside for a moment, longer term rates going down. Would bring down borrowing costs, allow you to generate more loan proceeds. As a result, cap rates would come down. So that would be good in general for commercial real estate financing. Now, your first comment was when they cut, there's typically a recession incoming.

So what is a recession? It's like two consecutive quarters of declining GDP growth. And I think we're kind of quite a ways from that. There's two plus percent GDP growth. If you believe those numbers, I don't know when they're going to call a recession. We may have already been in a recession. The payrolls reports get revised by 818, 000 jobs over that 12 month period.

So there's a lot of questions in the data, but to your point, when they cut, they tend to cut much more significantly and rapidly than the market is expecting. And they're leading you to believe that's just historically been the case. Typically. They may know that things are on the horizon. They can't really signal for that because perception becomes reality.

The more things that become signal, they kind of talk it into reality. So we've certainly been in a recession in the real estate business for the last two years. Since the middle of 2022, when they started skyrocketing interest rates, transaction volume has drastically slowed down. We've seen values deteriorate 20 percent plus or minus. So I guess time will tell.

David Phelps: A lot of the deals, the projects that were initiated, let's say, three years ago, 2021, before rates started to go up, a lot of money that has been pumped out, credit expansion, and direct money to consumers and business owners through the COVID relief programs, and a lot of operators, you know, I know, and that was really the traditional model was, particularly when it was a project that needed to get to the term that you would use is stabilization, you have to stabilize a project before you can get that longer term financing, which is, you know, What the operator needs long term, but to take a project, that's going to go through some renovations, or we call the value add, which causes sometimes some dislocation in the revenue stream initially, until you get it back up to a stabilization, they have to get that shorter term bridge loan, construction loan financing.

You mentioned that earlier when you're talking about where the federal funds rate, i. e. SOFR plays a part here, and that's what we're looking at for September and towards the end of the year. Those are the loans that could be greatly assisted in this near term because of what Powell said, am I correct?

Chris Litzler: They'll benefit in two ways. The first is the actual cost of their current loan. The actual interest rate would go down. If we did the loan in 2021 and SOFR was 15 bps and they had a 300 spread at the time, the cost of their loan was 315.

Today, that same loan, absent a hedge. Would be 530 plus 300. So you're at 830 every basis point that fed funds goes down, that would get passed through to the sponsor and their interest expense would go down.

So that's the first way it would help them. Now, most of these loans do have interest rate caps that are some sort of hedge. Now, the cap probably kicked in around 3 percent plus or minus. The actual net effective cost to the sponsor really wouldn't come into play unless SOFR dipped below that cap cost.

So you may not feel that impact right away. However, if they were to extend that loan and they needed to buy a new interest rate cap, the cost of that cap would be less than it would have been several months ago before they started talking about cuts. So that's the second way that it impacts you. The third way that it impacts you.

And more importantly is if that property is stabilized or could be sold, a lower interest rate environment will benefit the sponsor in a refinance by A, getting more loan proceeds because the lower interest expense means the same net operating income qualifies for more proceeds or B. If the property is getting sold, lower interest rate would, as a result, the buyer could pay a higher price to get the same yield.

Absolutely helps them in many ways.

David Phelps: Makes sense, Chris. Thinking through scenarios where an operator is up against a maturity and needs an extension because of the rise in interest rates, de facto going to devalue a property just based on NOI, what are you seeing in terms of banks? Willingness and what's criteria in general are you seeing them utilize with transactions you're involved in where a operator borrower is needing that extension?

What's the bank considering criteria and in many cases is the operator borrower having to bring more equity to the table as one piece of the potential extension?

Chris Litzler: I think the general feedback is to the extent that an extension is built into the loan, regardless of covenants to qualify for that extension, the lenders are generally being flexible to extend.

David Phelps: Covenants such as DSCR?

Chris Litzler: Dat Yield, DSCR, LTV, those are the usual suspects.

David Phelps: So you're saying they may put those aside?

Chris Litzler: Correct.

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David Phelps: Okay.

Chris Litzler: And use their business sense to say, Does it make sense to extend this loan? And I think in general, we're seeing these banks extend those loans. Part of that extension, there may require a new interest rate cap, a lower interest rate cap that's more in the money so that the coverage improves.

They may require a pay down. They may require a deposit made to the interest reserve account or placement reserve account, something. All of those things are negotiations. I'll say in general, the loans that are in trouble are the ones that got done in 2020, 2021, the first half of 2022. Generally speaking, most of those loans are safe, right?

Because if we did 75 or 80 percent of the purchase price, plus 100 percent of the CapEx, if the sponsor did execute the business plan and can operate the real estate, generally that loan, that Even though values have deteriorated some, there's been enough rent growth to offset much of that. So the lender's mortgage is safe.

