ANALYSIS
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COVID-19 and CRE Transaction Markets

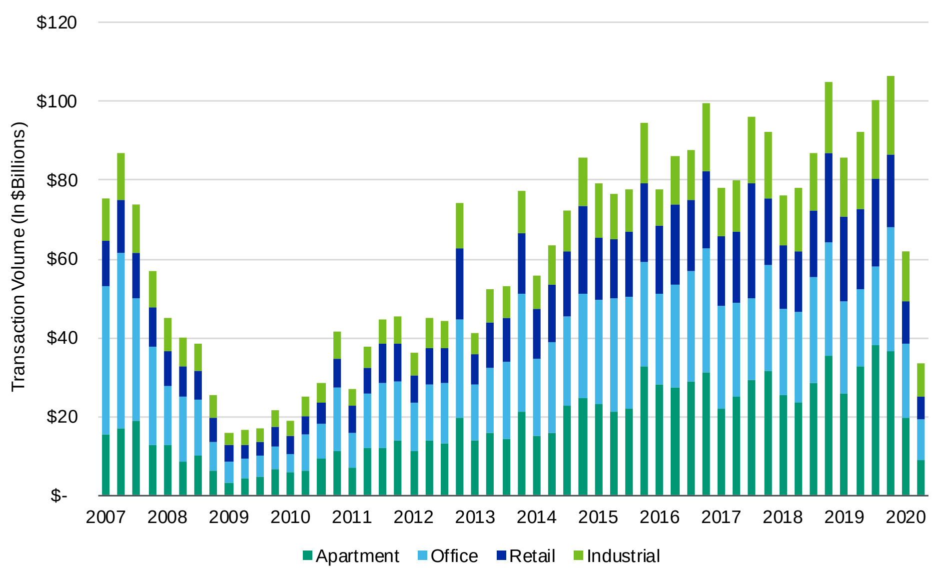
Emerging Evidence of Selective Distress

Introduction

In April, at the height of the first lockdown prompted by the COVID-19 pandemic, several articles appeared speculating on distress in property markets and how opportunistic funds were gearing up to take advantage of the situation. "Real Estate Investors Eye Potential Bonanza in Distressed Sales" was one headline.[1] Close to a thousand commercial property funds were raising a total of about $300 billion to take advantage of distressed deals, the Wall Street Journal reported.[2]

And yet few transactions actually cleared. Depending on how one measures it (quarter-over-quarter or year-over-year) transaction volume was down anywhere from 42 to 48% in the second quarter of 2020.

Figure 1 Transaction Volume by Property Type



Source: Moody's Analytics REIS

1 https://www.wsj.com/articles/real-estate-investors-eye-potential-bonanza-in-distressed-sales-11586260801

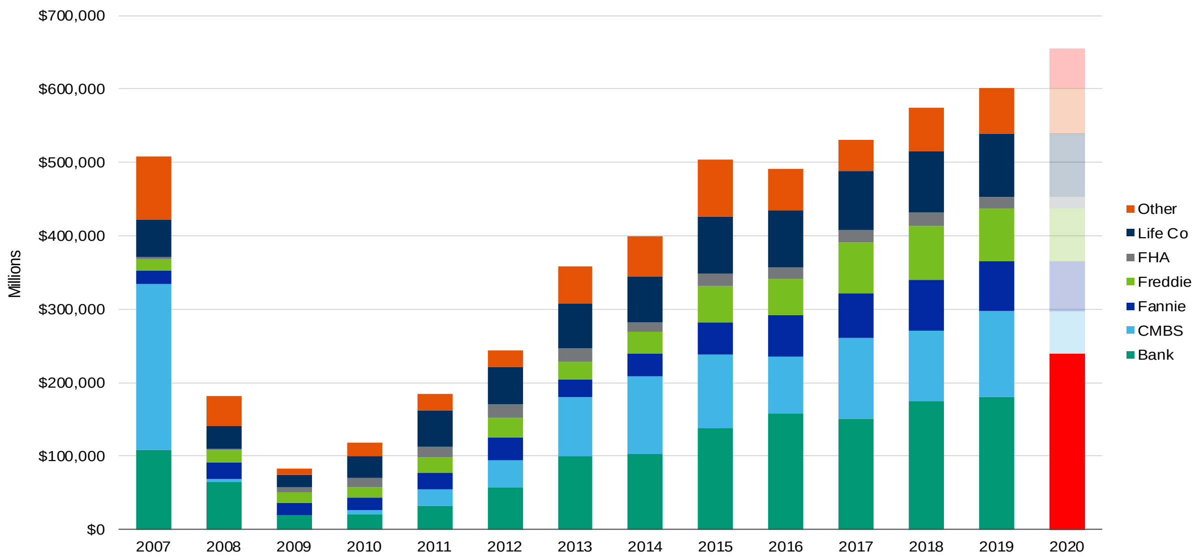
2 https://www.wsj.com/articles/cash-pours-into-distressed-real-estate-funds-as-investors-aim-to-play-offense-11587470400

