CONFIDENTIAL – Presentation Briefing

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Re: Real Estate Investment Advisory Council
Fourth Quarter 2021 Presentation: **18th Annual Debt Program – Hard Lessons from the Pandemic**
via Zoom

On December 9th, REIAC co-presented this celebrated annual event in partnership with the Atlanta Chapter of ULI. Members were treated to the collective knowledge of an outstanding panel of Debt Industry leaders, including

- Jeff DiModica, President and Managing Director, Starwood Property Trust
- David Harrison, Chief Operating Office, Midland Loan Servicing, a PNC company
- Jack Gay, Managing Director, Nuveen Real Estate
- Jim Costello, Senior Vice President, Real Capital Analytics
- Leah Nivison, Managing Director, Goldman Sachs, and
- Brian Olasov, longtime friend and moderator of REIAC events

The discussion delved deeply into the recovery and expansion of the debt capital markets during COVID, what works, what doesn't, and what is coming next.

How was this pandemic different from the last (painful) downturn?

Observers and real estate experts have been making post-pandemic trends and prognostications about commercial real estate recoveries by comparing this downturn to the Great Financial Crisis and recovery. Which is the wrong way to do it.

This downcycle is different from the last one (they always are). This recovery will not be a long slow slog ahead, but a quick bounce back.

The spread between cap rates and treasuries for all property types spiked during COVID, but this time, treasuries kept declining as to offset any dramatic loss in value. Further, part of the risk premium (risk of future events) has been offset by much higher income growth expectations.

The spread over treasuries are themselves not at any historic low; actually, it's been middling along for a number of years. But it is the treasury rates that have dropped to historic lows. Also, we have seen that cap rates do not move in lock-step with interest rates.

Delinquencies

Using CMBS as a guide, there was a big bulge in delinquencies and defaults during the GFC, but it is only a blip for the COVID downturn, not a default cycle. The strategy of having government flood the market with temporary relief (a "wall of capital") worked. CMBS recovery statistics are strong: the few bad loans recovered 91 cent on the dollar. There were not a lot of opportunistic loan sales, discounted payoffs or vulture fund investing. With the extra liquidity, things just got worked out this time. In fact, the overall weight of money in the market pushed cap rates back down. In the few years after the GFC, there were no buyers with the kind of buying power we are seeing now.

Investors anticipate more office defaults, though, as people return to the workspace and office users figure out how much space they really need. Since office leases are longer than hotels or multifamily, it will take three or four years from now to start seeing the effect. Office is the major unknown on the horizon.

The Year of the Debt Fund

Banks and GSEs calculate Debt Yield off trailing 12 months' net operating income, which is therefore a lagging indicator of current rent levels. Debt Funds, by nature of their pro-risk appetites, believe in pro forma net operating income, and will lend higher leverage on the same transaction. Therefore, debt funds are winning the lion's share of floating rate deals.

And borrowers want floating rate, not fixed rate. With 160+ debt funds out there, it's a borrower's market. Even aggressive CMBS lenders can't get a break, since CMBS is fixed rate. Apparently the threat of rising interest rates is not moving the needle with borrowers.

The move to floating rate is massive. Before the GFC, 66% of new loans were fixed rate loans. Now that number is reversed: 66% of this year's loans are floating rate.

Banks are not motivated to go higher than 65% LTC. They get a 150 bps spread doing a loan at 55% LTC, so they are happy with what is essentially a AAA risk. But banks act as the jet fuel that gets the debt funds into double-digit yield territory when the funds piggyback on a bank's senior loan to get to a 75% or 80% LTC.

Got yield?

So how does a Life Company get any yield, since it's charter is to make conservative loans, and long term loans at that (which are declining in volume)? Try mezzanine lending, or allocate some capital to real estate equities. But the concern here is "risk creep" up the capital stack just to maintain the same overall return on its portfolio holdings.

So far, though, the panel doesn't see that conservative lenders are making any "sporty loans" and getting themselves into trouble – this is usually where in a cycle this happens. But the GFC burned a long memory into banks and life companies. Debt Funds do not have the same appreciation for longevity.

ESG

Two years ago, nobody really cared about the ESG movement (Environmental, Social, Governance). Now, it's almost like social activism, no longer just green-washing.

Institutional investors take it very seriously. So debt funds and other lenders have to as well. But deals still have to be solid real estate deals, not just some LEED-certified building to check a box for "green."

How does one quantify having ESG in your portfolio? And does a lender price an ESG deal at a discount in rate? The metrics are still a bit squishy, but the industry is getting up the curve on coming up with real measurements to define an ESG deal.

"E" is the easiest loan to make, as environmental issues have been in the news for years. "S" and "G" are hard to figure out lending-wise, as it depends a lot on how the borrower behaves, and a lender can't really control that after the loan closes.

In CMBS world, the consensus is that ESG conduit loans do not price any better than non-ESG loans; the issue is that CMBS lenders and ratings agencies have to educate B piece buyers on the value of ESG.

Bonus track: The Big Picture in Politics

The recently passed infrastructure deal represents the most spending ($1.3 trillion) on such areas since FDR's New Deal. That is the "hard infrastructure" part of Biden's agenda; next is the "soft infrastructure" of $1.6 trillion, also known at the Build Back Better Act. But despite the promise of the math that suggests this expenditure will be offset by $1.3 trillion in newly collected taxes, this bill is in jeopardy, as Sen. Manchin of W. Virginia is strongly opposed to it.

At least the Build Back Better Act does not have any provisions for getting rid of 1031 exchanges or other tax implications for the real estate community if it does pass. Hat tip to Sen. John Tester of Montana for (quietly) maneuvering those obstacles out of the way.

REIAC

The Real Estate Investment Advisory Council (REIAC) was established as a nonprofit trade association to provide a forum for the exchange of ideas, concerns and experiences among senior executives who conduct commercial real estate transactions. The Southeast chapter of REIAC was founded in 1994.

REIAC is an exclusive, principals-only national fellowship of top real estate executives that offers superior educational events, networking opportunities and community service. REIAC's institutional quality programs are presented in a social environment where members can share experiences and knowledge with their peers. REIAC events encourage members to broaden horizons and develop personal relationships that further their success within the industry.

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