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The 2008 Global Financial Crisis

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It's Like Déjà Vu All Over Again

BY K.C. CONWAY, CRE®

DIRECTOR OF RESEARCH & CORPORATE ENGAGEMENT
CULVERHOUSE COLLEGE OF COMMERCE,
ALABAMA CENTER FOR REAL ESTATE



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HISTORICAL PERSPECTIVE MATTERS

Yogi Berra had a fortuitous quote for virtually every baseball situation – and most still apply to so many life and business situations. Yankees No. 8 drew on perspective from his service during World War II in the Navy (1943-1946), his epic performance as a star Yankees player in the mid-1940s through the early 1960s, and later as a championship-winning coach into the 1970s. Yogi Berra played or coached in a record 22 World Series. His infamous quote, “It’s like déjà vu all over again”, was in reference to when he witnessed Mickey Mantle and Roger Maris repeatedly hitting back-to-back home runs in the Yankees’ seasons in the early 1960s. Today, the quote is as valid regarding the state of real estate finance as it was then to baseball. I think he might offer it up today in response to a question regarding his thoughts on the FED raising interest rates. I use this historical reference to queue up a discussion on commercial real estate finance to draw out some personal perspectives on this topic having held a front-row seat at the Federal Reserve before and during the Financial Crisis.

Between 2005 and 2010, I served within the Federal Reserve System – first as the Atlanta Federal District Bank’s real estate subject matter expert (2005-2007), and later as the Commercial Real Estate Risk Specialty Officer at the New York Federal Reserve District Bank (2008-2010) during the heart of the Financial Crisis. I mention this because having a front-row seat engaged with Chairman Bernanke and the respective FED Presidents during the most disruptive economic and

real estate finance event since the 1930s provides one with a unique perspective to assess where we are today and speculate on where we are headed. YES, I am in the camp that a major commercial real estate disruption is more likely in 2019 and 2020 than not; but NO, I do not see a repeat of a disruption as severe as 2008-2009.

THE GOOD, THE BAD - AND LET'S HOPE NOT - THE UGLY AGAIN

Let’s start off with some perspective on where real estate has come and then explore the historic risks that are re-emerging that threaten the calm real estate finance waters we have been enjoying in 2017 and 2018. Commercial real estate finance has come a long way since 1955 when the total debt capital invested in it was a mere \$250 billion.¹ The total amounts of commercial and multifamily debt outstanding through the first half of 2018 were \$4.1 trillion (inclusive of construction loans according to REIS Capital Markets and Federal Reserve data) and \$3.2 trillion (excluding the \$900 billion in bank construction loans included in the REIS tally and the figure quoted by the Mortgage Bankers Association).

This growth equates to a staggering 1,500+ percent increase in debt capital for commercial real estate in less than seven decades. Focus on the red line in Figure 1 – the growth in commercial real estate lending by banks. Does that growth in banks seem consistent with the message from bank regulators that commercial real estate lending has been tamed or diversified out of the banks? What do these figures really indicate?

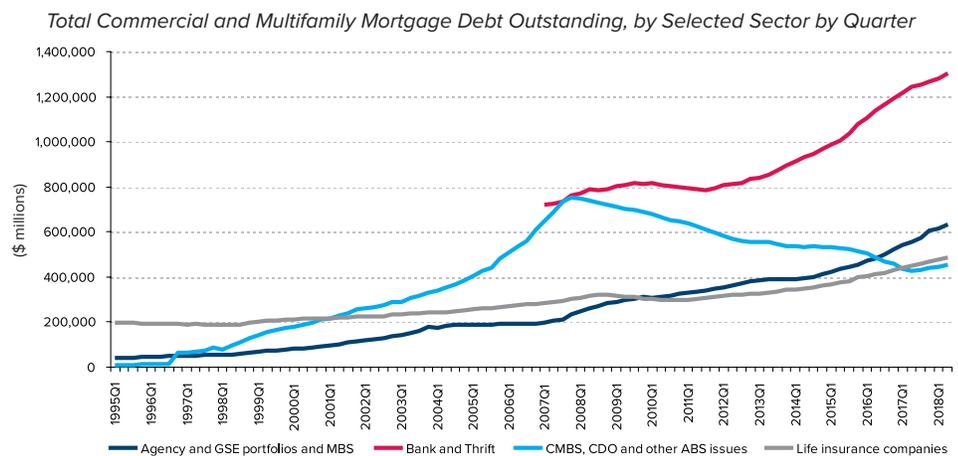
(CONTINUE ON PAGE 3)

