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Capital Markets: Revisiting Risk and Return in the Face of Uncertainty

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Capital Market Risk was listed as the #3 issue in the 2020-21 Top Ten Issues Affecting Real Estate® by The Counselors of Real Estate®.

The last three months have presented the real time volatility of the capital markets and how quickly debt and equity capital liquidity can stop flowing when risk and returns are difficult to measure. Since the middle of March when the U.S. population was told to shelter at home, markets started to shut down, the capital markets have demonstrated volatility in the face of uncertainty. The debt capital markets, based on feedback from both the CMBS and broader bank and non-bank lending market, had been positioned for an active, yet somewhat cautious 2020. The expectation was that the economy would continue to grow, although economic measurements did indicate that the pace was slowing. There was no expectation in the real estate capital markets, or any of the broader capital markets, for an event like COVID-19 that would bring unprecedented changes to the functioning market.

When you look back at historic capital markets corrections, they have traditionally come from some supply and demand mismatch. The last financial crisis that began in 2007 seemed to be primarily driven by excess in the capital markets. We are experiencing a shutdown of travel, retail shopping and services and office-based businesses unable to access their space. We have tested the remote working model, and the results might affect the long-term view of it as part of business operating strategy. E-commerce, which was already testing the viability of the existing brick and mortar retail model, received an adrenalin shot, as online shopping became one of the only ways to shop. We will look at uncertainty and risk and recent trends in both the debt and equity capital markets, with an eye towards what 2020-2021 might have in store.

ABOUT THE AUTHOR

Constantine "Tino" Korologos CRE, MAI, MRICS, has worked in the real estate industry for 35 years, and has held several senior executive and managing director positions at Wachovia Securities, Bear Stearns and Co., GE Capital Real Estate, Moody's Investors Service, Equitable Real Estate Investment Management and Deloitte & Touché, where he focused on the capital markets, valuation, structured finance, consulting and investment banking. Complementing his professional experience, he is a Clinical Assistant Professor, teaching graduate real estate finance, capital markets and portfolio risk courses in the New York University Schack Real Estate Institute, where he has been on the faculty for over 25 years.

UNCERTAINTY AND PRICING RISK

In prior market corrections, it was a little easier to look back at the past, measure risk based on observations and expectations, and price capital. The Black Swan infected with COVID provides a backdrop that makes correlation to the past challenging. Changes to how space is occupied, building operations and design, and the question of remote work, present challenges to the office market, especially for CBD markets driven by public transportation. Retail space density and formats in the face of long-term demand, continue to be reevaluated. Lodging operators and owners now look at cleaning protocols and training in a different way, with some brands partnering with health professionals and cleaning product brands to "brand" hygienic protocols. This uncertainty exists in the face of some probability that things go back to a normal that may be defined differently, like post September 11th building security protocols. When the question of vaccine timing and a potential second wave of infection are considered, pricing risk-adjusted returns becomes an even greater challenge.

DEBT CAPITAL MARKETS

One thing we have seen since the middle of March is that volatility has spiked and that makes pricing debt more challenging. In the face of effectively zero interest rates, the risk premium spreads, valuation metrics and the underwriting assumptions become critical. Even if you can select a spread over the risk-free rate, what cash flow assumptions do you use, and how do you assess the value of your collateral for the purpose of determining leverage? Percentage of rent being paid in each sector (retail being the most challenged) is also an important metric as is late debt service payments.

We look at the CMBS Conduit multi-borrower deals, Agency Multifamily CMBS, SASB (single asset single borrower) CMBS deals and the CRE CLO (Collateralized Loan Obligation) deals to understand liquidity and pricing. As of June 18, 2020, there has been $32.8 billion of Non-Agency CMBS, and $66.3 billion of Agency CMBS issued YTD. Annual issuance in 2019 reached $118.2 billion and $161.2 billion respectively for non-agency and agency CMBS.[1] The non-agency side had effectively stopped in mid-March, and only recently has issuance began. A big part of that was the volatility in bond spreads. New issue 10-Year AAA Conduit bonds were trading at 114 basis points (bps) over 10-Year Swaps as of June 18, down from a 330 bps in late March, but only slightly above the 52-week average of 111 bps. The lower rated BBB new issue bonds were trading at 625 bps over the 10-Year swaps as of June18, wide of the 458 bps 52-week average, but well below the 52-week high of 1150 bps. Agency CMBS (Freddie K bonds) are trading below the 52-week averages, and for senior-rated securities, they are down YTD.[2] These levels are reasonably strong given the property markets being effectively shut down for the last few months.

Spread tightening and normalizing somewhat came as a result of significant Fed intervention in the form of fiscal and monetary support. The **CARES Act** provided checks to small businesses and individuals, and forbearance (ability to delay debt service payments) to Agency CMBS borrowers. The **TALF** facility (**Term Asset-Backed Securities Loan**) provided leverage to holders of certain seasoned CMBS bonds, and **Agency CMBS Direct Purchases** provided liquidity and helped to stabilize spreads. Intervention helped to limit a complete seizing of the markets but doesn't necessarily mitigate the longer-term concern about defaults and losses.