The equity very well could be in jeopardy, but the lender is coming from a place of, they're pretty secure.

David Phelps: So overall, you're not seeing banks in general that are being aggressive, like they don't really want the property. They feel like from a business standpoint, makes, I mean, that's the way I would look at it.

A bank doesn't really want the property.

Chris Litzler: That's right.

David Phelps: But that's the last resort. Where does the pressure come from on a bank? I mean, obviously they have their criteria, but does the federal reserve, do they have some mandates and pressure? It doesn't sound like they're being real aggressive right now.

I mean, what's your sense of capital requirements and that sort of thing with loans that are not performing, you hear the term extend and pretend, I mean, what's all that look like today?

Chris Litzler: Keep in mind that most of the bridge loans that got done were done by non bank lenders, so debt funds. They don't have the same financial regulations as a traditional bank.

However, the warehouse lines that were used to make those loans often are with some of these bigger banks. So that's where the pressure would start to come from the warehouse lenders. The non bank lender would really need to buy the loan Out of that securitization to satisfy their warehouse lines.

That's where it would come into play. And we are seeing some of these groups sell loans. That is, you know, kind of the first step. So some of these groups are hiring shops to sell a bunch of their loans. They're mostly performing loans. Just to free up that space.

David Phelps: Could you take just a couple of minutes because you let out some terms there that I know are not going to be really that familiar to a lot of people.

Could you go back and maybe define a little bit the difference between a non bank loan and what we as lay people would say, well, there's a community bank here that also makes loans. Tie that into warehouse lines. Give people just a little bit of color to explain that. Cause I think you did a good job painting a picture here. They just might need a little bit more definition.

Chris Litzler: Think of a construction loan or a loan with any one of the regional or community banks, right? They're going to make this loan. They're going to hold this loan on their balance sheet for the duration of the term. Whereas some of these bridge loans were made by a non bank lender.

So not a chartered bank. They're then. You know, put on warehouse lines and then securitized into a collateralized loan obligation that is then bought by bondholders, just like CMBS. So that's just the difference. One is held on the balance sheet of a bank. One is sold into a secondary market.

David Phelps: And so when it sold into the secondary market, you made a comment about having to buy that back out of the securitization.

Chris Litzler: The lender sometimes takes the first loss. They'll retain servicing or they'll take the highest risk piece. And when some loans are underperforming and they have a chance to negatively impact the overall securitization, it's kind of an unspoken, but spoken rule that the lenders needs to buy it back out of the securitization so that it doesn't negatively impact the CLL.

David Phelps: All right. Here's my macro question. We won't hold you to it, but we've had, as you said, real estate span in recession last two years. So we've had disinflation there in values. Our guess is the Federal Reserve comes in and cuts the federal funds rate, and depending upon how heavy the unemployment goes, the labor market, recession, what level, most people I hear feel like the Federal Reserve will once again, quote, come to the rescue.

The lower interest rates on the front end, but also go back more into quantitative easing, just turn on the, as we call it, the printing press. I don't know if you buy that or not, but seems like that's been history. The question a lot of people have is how far can this go? And isn't that going to turn back on the inflation spigot?

If so, again, this is a lot of hypotheticals, but if so, long term, hard assets, tangible assets, real estate, still a good play?

Chris Litzler: I think so. Good quality real estate without deferred maintenance in good demographic markets in typical asset classes, I think, of course, do well over time. Think the way that they would backstop it is they would buy bonds.

That's kind of what they haven't been doing is they've just been letting only half of the bonds roll off. They would stop that and then perhaps buy more and that would reduce yields and a reduction in yields would be better for the real estate business. In my mind, that's how that would play out. I don't necessarily know that them buying bonds is necessarily Inflationary? It's definitely accommodative. It's not as much so as them just handing out checks.

David Phelps: What I think a lot of people have learned, both operators and investors, over the last few years is that Changing of the economy and therefore Fed policy, inflation, interest rates have shown that we have to go back to fundamentals in terms of being long term investors versus, you know, traders or speculators, and that the quick turns, the quick flips that were prevalent and typically worked out quite well for a number of years going back, you know, coming out of the GFC a decade or so ago, that's worked in the past.

Going forward, Would you say that there's a much more focus both from your standpoint as a lender, as a credit analyst, to really be looking at fundamentals of both operators and projects that can withstand the test of time and not the quick turn? Is that more the focus today than it was three, four, five, six years ago?