1. Source: Mortgage Bankers Association and Federal Reserve

The GOOD

The good is that the growth of capital into commercial real estate has resulted in commercial real estate finance evolving from an “Alternative Investment” post-World War II into a “Mainstream Asset” embedded in every debt and equity investment vehicle and structure today. One can see this in the spectrum of commercial real estate finance sources ranging from primarily credit unions and regulated banks in the 1950s and 1960s, to the expansion and addition of pension funds and REITs in the 1970s, to hedge-funds and mezzanine debt lenders in the 1990s and early 2000s, to alternative lenders/finance-companies and crowdfunding platforms post-Financial Crisis. While this growth in commercial real estate finance capital and the evolution of investment structures is a proxy for the acceptance of commercial real estate as an asset class that permeates all capital structures and platforms, it is also a risk — a risk that has met with economic disruption every decade since the 1850s.²

Figure 1: Commercial and Multifamily Mortgage Debt Outstanding



Source: Mortgage Bankers Association; Federal Reserve Board of Governors; Wells Fargo Securities, LLC; Intex Solutions, Inc. and FDIC. Used with permission.

The BAD

Commercial real estate finance is now too big and systemic to be put back into the “Alternative Asset” bottle. While this is generally considered good for the health of the commercial real estate industry due to the increased level of liquidity for commercial real estate assets, it is not without its risks – many of which are

re-emerging approximately one decade since our last recession and real estate finance disruption.

Risk number one is that commercial real estate concentration matters when things go dry in real estate finance – like they did in 2009 and 1981.

(CONTINUE ON PAGE 9)

2. Source: National Bureau of Economic Research

Figure 2: Mid-2018 Stratification of Commercial Real Estate Mortgage Debt Outstanding

Mortgage Debt Outstanding	2018 Q1		2017 Q4		Change		Sector Share of \$ Change
	\$ millions	% of total	\$ millions	% of total	\$ millions	Percent	
Bank and Thrift	\$1,279,501.00	39.8%	\$1,264,789.00	39.9%	\$14,712.00	1.2%	33.2%
Agency and GSE portfolios and MBS	\$616,927.00	19.2%	\$606,124.00	19.1%	\$10,803.00	1.8%	24.4%
Life insurance companies	\$471,308.00	14.7%	\$462,155.00	14.6%	\$9,153.00	2.0%	20.7%
CMBS, CDO, and other ABS issues	\$446,490.00	13.9%	\$440,849.00	13.9%	\$5,641.00	1.3%	12.7%
State and local government	\$114,676.00	3.6%	\$114,031.00	3.6%	\$645.00	0.6%	1.5%
REITs	\$88,187.00	2.7%	\$87,131.00	2.7%	\$1,056.00	1.2%	2.4%
Federal Government	\$86,310.00	2.7%	\$84,978.00	2.7%	\$1,332.00	1.6%	3.0%
Finance companies	\$28,640.00	0.9%	\$28,573.00	0.9%	\$67.00	0.2%	0.2%
Nonfarm non-corporate business	\$25,720.00	0.8%	\$25,403.00	0.8%	\$317.00	1.2%	0.7%
Private pension funds	\$20,643.00	0.6%	\$20,637.00	0.7%	\$6.00	0.0%	0.0%
Other insurance companies	\$18,044.00	0.6%	\$17,199.00	0.5%	\$845.00	4.9%	1.9%
Nonfinancial corporate business	\$11,197.00	0.3%	\$11,381.00	0.4%	-\$184.00	-1.6%	-0.4%
State and local government retirement funds	\$4,892.00	0.2%	\$4,975.00	0.2%	-\$83.00	-1.7%	-0.2%
Household Sector	\$1,110.00	0.0%	\$1,098.00	0.0%	\$12.00	1.1%	0.0%
TOTAL	\$3,213,645.00		\$3,169,323.00		\$44,322.00	1.4%	

Source: Mortgage Bankers Association; Federal Reserve Board of Governors; Wells Fargo Securities, LLC; Intex Solutions, Inc., and FDIC. Used with permission.