This decrease parallels the 48% drop in mortgage originations in the second quarter (relative to one year ago) reported by the Mortgage Bankers Association (MBA).[3] Given the immediate and severe impact of the COVID-19 crisis, it is no surprise that origination volume fell the most for the hotel (91%) and retail (74%) sectors—with office (71%) following closely behind.

The MBA estimates that originations volume will fall by 60% for all of 2020, coming off a record high of about $600 billion in 2019. As recently as February of this year, the MBA was expecting a 9% increase relative to 2019—but the world has changed.

Figure 2 Issuance Volume by Lender Type

The red solid bar for 2020 represents updated (post-COVID) forecasts. The translucent sections represent pre-COVID estimates from February 2020.



Source: Mortgage Bankers Association

How can we reconcile potentially conflicting reports of hundreds of billions of dollars of "dry powder" seeking to invest in CRE deals, and the fact that transaction activity still appears to be severely constrained?

Uncertainty and the Bid/Ask Spread

From conversations with close to fifty large institutions ranging from balance sheet lenders to life companies, property owners and operators—as well as opportunity funds—we believe that the ongoing uncertainty fuels a bid/ask spread that remains wide. On pricing, for example, buyers and sellers of properties have significant differences of opinion on future rents, occupancies, business prospects, and ultimately expectations of net cash flow going forward. Owners prefer to value properties on pre-COVID performance with little consideration of current capital market conditions while opportunistic buyers tend to take the opposite view. Moody's Analytics REIS predicts that a rise in cap rates will prompt a decline in value ranging anywhere from 7 to 9% (multifamily and industrial) to 20% or more for office, retail, and hotel.

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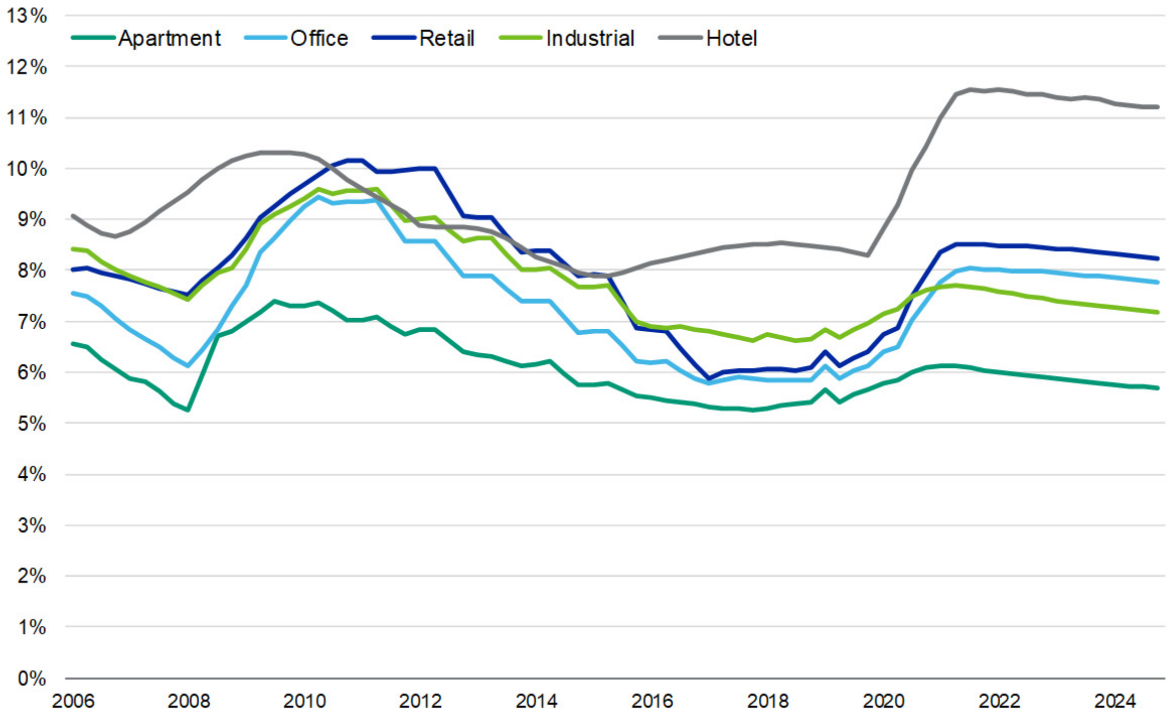
[3] https://www.mba.org/2020-press-releases/august/commercial/multifamily-borrowing-falls-48-percent-in-the-second-quarter-of-2020