Chris Litzler: Yeah, definitely. When credit tightens, there's a renewed focus on diligence and diligence is specifically on sponsorship. So, you know, you're just seeing much more scrutiny on sponsorship, experience, financial strength, credit worthiness. So those are kind of back to the basics. I think the other lesson that we learned in this cycle is the cost to hedge was nothing and we didn't do it in 2021, to buy a three year cap at 1 percent cost us nothing and we chose not to do it. And we didn't put on long term fixed rate loans because we thought we were going to be able to come in and flip it quickly. So there's definitely been a renewed sense of how do we de risk these deals going forward. Those are kind of the biggest learning lessons that we're seeing our clients take.

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David Phelps: Chris, I always appreciate your time. Thank you for the insights today. They're always valuable and I enjoy the conversations. We'll definitely have you back again as things go forward.

Chris Litzler: Let's do it, David. Well, anytime, great to see you and speak with you soon.

David Phelps: Seeking high yield and high return is what a lot of people want to do. It's normal. It's a tendency. It's like, I want to jump on board with that thing. Cause it just went up crazy. Bitcoin several years ago was climbing up to 69, 000 and then it did what?

The free fall, the volatility. That's speculative, right? I'm talking about investing. Investing, certainly you need to get a return. I get that. But when you're playing the long game and I'm talking about decades, not a year, two years and trying to He'll hit the home runs that won't get you anywhere. Babe Ruth was the highest home run hitter in history.

And yet I think his batting average was like about 333. So you see that trying to shoot for the moon all the time is not going to get you what you want. What you need is a game plan of understanding the specific investment assets that you're going to invest in. That's going to move you to your goals.

Some people think they can do it in the financial markets, and I'm not saying that you can't, but I've never found anybody who was in the financial markets who, once they saw alternatives, real estate and business, they never went back to financial. Maybe they kept a little bit over there, but I've never seen anybody go back.

I've certainly seen a lot of people from the financial markets coming to real estate, but people who understand alternatives never go back to the financial side. That's just a fact. Show me somebody and I'd be glad to meet them. So that should tell you something right there. The thing is, investing for the future in the long game Is not easy.

If it was easy everybody would do it. Everybody just invest in that index fund or that ETF and call it good. That's why when you put your money on a Wall Street and just give it to a money manager, who's going to give you a few menu items and go, we'll put you in this balanced fund and we'll put you in this small cap fund and we'll put you in this growth fund.

It's like, do you really know? Does he really know what's in it? It's just nomenclature. It's just names. If you're really going to drive your financial future, With a game plan that makes sense, you're gonna have to put some time into it. You're gonna have to get educated on this. And I know everybody says, well, I don't have time and I'm supposed to just spend my time in the chair or whatever I do or my time value is greater.

Yeah, there's a point to where you should do that. But there's also ways that you can full time, collapse time to get an understanding of areas of your life that right now you probably don't. And you feel probably a little bit ignorant. It's hard to feel ignorant when you're, Educated and you're really good at what you do, but you can't do everything.

So just admit it and say, well, where can I go to get the right information from somebody someplace where they're not biased about selling me some product that they've built that supposed to make a square peg fit around hole. You know exactly what I'm talking about. You need something that's customized and built for you, that you can get an understanding and have a place where you're not being sold something, some investment product, just because it's the product of the day.

This is what makes or breaks long term investing. How do I know? I've been doing it for four plus decades. That's a pretty good long span of time. It's not forever, but I've seen the ups and downs. I've figured out in my own life, what made sense and what will actually work for me. It's not theory. It's what works.

And I took the same model of what I learned being a product of the product. And now I'm able to help hundreds of other doctors, medical professionals with their game plan. And when they come and are enlightened as to what that world looks like, it's really a revelation that gives them the optimism that wherever they are on the pathway to their freedom, That they now see a light at the tunnel.

It's not just keep your fingers crossed some guessing game. There's actually measurables that you can look at and see and understand how to shift your money in the market cycles. It's going to be very important to be able to do this coming years and decades because we're not going to go back to the old days where it was just money figuratively running uphill.

It's your freedom. You've got to stay focused on it and I invite you. To find out exactly how you can do that. In the second week of October, I will be hosting a Freedom Founders member meeting in Plano, just outside of Dallas, Texas. To discuss, strategize, and formulate the next best moves for investors and business owners to steward their capital to safety and grow their wealth within the volatility of the current economic scenario.

The recent federal rate cut may be touted as a good sign of a comeback economy, but this is only short term in my opinion. There's more going on and if you're not truly prepared, you may find yourself on a sinking ship. I'm offering an opportunity for those serious about protecting their financial future to attend our member event as a guest and discover how we help our members create a plan B blueprint for financial freedom that hedges against these recessionary environments, these crashes and all the volatility.

To see if you qualify, go to freedomfounders.com slash discover. To schedule a call with my team and reserve your seat. That's freedomfounders.com slash discover. It's your freedom and I'll see you next time.