CONFIDENTIAL – Presentation Briefing

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Re: Real Estate Investment Advisory Council
Second Quarter Presentation: **Debt Capital Markets**
Buckhead Club

On Tuesday September 12th, The Real Estate Investment Advisory Council gathered at the Buckhead Club for the 21st annual Debt Capital Markets, episode one of the limited series *Show Me The Money!*

The 100+ REIAC members and guests were treated to the high-level expertise and experience of:

Tim Stoner, Affinius Capital (formerly USAA Real Estate), Managing Director of Capital Markets
Greg Michaud, Voya Investment Management, Managing Director and Head of Real Estate
Sadhvi Subramanian, US Bank, Market Manager, Commercial Real Estate East region
Chris Marinac, Janney Montgomery Scott, Director of Research
Brian Olasov, Long-time friend and moderator of REIAC events

<u>Who controls how much?</u>

First, to get directly to the source of the angst in the debt markets: **banks control the majority of debt capital, about 61% market share.** The rest of the industry's debt comes from almost equal amounts via life companies, REITs, and GSEs (Fannie, Freddie and HUD). Even in multifamily-world, banks still out-lend the GSEs (33% market share vs. 23% share).

So when banks pull back from lending, everyone suffers. Bankers quickly direct the focus/blame to Congress and its various financial oversight entities, appropriately. The federal government is giving the heads-up that more rigorous regulations are on the way; meaning, real estate banks need to stockpile

greater reserves to cover loan losses. Unfortunately, **Congress has not specified "how much?"** so banks are in the dark about where the new reserves levels will be drawn. In order not to be caught by surprise, lenders are reining in real estate lender to prepare for the new rules.

Interestingly, banks have been lowering their loan-to-value (LTV) metrics steadily since the dot-com bust in 2000. At that time, average LTV was 85% to 95%. After the Great Financial Crisis (GFC) in 2008, leverage pulled back to 75% to 80%. Now, with the pandemic behind us, **leverage hovers around 55% to 65% LTV.**

<u>How bad will it be?</u>

The worst is yet to come, say our panelists. In looking back at the previous economic downturns, especially the GFC, the real estate market bottomed out four years after the 2008 Wall Street crash. Same story with the dot-com downturn. So our current downturn has not hit the lowest point in the trough, which is about a year or so ahead of us. A 65% LTV loan on an apartment property will still perform even with a 25% value decline this past year. But office property values have dropped significantly more than that, **and this is where the pain is felt the most.**

With that, the conversation turned to foreclosure and lender remedies. Lately, even the most institutional property owners are handing back the keys with greater frequency. Loan defaults on office properties are not viewed as the fault of a poor operator or sloppy management, but as a result of the pandemic and work-from-home dynamics.

So there doesn't seem to be any stigma in handing back a property.

Nor is it indicative of rocky borrower / lender relationships. Lenders recognize that the borrower has no equity value remaining in some properties, and thus no economic incentive to keep feeding a property that has no hope of overcoming the steep drop in value. Institutional borrowers point out that it is simply a matter of doing the math, and these borrowers have **"figured out the math faster than everyone else."** To paraphrase an oft-quoted line from a certain Oscar-winning movie of the early 1970s, '*It's nothing personal; it's strictly business.'*

Lenders readily acknowledge they are bad landlords and property managers, and absolutely do not want an office building thrown back at them. So how to fend off a foreclosure? Bank regulators recommend that bankers 'work with their borrowers' to avoid foreclosure. However, the advice is nothing more specific than that. So what does that mean, exactly? Extend and pretend again?

One lender's strategy is to put the borrower on the defensive, arguing that the property has suffered "waste and neglect," which would trigger recourse repercussions on the borrower who thought he could simply walk away from the property and the loan.

Time to clean house before the dam breaks

Once a property ends up back with the lender, though, it is even more difficult for the bank to be made whole again. Banks are notorious for quickly pushing properties back out to the market for sale, and offering seller financing if that would move the matter to a head. But such behavior only creates an even greater sense of panic (read: price discount in the acquisition market) and values continue to drop.

Yet bankers point out that cleaning up its balance sheet is more valuable to Wall Street analysts than the additional 5% hit as it gets the property out the door as rapidly as possible. So there is a bit of truth to the "Doom Loop" as reported recently in the Wall Street Journal: foreclosed and marketed properties further reduce overall market values and thus push up the LTVs of the exiting loans on the books which impacts the bank's credit rating and stability.

To add to the misery, **Atlanta ranks second among all US property markets for the percent of office loans coming due through 2026** (behind only Washington DC). Prognosticators on the panel state that **the dam breaks in Q3 2024,** so get bad assets moved out by then.

So who is lending?

One lender's capital drought is another lender's bonanza. Non-regulated lenders like life companies and debt funds are enjoying a bounty; lending into an economic trough is the best of times for these groups.

Opportunistic funds have seen a big swing in risk-adjusted investing, i.e., two years ago the portfolio was two-thirds equity; now it is two-thirds debt. The investor appetite for real estate has not disappeared, and the capital that was meant for equity investments has re-directed to high-yielding debt. The debt strategy offers outsized returns at a far lower level in the capital stack. No one wants to be the last dollar in anymore.

For life companies, the only hitch is matching the duration of its liabilities (insurance policies) to loan terms. A five year term is the most popular in the real estate market right now (no one wants to lock up a lower leverage, high interest rate loan for 10 years) but most insurance liabilities are far longer than five years.

Where will rates be in one year?

Predictions are difficult, especially ones about the future. But the REIAC panelists weighed in their best guess. Rates will be lower, but no consensus:

- Slightly lower (maybe 25 to 35bps decline)
- Larger decline (50 to 75bps)
- All-in rate (SOFR + rate spread) bottoms out at 6.0%
- All-in rate (SOFR + rate spread) bottoms out at 4.5%

In conclusion

Rates will remain higher for longer, as the industry goes through its cyclical value-reset. The less-than-uplifting market review was capped off by an open bar for REIAC members, as they look forward to **Episode 2 of the limited series "*Show Me the Money: can Equity pencil it out*" on October 25th.**

Stay tuned!

The preceding Confidential Briefing is for information only and does not represent the respective opinions of REIAC, its membership or its Board of Directors.

About 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.

For further information, please contact:

Jerry Monash, President, Southeast Chapter of The Real Estate Investment Advisory Council
(404) 847-9781
jerry@lancetrealtyadvisors.com