Figure 3 Cap Rate Forecasts by Property Type



Source: Moody's Analytics REIS

This is internally consistent with Moody's Analytics (CPPI)Commercial Property Price Index, which projects similar price declines across property types at the national level.

Figure 4 Moody's Analytics CPPI Peak to Trough Declines

Comparison Between Great Recession (2008-2010) and COVID-19 Recession (2020-)

GREAT RECESSION	MILTIFAMILY	OFFICE	RETAIL	INDUSTRIAL
CPPI Peak	140.37	158.94	158.24	155.12
CPPI Trough	99.38	93.77	109.31	112.41
% Change	-29.2%	-41.0%	-30.9%	-27.5%

COVID-19 RECESSION*	MILTIFAMILY	OFFICE	RETAIL	INDUSTRIAL
CPPI Peak	249.86	188.48	183.19	230.33
CPPI Trough	223.32	144.73	125.32	208.04
% Change	-10.6%	-23.2%	-31.6%	-9.7%

Source: Moody's Analytics

Note that CPPI forecasts for the COVID-19 Recession are almost everywhere less severe than the Great Recession, with the notable exception of retail—no surprise given the kind of disruptive forces that are currently putting pressure on this property type.

However, with transaction volume remaining depressed and few sales comparables available, property owners and lenders are examining their specific portfolio of buildings—many of which are still generating income, with relatively low rent collection losses—and wondering whether property values really ought to be marked down by anywhere from 10 to over 30%. Performance metrics like occupancies were still holding steady at the national level as of the second quarter. Though asking and effective rents have begun to decline, a magnitude of decline between 0.1 to 0.4% at the national level[4] does not yet seem to be a cause for immediate worry.[5] As a result, a survey in September conducted by the Pension Real Estate Association suggests that owners and managers of institutional grade commercial properties expect much less of a price decline relative to the forecasts published by Moody's Analytics.

Figure 5 Average Appreciation Return Forecast

	APPRECIATION RETURN 2020	APPRECIATION RETURN 2021	APPRECIATION RETURN 2022	APPRECIATION RETURN 2020-2024 (PER YEAR)
National - All Property Types (NPI)	-6.8%	-1.9%	2.9%	0.2%
Office	-6.8%	3.5%	2.5%	-0.5%
Retail	-15.4%	-5.9%	1.0%	-3.7%
Industrial	-0.8%	1.8%	4.5%	2.8%
Apartment	-4.9%	0.8%	3.8%	1.5%

Source: Pension Real Estate Association Consensus Forecast Survey of the NCREIF Property Index, Q3 2020 (released September 8). Average of respondents' forecasts of appreciation returns for the NCREIF Property Index (NPI) and sub-indices by property type.

Figure 5 suggests that the 21 institutions that participated in PREA's survey expect *appreciation returns* to fall by approximately 8.7% through the end of 2021. But this is for NCREIF's NPI, which means that the figure includes an estimate of how much capital expenditures may change. The long-term average[6] ratio of capital expenditures relative to property value is 1.9%. That roughly translates to *price decline expectations* of only 4.9% in 2020 and zero in 2021, markedly more optimistic than other forecasts.

Opportunistic buyers, on the other hand, are likely seeking a haircut of approximately 30% before committing to a purchase. In other words: divergent expectations of a majority of buyers and sellers in a highly uncertain market is likely depressing transaction volume.