Then and Now: Changes in Multifamily Fundamentals Over the Past Decade

BY KIM BETANCOURT, CRE®

DIRECTOR OF ECONOMICS AND MULTIFAMILY RESEARCH | FANNIE MAE

The U.S. economy has been expanding for nearly 10 years, making this one of the longest economic recoveries since World War II. During the recent recovery and expansion, multifamily fundamentals have also changed drastically.

Some of these changes are demographic in nature, such as an increase in young adults coming of age and forming households, as well as an overall increase in the number of renters versus homeowners. Others concern supply, such as the dramatic increase in new Class A projects coupled with a loss of older Class B and C properties due to value-add opportunities. And it's not just an overabundance of new, more expensive units: the bulk of them are concentrated in a limited number of metros, in a handful of submarkets, and sometimes in just one or two neighborhoods.

As a result, multifamily rent levels have been rising since 2010, and vacancy rates are down to historically low levels. This has had a negative impact on affordability and created a supply/demand imbalance in many places across the country. So how did we get here?

AN INCREASE IN RENTERS – BUT NOT MULTIFAMILY RENTERS

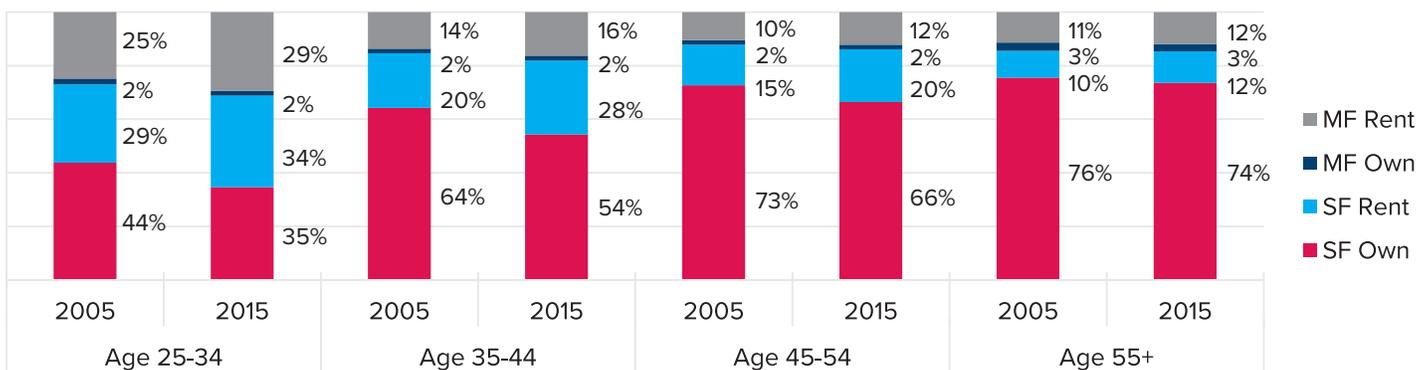
One of the key changes in residential real estate over the past decade has been the increase in the number of households that rent. The homeownership rate peaked at a seasonally-adjusted rate of 69.4 percent in the second quarter of 2004 and stands at 64.4 percent as of the second quarter of 2018. That means that about 36 percent of households rent, and they are renting not only apartments but single-family homes, too.

MORE RENTERS OF ALL AGES...

In addition to more renters overall, there has been an increase in the percentage of renters in all age cohorts between 2005 and 2015. People between the ages of 25 and 34 are most likely to rent multifamily units, but there are more single-family renters and homeowners in that cohort than multifamily renters. Although rentership has increased across all age cohorts, it is still primarily younger people driving the demand for multifamily units: 29 percent of people aged 25 to 34 years old were renting a multifamily unit as of 2015, compared to 25 percent just ten years earlier. By contrast, rentership rates among those aged 55 and older increased by just 1 percent over that same time period.

