**Bridge Over Troubled Water: The Evolution of Transitional Lending**

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**EVOLUTION OF BRIDGE LENDING. CREDIT: CHRISTOPHE HITZ/ FOR COMMERCIAL OBSERVER**

*“Oh, when times get rough, And friends just can’t be found*

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*Like a bridge over troubled water, I will lay me down.”*

– Paul Simon

“Troubled water” would be a generous way of describing market conditions in 2020.

As the clock struck midnight on New Year’s Eve 2019, we all raised a glass to what *looked*like a great year ahead. The bull market stampeded on, and nobody could quite pinpoint the red flag that would eventually make it veer off course, or — as we soon learned — impale us.

But, by late March, the coronavirus had brought the commercial real estate industry to a screeching halt, and the bridge lending sector went from a crowded party that would never fly under social distancing rules to a scene fit for blowing tumbleweeds. After all, lending on stabilized, cash-flowing assets was scary enough, let alone properties that were in transition and had a distinct element of hairiness to them.

The shutdown arrived swiftly. “I thought it was too quick at the time, but I was wrong,” Seth Grossman, a senior managing director at Meridian Capital Group, said. “I wasn’t a believer that the whole world would shut down drastically, but a lot of lenders rightfully hit the brakes.”

For some who retrenched, their sources of secondary financing (or leverage) had become volatile overnight, or dried up completely. The collateralized loan obligation (CLO) market — which several bridge lenders funneled loans into — had dissipated, and warehouse lines were abruptly cut off. Margin calls rang out, some more publicly than others.

“Beyond the fact that some [lenders] were too levered — and with the wrong leverage — was the fact that they had huge hotel exposure,” Josh Zegen, a co-founder of Madison Realty Capital, said. “The  average debt fund or mortgage REIT probably had 15 to 30 percent of exposure to hotel lending. I think that’s one of the things that really hurt a number of the marquee names that were very active a year ago.”

Now that we’re 10 months into the pandemic, a combination of factors is affecting lenders’ activity on any given day, Grossman said: “You can have a ripple of good or bad news in the secondary markets, and that can cause lenders to tighten or widen based on where they think they’re going to get their leverage from, or the CLO execution. You can also have a scenario where nothing changes in the secondary markets, but a lender has a handful of loans with more tenant defaults for the underlying assets, so they tighten the credit screws.”

The current ebbing and flowing of willing financiers in the bridge lending space marks a period of choppy waters to be navigated before a return to smoother sailing, poetically mirroring the participants’ lending niche.

In the meantime, COVID-19 has altered the very nature of bridge lending as we know it.

“It’s going to be a lot more complex going forward,” Jonathan Roth, co-founder of 3650 REIT, said. “Over the past 10 years, you could buy a building as an operator, sandblast the wood beams and, all of a sudden, you’ve created creative office space and can increase the rents. That’s over for a while. Now, you’re going to have to take that shuttered JCPenney box and turn it into something completely different.”

Roth noted that the essence of bridge lending has always been taking a, say, 60 percent leased asset, doing a short-term loan, and getting its occupancy up to 85 or 90 percent. Post-COVID,“that property is empty and a borrower has to figure out the higher and better use for it,” he said. “The lender to that situation is somebody who understands every moving part. It’s a firm that understands construction and really technical lease negotiations. It’s not for everybody, and I think the pool of lenders will get smaller and smaller.”

**Building a Bigger Bridge**

A full cycle of evolution has occurred within the bridge space since the global financial crisis (GFC), and it’s once again figuring out its next iteration.

For Mark Fogel, co-founder of ACRES Capital, this period is reminiscent of when he started bridge lending 20 years ago. “People are trying to figure out their way,” he said. “In 2000, we were also feeling our way around how bridge programs were going to work on a go-forward basis. It felt the same way in 2010. So, it seems like every 10 years we go through this to figure out how the space works, and reinvent it in a way that makes better sense.”

While bridge loans existed prior to the GFC, their evolution proved especially important in the years following it, as regulators tightened the reins on banks’ lending activities and a new breed of lenders — alternative lenders or debt funds — found their footing in filling the void.

Other lenders with a taste for risk, and yield, soon caught on and the draw to the bridge space continued to build to a crescendo point. Just prior to the coronavirus hitting the reset button, new entrants piled into the space seemingly every week, and the reward for the risk associated with transitional lending was diminished.

“Since [the pandemic hit], you’ve seen many groups that were in the market take a step back and groups that had taken steps back coming forward, and now, new groups entering,” Grossman said. “We’re in a very interesting time that I think is going to be the next phase of the alternative lending market.”

ACORE Capital is one firm that’s continued to lend on bridge opportunities consistently throughout the pandemic.