While pricing stability and liquidity appear to have somewhat returned, late payments and loan defaults have seen a significant increase. The June remittance reports indicated that payment rate on conduit loans increased from 85.9% in May to 86.6%, a positive and welcome measurement, but loans that were 60+ days delinquent rose to 8.7%, with concentrations in retail and hotel assets.[3] As loans hit that 60-day mark and move to Special Servicing, fees and valuation requirements to estimate losses become part of the process, and given the difficulty in appraising assets today, it raises new issues. As of year-end 2019, CMBS agency and non-agency debt outstanding represented under 20% of the total CRE Mortgage Universe. Banks representing just over 50% of commercial real estate

mortgage debt outstanding represents the majority of exposure. While not as susceptible to the spread risks described above, they are subject to uncertainty and the risks associated with business closures and the impact on their balance sheets.

Insurance companies have always been focused more on lower leverage institutional quality assets and sponsorship. That doesn't preclude them from loan performance risk and adjusting their pricing to reflect the market. Borrower requests for forbearance are increasingly common for insurance balance sheet loans, and as some focus turns towards playing offense and originating new business, the loan profile, leverage and pricing is clearly reflecting a repricing of risk. As significant investors in CMBS securities, balance sheet allocation for investments might change based on perceived risk.

Mortgage REITs took a significant hit early in the pandemic, despite no losses in collateral due to loan defaults. Some large MREITS were impacted by margin calls from their warehouse facility lenders, requiring the sale of investments at a discount in order to cover their position. Even with some share price rallies, the commercial mortgage REIT sector is down over 36% YTD according to NAREIT (National Association of Real Estate Investment Trusts), with several down over 50%.

Debt funds that primarily issue bridge and mezzanine loans on transitioning assets were also subject to significant repricing and margin calls. The cost of financing their businesses, along with the added risk of assets not hitting their business plan, presents an increase in expected losses.

As we look out over the next 12 months, term defaults driven by an inability to pay debt service, and maturity defaults driven by valuation, liquidity and cash flow shortfalls, will likely keep pressure on the debt side of the capital stack.

EQUITY CAPITAL MARKETS

The equity markets, particularly the public REIT markets, reprice real time when the markets are open. REIT NAVs (net asset values) which symbolize the asset values after debt, and implied cap rates represent one indication of perceived market value. Year to date, the Equity REIT market is down 16.6% as of June 12, according to NAREIT's U.S. Real Estate Index Series. Not all sectors were losers as you might expect, with lodging, retail and office down 40.2%, 34.2% and 22.5% respectively. Infrastructure, industrial, and data center REITs had YTD growth of 15.5%, 1.9% and 14.9% respectively, reflecting the expectation of future returns, in asset sectors that have been resilient and offering more long-term stability and demand. The multifamily sector is down just over 14% YTD.[4]

REIT Capital Markets activity during the week ending June 19 included raising $2.9 billion in the High-Grade unsecured debt REIT market, for a YTD total of $42 billion. In 2019, REITs raised $68.4 billion.[5] REITs have also drawn down on significant percentages of their credit lines over the last few months to assist with cash flow needs. While the publicly traded shares have come back from early pandemic levels, some sectors continue to feel the effects of market repricing, especially the mall and lodging sectors. If the publicly traded markets are an indication of a long-term view on values, commercial real estate markets will experience a revaluation driven by lodging, retail and office.

Institutional private real estate ownership trends measured using NCREIF's NPI index presented a 1st Quarter 2020 market value of just over $683 billion, up .71% from the end of 2019. Since these measurements are based on valuations at the end of each quarter, they don't truly capture the full impact of the pandemic. Hotels and retail had decreases in returns during this period, while industrial and office showed positive gains. Second quarter data will be more telling as it captures a full quarter of the impact.

Private equity funds have been continuing to raise capital for their various strategies. Real estate fund "dry powder" as of June 2020 is estimated by Preqin to be over $208 billion with opportunistic, value add, and debt funds holding the majority of the capital. Having significant capital helps assure liquidity for real estate at

the right price, though this is something that is yet to be determined.

As the equity markets look to find some balance for price discovery, uncertainty around future expectations continues to mute activity. Limited trades of properties in the market seem to be focused on the less uncertain asset types including multifamily and industrial. Looking forward to the Fall of 2020 and into 2021, a better understanding of where the market starts to settle will be needed before equity capital can better price itself. "Cash is King" is critical now more than ever.

THINKING AHEAD

As we step back and look at capital markets pricing and risk, models and assumptions behind them become more critical. Not just financial and valuation models, but the models we have been watching the last few months—COVID-19 infection rates, the "curve," and what other parts of the world are experiencing. In the absence of any certainty around vaccination timing and a possible second wave of infections, the capital markets continue to estimate an appropriate measurement of risk and returns adjusted for that risk. Industries such as the airlines, restaurants, retail, hospitality, and entertainment try to survive in the face of bankruptcies that will likely continue to come. What ways of life go back to normal and what becomes the new normal will affect how businesses operate, where people shop, how we commute, where we travel, and where we live. These will drive real estate and ultimately the cost of capital. And let's not forget a few non-COVID related risks that deserve our attention, such as the 2020 presidential election, the switch from LIOR to SOFR as an index, and reporting regulations like CECL (Current Expected Credit Loss) that will require investor focus.

We will get through this and come out stronger, but what are the risks ahead and what will they cost? •

ENDNOTES

1. Wells Fargo Securities Structured Products Research: *CMBS and Commercial Real Estate, CMBS Weekly,* June 19th, 2020.
2. Ibid.
3. Ibid.
4. Wells Fargo Securities Fixed Income Research: *Wells Fargo REIT Weekly,* June 19th, 2020.
5. Ibid.

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