"It's a tale of two worlds right now: you've got a national public health crisis putting downward pressure on hotel and retail asset prices. But even within those two sectors, you have high quality assets that are still posting steady if not increasing revenue metrics. It's no surprise therefore that a large enough number of buyers and sellers have yet to come to an agreement about pricing," said Ryan Severino, Chief Economist at Jones Lang LaSalle.

Comps *Are* Beginning to Emerge … Kind Of

There is, however, some evidence of the magnitude of CRE value declines available from appraisals on assets impacted by the COVID crisis and of the distress that pervades large swaths of the economy. We reviewed data from over 160 appraisals completed after April 1, 2020 for newly specially serviced assets. We excluded those assets already defaulted prior to April to minimize the influence of pre-existing performance issues on value. The distress and value change on post-April assets is therefore driven mainly by the COVID crisis.

We compared the new appraisals to the values reported at underwriting. Given the unique nature of every commercial property, we expected, and found a wide range of value changes within each category.

4 https://www.moodysanalytics.com/webinars-on-demand/2020/q2-2020-reis-quarterly-economic-briefing

5 Preliminary third quarter figures, however, produced in early October, suggests that multifamily effective rents have begun to drop – at record rates for several markets.

6 Defined as values from the first quarter of 2000 to the second quarter of 2020.

Figure 6 Change in Appraisal Value, Pre- and Post-COVID

CATEGORY	COUNT	AGGREGATE CHANGE %	INDIV AVERAGE	INDIV MEDIAN	LOWER BOUND	UPPER BOUND
Hotel						
Extended Stay	4	-27.5%	-26.1%	-32.5%	-36.0%	-3.3%
Full Service	50	-23.6%	-26.5%	-26.5%	-64.8%	24.2%
Limited Service	63	-27.1%	-29.6%	-31.9%	-63.2%	37.8%
Total	117	-24.8%	-28.2%	-30.2%	-64.8%	37.8%
Retail						
Anchored	12	-12.6%	-19.7%	-14.9%	-49.7%	-0.5%
Shadow Anchored	2	-19.2%	-20.3%	-20.3%	-23.7%	-16.9%
Single Tenant	4	-28.3%	-38.3%	-38.1%	-63.3%	-13.6%
Unanchored	8	-34.4%	-29.1%	-31.8%	-49.7%	0.5%
Mall	8	-23.9%	-44.1%	-48.3%	-77.6%	1.3%
Total	34	-22.3%	-29.9%	-25.0%	-77.6%	1.3%
Mixed Use						
Mixed	10	-41.5%	-32.1%	-35.3%	-53.4%	0.6%
All Assets	**161**	**-24.7%**	**-28.8%**	**-30.1%**	**-77.6%**	**37.8%**

» Hotels: Median value decline: -30%. Lower Bound: -65%. Upper Bound: +38%.

- Largest individual declines in Full and Limited Service

  › Hotels, in particular downtown and urban settings, proximity to closed business centers, airports, and those in already saturated market settings showed some of the largest value declines. We attribute much of the decline to limited business activity, closed offices, and a trend of migration away from densely populated city centers. Overall, Moody's Analytics REIS hotel data and estimates suggest that national occupancy rates in September declined to 44.2%, representing a 32% decline relative to the same period last year. This alone is indicative of overall distress.

  › On the upside, some hotels actually showed strong gains—those situated close to essential governmental facilities for example, which continue to operate, and certain properties deemed to be a unique product type (for example an historical building, or destination viewed as having long-term attraction) actually showed increases relative to underwriting. Location and asset quality really do matter!

» Retail: Median value decline: -25%. Lower Bound: -77%. Upper Bound: +1.3%

- Largest individual declines in Malls

  › No surprise here. Underperforming malls have taken the largest valuation hits (as a category, -48% with wide dispersion). Although many malls have reopened, retail tenant closures, bankruptcies, anchor sales at half of pre-COVID levels, tenant rent collections at less than 50%, and a flood of unresolved rent abatement requests significantly impact expected performance. Certain other properties, for example urban restaurants, also saw significant declines as locations closed or remain restricted.

