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Real Estate Update

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Dave Opalek, JD/MBA
Director
David Opalek has 20 years of real estate finance experience with an extensive background in the affordable housing sector. In addition to his extensive mortgage banking experience, Mr. Opalek has been instrumental in developing new financing structures for the capital markets.

By Dave Opalek

Welcome to the inaugural issue of the Lawrence Evans Real Estate Update.

Is Consolidation Coming to Agency Lending?

By now, I'm sure that most readers of this newsletter have seen the Orix USA press release announcing their acquisition of Hunt Real Estate Capital. If you have not seen it, you can find it here. Congratulations to all parties involved. It appears that the acquisition will accomplish several strategic and financial objectives for both companies. This announcement has us asking ourselves is this a one-off transaction or the start of a larger wave of mergers?

We have been hearing vague rumors about consolidation coming to the Agency lending space for several months now. The Orix-Hunt deal is the first large scale acquisition that we have seen recently. There have been other recent mergers around the space, the JLL-HFF merger comes to mind, but this is the first large merger of Agency Lenders we have seen this cycle. We believe that there are several reasons that we will see more consolidation in the Agency Lending space over the next several months.

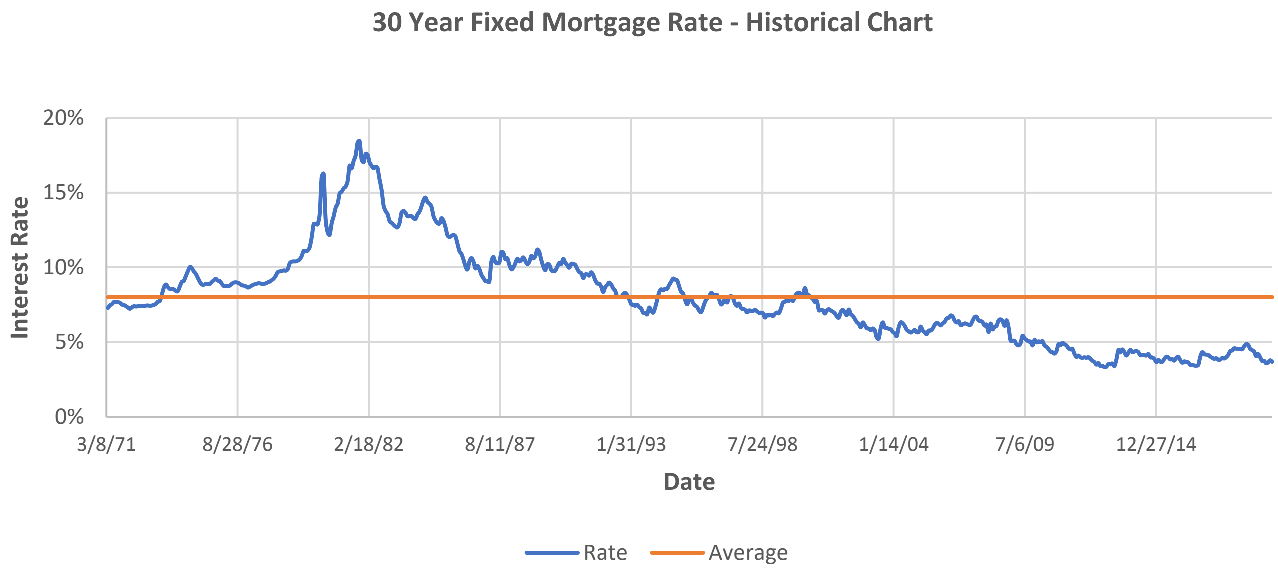
1. Most estimates indicate that there will be no respite from the rising costs of construction. The continued trade war and tariffs with China show no real signs of being resolved soon. Likewise, the national shortage of skilled labor shows no signs of easing, in fact one could argue that continued border issues will only exacerbate the problem.[1] This leads to slower development and lower deal volume for the national construction lenders as rental rates struggle to keep up with the cost to construct.

2. As illustrated in the chart below, Interest rates have been significantly lower than the 30-year market average since 2009.[2] This represents 10 years of relatively low rates for developers. It also means that the refinance market

[1] https://www.entrepreneur.com/article/339978, https://www.bls.gov/careeroutlook/2018/article/careers-in-construction.htm and https://www.bls.gov/careeroutlook/2019/data-on-display/older-workers-and-occupational-employment-growth.htm

[2] https://www.macrotrends.net/2604/30-year-fixed-mortgage-rate-chart

that we typically see picking up the slack when the new construction market softens, will not be as robust for lenders as the refinance opportunity will only save a few basis points.



3. Increased reporting and monitoring requirements in recent years from HUD and the Agencies require a greater scale to manage in a cost-effective manner.

Even though commercial and multifamily loan originations are up 24% compared to a year ago and up 9% from the second quarter, we believe that the number of new construction deals will slow in late 2020 due largely to labor and raw material pricing.

If the new construction market is becoming more challenging and the refinance market is not able to pick up the slack, how will these agency lenders find the volume they need to maintain margins? The short answer is – they won't find it in traditional lending. This means scaling up the servicing operation in anticipation of lower fee income from new loan originations and opening alternative lines of business. The only way to grow servicing in the above described environment is to purchase it. We expect to see broader non-agency lending options from some of these larger entities as they see to put capital work in the space. Additionally, we expect to see more M&A Advisory options from the bigger players as the seek to drive fee income over the next several years.

We have heard rumors that several small to mid-sized agency shops are being quietly marketed. The firms that we know about all face similar issues in the market:

1. How to maintain originations talent without a full complement of lending solutions
2. How to increase volume and/or market share in the face of more efficient competitors
3. How to contain servicing and origination costs

Larger loan volume goes a long way to solving all three of those issues.

Hopefully industry consolidation will not have large detrimental effects on borrowers. In theory, larger firms will have more market power to demand lower rates from note buyers and the loan volume to realize efficiencies of scale in underwriting and servicing. This should result in competitive rates and more efficient processes to get deals done.