(CONTINUE ON **PAGE 5**)

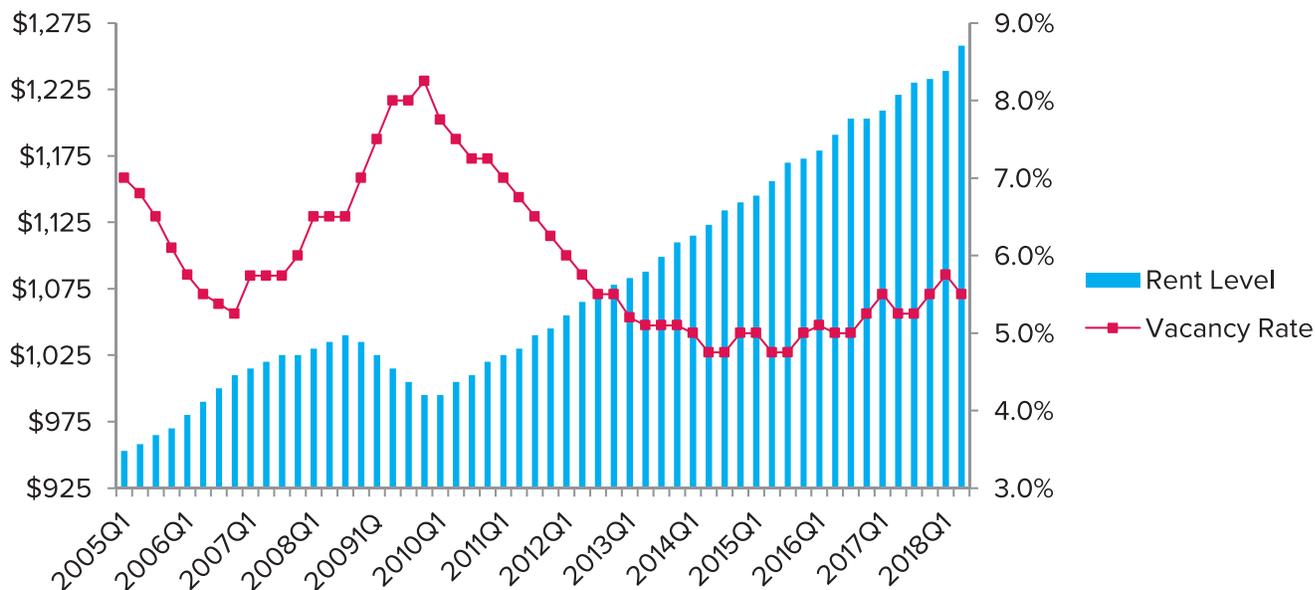
Figure 1: Cohort Structure/Tenure Share



Source: U.S. Census Bureau, American Community Survey 1-Year Estimates.

Note: Single-family includes housing units in structures with 1-4 units. Multifamily includes units located in 5+ unit structures. Excludes manufactured/mobile homes and other less common types of housing units (e.g., boat or RV).

Figure 2: Estimated National Rent Level and Vacancy Rate



... BUT DEMAND IS COMING FROM YOUNGER RENTERS

The demand for rentals coming from younger people can be attributed to the sheer number of them. It is estimated there are currently more than 68 million people in the 20- to 34-year old cohort alone. That number is expected to peak in 2024 at nearly 70 million people. As a result, demand for multifamily rentals has been robust and is expected to continue over the next five years.

RENTS UP, VACANCIES DOWN

With the increase in renter households, coupled with the increase in the population of younger adults, multifamily fundamentals have experienced dramatic changes over the past decade. Since 2010, estimated multifamily rents have been rising, while vacancy rates have been plummeting. Between the first quarter of 2010 and the second quarter of 2018, estimated multifamily rents have soared by more than 26 percent, far outpacing the rate of inflation – and, more importantly, wage growth. This unprecedented demand has

also pushed the national vacancy rate down to historically low levels, with the rate reaching a nadir of 4.75 percent in the third quarter of 2015. While it inched back up to 5.5 percent as of the second quarter of 2018, it remains below its recent 10-year average of 6.0 percent.

