Why Real Estate Market Compression Should Raise Concerns for Mortgage Investors and Lenders

For the first time in several years, lenders are raising their rates, in response to the rising prime rate and the continued shortfall in home supplies. While the 30-year mortgage rate declined over much of 2017 to a low of 3.78% in September 2017, it has since climbed steadily to the current rate of 4.66%. Even private money and equity-based lenders are adjusting their rates.

With rising interest rates, the expectation is this will almost certainly result in declining real estate values in the not too distant future, with residential housing and commercial markets near or at their all time highs. This combination of rising interest rates and constrained prices has been setting off alarm bells in the minds of analysts in our office, and for good reason.

Many real estate lenders—and their investors—found themselves over-leveraged when similar conditions occurred a decade ago.

The vast majority of private lenders don't rely strictly on investor funds to make loans. Instead, they will use raised funds as collateral to obtain loans from hedge funds, investment banks, or other non-bank affiliates. This allows them to potentially increase their investor yield, but at the cost of being accountable for anywhere between 15% or up to 400% of the investor funds under management.

This can be rather stressful for private lenders, as the lending terms dictated by their leverage partners can be punishing, as a number of borrowers have learned. But when interest rates are low and property values are soaring—as has been the case, and was the case in the lead up to 2007-2008—it's relatively easy to make good on these loans while realizing a handsome profit.

However, lenders in this position live in abject fear of two things: rising interest rates, and declines in real estate prices. Inevitably, the former leads to the latter. Buyers balk at mortgage terms, and choose to delay their purchase, or instead choose a cheaper, safer option. As demand drops and the market slows, prices have to come down.

This leaves leveraged lenders in an awkward position. Some private lenders commit to what they call "use it or lose it" lines, where they are charged interest for the full amount of leverage committed, regardless if they use it or not. In this case, it creates an incentive for them to make deals they otherwise would not normally make. Additionally, they also have to raise their rates as their profit margin thins out with rising interest rates, which makes it harder to close.

Compression in the housing market is going to lead to a repeat of the crises of a decade ago.

Lenders are intimately familiar with the concept of compression in the real estate market, but many laymen investors found themselves caught off-guard when the mortgage pools they had invested began to fail in 2007 and 2008.

The interest rate a homebuyer can secure has a profound impact on what they can actually afford.

For instance, a home listing for $600,000 purchased on a 30-year note at 4.5% will ultimately cost a total of $1.094 million. But if rates climb, and that same homebuyer can only secure a loan at 6%, a home

listing for $500,000—$100,000 less—will in the end cost almost exactly the same: $1.079 million. Thus, increasing interest rates can result in significant devaluation of real estate, as borrowers are forced to stay within a budget.

This creates an awkward market conflict. When interest rates climb, the most expensive properties are most affected, and thus market appetite for these properties drops the most. As buyers start snapping up more modestly priced properties, prices for real estate in this median area are driven up. Inevitably, the two run into each other. The modestly priced homes can't continue to appreciate in value, as they can't possibly be worth more than the nicer homes. At the same time, the nicer homes can't continue to drop in price in response to lagging demand, as it makes no sense for them to be cheaper than mid-tier homes.

This leads to price stagnation, which in turn slows profit-based real estate investment. Why buy a piece of property if there's no reason to expect its value to increase in the short- to mid-term?

Capitalization rate compression also presents challenges to commercial real estate investors as interest rates climb.

When valuing a piece of commercial real estate, the capitalization rate, or cap rate, is a key means of measuring the value of the property. The formula for calculating the cap rate is simple:

Net Operating Income (NOI) ÷ Total Property Value = Cap Rate

Thus, a multi-family unit or commercial building valued at $1,000,000 that generates $100,000 in annual net income has a cap rate of 10%. The tricky thing is that income and value often don't move in correlation to one another.

Consider someone who bought a multi-family unit in the beginning of 2011 for $500,000, and that year realized an income of $25,000, with a resulting cap rate of 5%. That same unit may now be valued at $1 million (potentially more). In the meantime, while Sacramento's rent prices have exploded, they haven't kept pace with housing prices, increasing perhaps a *mere 50%*. Thus, that now $1 million building produces an income of $37,500 in 2018, yielding a cap rate of 3.75%.

This means that for someone considering buying the building in 2018, it has become a substantially riskier investment than it was in 2011. Assuming a perfectly stable market, and ignoring the resale value of the building (and inflation), the 2011 buyer might expect to recoup his investment in 20 years. But the 2018 buyer would be facing a nearly 27-year wait. That's a profound increase in risk for little return.

This is why, generally speaking, the higher the cap rate, the better the opportunity to invest. As of right now, cap rates are continuing to shrink. This decrease in the cap rate, with property valuation outpacing NOI, is known as cap rate compression. It's a leading indicator of a downturn in the market. Real estate investors, especially those relying on leverage, can't afford to take on debt to purchase properties with low cap rates.

The pinch of rising interest rates, residential real estate values decreasing, and commercial cap rate compression poses a danger to private moneylenders.

All of this brings us back to private lenders relying on leverage to increase deal flow and subsequent returns. With rising interest rates, these leveraged operators are then forced to increase their own rates in response to their costs increasing, which inevitably leads to homebuyers balking at the cost of

homeownership and commercial property investors can't square repayment costs with climbing cap rates.

Deals dry up, would-be lenders can't generate returns with their funds, and eventually they default on their leverage loans. Many overleveraged private lenders went under during the real estate crisis. And we anticipate that this is going to happen again, as the majority of the private lending industry still relies on leverage.

What's the takeaway from all this?

- Borrowers: Rates have gone up, and they're going to continue to go up. If you need to make a purchase, lock in a rate now.
- Mortgage Pool Investors: Is the fund you're invested in leveraged? If so, it may be time to consider reducing your exposure, and to seek out real estate investment firms that are unleveraged.
- Mortgage Pool Managers: If you're seeing what we're seeing, it's high time to reduce your leverage, or eliminate it entirely, if possible.

Here at Socotra Capital, much of our long-term strategy was shaped by what we saw play out a decade ago. It's because of those experiences that we utilize absolutely zero leverage. We rely strictly on investor funds to make our deals, and will never use our investor money as collateral for any loan.

If you're considering the merits of investing in a mortgage pool fund, but want to hedge against anticipated market changes, contact us today by calling 855-889-7626, or send us a message using our contact form.