  › On the upside, anchored retail centers (-15% average) and certain trophy properties, including malls in that category, saw more modest value declines (-16%) when compared to the average, although nearly every property experienced some level of decline. Anchored retail experiencing larger declines included non-essential anchors such as home stores, movie theatres, and other businesses which closed during initial phases of the crisis. Not all anchors are equal!

» **Mixed Use:** Median value decline: -35%. Lower Bound: -53%, Upper Bound: +0.6%.

- Mixed use properties in urban centers, mostly those containing a majority of hotel space with a mix of retail or office space, experienced the largest value declines, while properties with a majority retail component in destination areas actually fared better. Once again, travel and its impact on hotel and retail performance weigh heavily on the valuation.

Again, a major theme in identifying both risk and value in this market is individual *asset quality*. Are the tenants essential businesses? Is the property well positioned relative to an essential business center? Is it a historic property or does it have attributes that will make it an attractive destination in the long term?

"There is evidence that equity investors have capacity to sign checks and make deals happen," says James Shevlin, President and Chief Operating Officer at CWCapital. "The problem is that at this stage in the cycle, the deals offering the biggest discounts tend to be lower-quality assets located in less attractive locations. They would have been up for sale with major haircuts without COVID. The savvy equity investors are looking for quality. A good indicator is that most of the dispositions are below $10mm. Attempts above that level have been difficult."

When Will Deal Flow Normalize?

There remain several sources of uncertainty, driving sentiment that is wildly unpredictable (note the relatively high stock market valuations, given the current state of the economy). Depending on how economic data, CRE fundamentals, and the global economic recovery plays out, transaction volume is likely to remain muted through early 2021. The results of the US election and the introduction and widespread adoption—or not—of a much hoped for COVID-19 vaccine are among the top sources of uncertainty that continue to weigh on business prospects and ultimately the overall condition of capital markets. For specific property types in CRE, the *timing of lagged effects* on performance metrics is something we are monitoring closely on a daily basis. These are a few key questions to keep in mind:

1. If government support wanes, will multifamily occupancies deteriorate significantly? Recent research from the Pew Research Center already suggests that households are doubling up at historic rates.[7] Third quarter results from Moody's Analytics REIS shows that multifamily vacancies have risen to 5.0%, the highest level since 2012. Furthermore, effective rents at the national level declined by 1.9%—the largest drop since quarterly data began to be published in 1999.
2. How will significant structural change truly affect the retail sector? When will distress truly manifest in lower incomes and values? Bankruptcies do not automatically mean vacant space: Sears filed for bankruptcy in 2018, and JC Penney just avoided liquidation given support from Simon and Brookfield Properties.[8]
3. Will office space truly experience a significant decline as a result of COVID-19 and options for working from home? Will this mainly occur in urban areas, for specific types of firms? Not all jobs can be done remotely[9] but the secondary market for office space in the form of subleasing will be indicative.
4. Will there truly be a trend towards repurposing retail space for logistics, given the actual and expected rise in demand for warehouse space and fulfillment centers? We discuss institutional and economic constraints preventing this from being a widespread phenomenon in a recent paper[10] but industrial giant Prologis itself does not expect much (at most 10-20% of existing mall space, and between 0 to 2% for other property types like power centers and neighborhood and community centers).[11]

Even if distressed sales do pick up, one possible variable that will constrain transaction volume from ramping up is that many court systems appear backed up and short-staffed due to COVID-19. One source who asked to remain anonymous shared that New York courts may be backed up through the rest of 2021, suggesting that many judgments about distressed note or asset sales may not be finalized until 2022.

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7 https://www.pewresearch.org/ft_18-01-12_sharedliving_featured-image1/

8 https://www.nytimes.com/2020/09/09/business/jc-penney-sale-simon-brookfield.html

9 What jobs are being done remotely during the COVID-19 crisis? This paper provides some clues: https://www.nber.org/papers/w27422

10 "COVID-19 and the Convergence of Retail and Industrial" (August 27, 2020): available upon request.

11 Logistics Real Estate – Sizing The Retail Conversion Opportunity (Prologis Research, September 2020) available here: https://www.prologis.com/logistics-industry-research/logistics-real-estate-sizing-retail-conversion-opportunity

Moody's Analytics and CWCapital will continue to monitor deal flow, analyzing signs of a possible thaw in the frozen market and the direction and magnitude of price trends. In the meantime, COVID-19-induced uncertainty continues to cast a shadow on CRE transaction markets.