The exodus of other bridge lenders “leaves a hole for the likes of us who really don’t have any material problems in our portfolio of roughly 200 loans totaling approximately $16 billion,” Boyd Fellows, a founder and managing partner of ACORE, said. “It leaves us in a pretty unique spot right now, because we have plenty of dry powder to selectively deploy with materially reduced competiion. We’re not overwhelmed with problems, and we have a large asset management team in place already.”

Indeed, ACORE has roughly 30 people focused on asset management today. “Before the pandemic, we used to think, ‘*Wow, we’ve really built out one hell of a big asset management team*,’” Fellows said. “Now we’re saying, ‘It was really smart we built out this very large asset management team.’”

And until the bridge lending sector figures out how the leading indicators relate to changes in human behavior and the impact on commercial real estate, tempered liquidity is to be expected, Warren de Haan, also a managing partner and co-founder of ACORE Capital, said.

“If you’ve got an office building that’s in West Hollywood and it’s fully leased to Netflix, it’s going to get bid extremely strongly by a handful of bridge lenders at very tight pricing, and it’s going to feel like pre-COVID,” de Haan said. “But, as you drift further out into deeper renovations and so on, there’s a much thinner bidding list.”

**The OGs**

While even some of the most well-established lenders pulled back on credit metrics and dipped out for periods during the pandemic, many have been a steady hand throughout it, Meridian Capital’s Grossman said. “It’s been more difficult for some of the public vehicles because they’re at the whim of the stock market. But, generally speaking, several of the stronger, established lenders have been the most consistent.”

Prior to the pandemic hitting, “you just had so many different names out there,” Zegen said. “And unfortunately, brokers or borrowers were willing to take a chance on the new kid in town. But the question is, can that new kid provide what the people that have been in the business a long time provide? And do they have the experience, the track record through up- and down-cycles and the ability to fund construction loans without using leverage? One trend I’m seeing in this cycle is a lot of lenders not meeting their commitments.”

Emerald Creek Capital —not a new kid —  has been bridge lending since its formation in 2009. “Banks were pulling back massively in 2008 through 2010,” Mark Bahiri, Emerald Creek co-founder and managing partner, said of his initial draw to the bridge space. “My partner and I thought it was a great idea to start a business at the bottom [of the market], as there’s only up from there. We were looking to capitalize on the pullback and fill that void.”

As the cycle progressed, Bahiri watched the influx of competition and capital into the bridge space. But since COVID hit, much of that competition has dispersed.

“Mainly, the less-established lenders; the pass-the-hat, participant-type lenders, whose investors decided to stay on the sidelines while the pandemic played out,” Bahiri said. “The more-established institutional lenders have continued their presence in the space. Having committed discretionary capital through a global crisis is certainly a benefit.”

The weeding out of weaker firms is a healthy thing for the market, Bahiri said. After all, the cutthroat bridge lending environment pre-pandemic was the reason some established lenders chose to step back.

“In the pre-COVID times, we were only lending on situations with existing customers that had familiarity with us,” Jason Baker, an executive vice president at Pacific Western Bank, said. “If there was a situation where it was just a broadly-marketed deal via brokers, and they were going to get 15 quotes from various lenders, we were never going to be the most-attractive quote in that matrix, from a pure cost-of-capital perspective.”

Baker made his first bridge loan in 2005, while at Fremont Investment & Loan.

“The real difference is there were fewer participants in the space and higher leverage then, so you could do a bridge loan at, say, 80 percent of cost, whereas today, a bridge loan that we might consider doing is going to be 60, 65 or maybe 70 percent in some situations. There’s a more appropriate level of leverage today.”

While Pacific Western remains an active bridge lender today, it’s turned its attention to construction lending, an area in which it has significant expertise and where the competition has truly thinned post-COVID.

“Because of mortgage REITs’ obligations to fund and capitalize forward commitments, they’re staying away from construction,” ACORE’s de Haan said. “We are running towards it. And because we’re a true one-stop-shop, we’ve been very successful at doing a lot of — what we view as — great risk-adjusted-return construction transactions, because the field is very thin.”

Roth said 3650 is experiencing a similar trend. “Our life got a little easier, by virtue of the fact that, a number of our competitors, most of whom use leverage, are having a much more difficult time getting inexpensive leverage today,” he said.

Construction bridge lending is part of the sector’s evolution. ACRES Capital’s Fogel started making bridge loans when he was with Arbor Realty Trust: short-term, value-add loans that would go into Fannie Mae permanent financing within a year. “It wasn’t stretching into what we do here at ACRES, where it’s ground-up construction, or renovation or adaptive reuse. It was a much simpler bridge lending program,” Fogel recalled.

There’s another paradigm shift underway currently, and bridge lending will likely come out of the pandemic looking quite different again, Grossman said: “My guess is, it’s all for the better. The smart lenders are going to survive, and grow, and figure out ways to make more money. The groups that probably shouldn’t be playing in the sandbox may realize this when things don’t go as planned.”

**Crossing the Bridge**

With vaccines in circulation, and a light at the end of the tunnel that doesn’t appear to be a high-speed train, lenders are returning to the market, slowly but not consistently.

As a result, it no longer makes sense to only go to three of four prospective lenders when seeking financing, Grossman said: “You now have to go pretty wide, not collecting 50 bids, but going wide enough to make sure you know who’s lending and on what. A lender that may have been interested in a deal literally two months ago may have hit pause again. And conversely, lenders that were out of the market for two, six or nine months on any given date can be back in the market.”

Consequently, the time to get a loan signed up and to receive quotes is significantly longer than it’s ever been in Grossman’s 15-plus years in the business.

And, a few new faces are stepping in.

“There’s an opportunity to enter now that probably didn’t exist pre-pandemic,” Grossman said. “And there’s been a greater influx of 7 to 12 percent lenders, than 4 to 6 percent lenders.”

You’re seeing more new entrants proportionally in the quote-unquote “hard money space,” because “there’s more yield there, there’s more opportunity there, and there’s more investors scrambling to get tougher deals done,” Grossman said. “Lenders want to get paid for it.”

But, new players shouldn’t take an overly simplistic view of transitional lending, Pacific Western’s Baker said: “They may think, ‘*Ground-up construction is very complicated, and I, as a new lender, don’t have the expertise to figure that out. But, I can wrap my mind around taking an existing office building and repurposing it for multifamily, because I’m using the existing structure, and so, there’s a lot less risk*.’ But, the reality is there are a lot of risks and pitfalls that lenders can quickly find themselves in.”

Plus, new firms tackling complex loans during a global pandemic may not exactly be a match made in heaven. As such, Grossman is avoiding groups he doesn’t think are able to see deals through to the finish line.

“You never want to deal with somebody who’s loan-to-own, and you never want to deal with somebody who’s not equipped to deal with potential changes in a transaction or structural issues that come up down the road,” he said. “There are definitely some groups out there that see this [market dislocation] simply as a yield arbitrage and want to take advantage of high rates. Those are probably the groups that are going to shake out and have some trouble.”

**Bridge Ahead**

For now, lenders are approaching new opportunities with caution. ACRES is taking on top sponsors with the best of business plans in the best of locations. “Whereas, pre-COVID, we were probably stretching a little bit into markets and with sponsors that we didn’t necessarily feel great about,” Fogel said.

ACORE has made tweaks, too.

“The deals that we’re doing now are probably 5 to 10 percentage points lower LTV than what they were pre-COVID, and pricing is probably, from a spread perspective, out 100 to 150 basis points,” de Haan said.

For 3650 REIT, “every asset stands on its own,” Roth said. “Whether we’re in an up cycle or down cycle, our first level of inquiry is on the sponsor; are they credible, do they know what they’re doing, do they have the capital? If we check that box, then we look at the real estate. As a lender, our job is to identify, quantify, and mitigate risk. We go through the same level of inquiry and due diligence that we always have.”

Madison Realty Capital continues to invest in all real estate asset classes, but is more skewed towards multifamily and industrial. The firm is also taking on some higher value-add construction completion financing.

“A lot of lenders are purely originators of loans,” Zegen said. “We’ve been able to make loans, buy loans and re-work loans [during COVID]. You need as many tools as possible, because in times like these, nothing is as straightforward as when things are rosy. Our experience in going through a financial crisis like 2008 has given us an advantage.”

One silver lining of the crisis, Fogel said, is that bridge deals that traditionally would go to bank lenders are funneling through to the active debt funds. Declining to name the property, he spoke of a financing opportunity on an “iconic Manhattan building,” where the sponsor is looking to do a gut renovation.

“It’s the kind of deal that never, ever would have come our way, or the way of any other lenders like us. It would have gone right to a bank,” Fogel said. “But the banks, especially when it comes to Manhattan, are sitting on the sidelines, not doing anything — especially when it comes to office.”

Fogel expects a leveling of the playing field when normalcy returns. “I think it’s going to come back faster than it did in 2010,” he said. “There was a lot more at issue back then, and the real estate fundamentals weren’t great. The fundamentals in real estate were very good pre-COVID and I think will bounce back to what they were very quickly.”

Until then, Roth will continue on.

“I’ve always done well as an investor and as a lender in going into areas where people are running the other way,” he said. “But, I’m a big believer in fundamentals. If something fundamentally works, you can find that value proposition, regardless of what’s going on in the rest of the world. Somebody much smarter than me once said, ‘There are no bad assets, just bad pricing.’ And it’s really true.”