NOT ENOUGH MULTIFAMILY HOUSING UNDERWAY, DESPITE WHAT APPEARS TO BE OVERSUPPLY

At a national level, there are more than 600,000 new multifamily units underway, a reasonable amount to add to the existing stock. Fannie Mae forecasts 2018 job growth to come in at 1.6 percent, which would mean an estimated addition of 2.4 million new jobs. Based on that amount of job growth, theoretically multifamily rental demand could range from 380,000 to 460,000 units in just 2018 alone.

BUT IS THERE TOO MUCH SUPPLY IN TOO FEW PLACES?

The larger concern for new multifamily supply is that it is too concentrated. Much of the estimated new multifamily

supply is located in 12 metro areas, and much of that is localized even further within a handful of submarkets. Worse, much of the new supply is coming online at the same time, leading to slow lease-ups and net absorption. The good news is that if job growth comes in as projected, much of this new supply should get absorbed. It just may take longer – and at a lower rent level – than developers had hoped.

TEN YEARS LATER: MORE IS NEEDED

Today, multifamily fundamentals are driving the sector in a more reasonable way, but there remains a large overarching concern: the lack of affordable multifamily housing.

According to the Harvard Joint Center for Housing Studies, an estimated one-quarter of renters spend over half of their income on rent and utilities. So while the multifamily sector has enjoyed increasing rents, occupancies, and values over the past decade, it needs to start providing more affordable and workforce housing over the coming decade. •

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AN INTERVIEW WITH JOHN J. HENTSCHEL, CRE®
EXECUTIVE EDITOR & PUBLISHER OF *REAL ESTATE ISSUES*
PRESIDENT | HENTSCHEL REAL ESTATE SERVICES, LLC

This year, *Real Estate Issues*, CRE's acclaimed international professional journal, has completed its transition from a quarterly, paid subscription, print publication, to a bi-weekly, open access, digital journal that is delivered free of charge via e-mail.

The Counselor asked Mr. Hentschel about the changes occurring at the new *Real Estate Issues* and what we can look forward to.

What motivated the change to a digital format?

HENTSCHEL: While the digital format yields some minor economies and savings in production and distribution costs, the principal motivation was strategic as part of a coordinated communications effort by CRE to use *Real Estate Issues*, in tandem with *The Counselor*, and the good works of The Consulting Corps and the CRE Foundation, to exemplify and demonstrate the CRE culture and

thought leadership to potential users and consumers of real estate services as well as to prospective members throughout the world.

The digital format is currently the preferred and most competitive medium for the contemporary consumption of information, enabling not only the more timely delivery of content, but also the collection, compilation and analysis of real time performance metrics which provide the ability to gauge the readership profile and refine the content accordingly. The digital format also provides multimedia capability (for example supplementing text with links to other relevant or related information or embedding links to video interviews and/or panel discussions about the topic or related matters).

The digital format has also eliminated the stress of meeting a fixed manuscript submission deadline. Submissions are accepted at any time throughout the year and

placed in the publication pipeline immediately after peer review.

How has *Real Estate Issues* changed? How is it the same?

HENTSCHEL: Our paramount goal has been to preserve and enhance the reputation of *Real Estate Issues* and its recognition as among the most highly respected and emulated of real estate professional journals in the world. The interdisciplinary composition and stature of CRE membership is unique. As a result the journal affords a singular opportunity to serve as a forum in which innovative ideas, techniques, and information about solving problems and capturing opportunities can be presented and examined from an interdisciplinary and international perspective including comparisons of the similarities and differences between viewpoints and techniques employed around the globe.

(CONTINUE ON **PAGE 7**)



Industry Legends:
Ray Torton, Ph.D., CRE
Volume 42, Number 1
By Steve Felix



Fundamentals: Cybersecurity Oversight and Strategy for Commercial Real Estate
Volume 42, Number 2
By Marie-Noëlle Brisson, CRE, and Michael Savoie, Ph.D.



The Revolution, Part II: Revisiting Opportunity in the Small Town
Volume 42, Number 3
By Owen M. Beitsch, Ph.D., CRE, and Tom Kohler

THE NEW *REAL ESTATE ISSUES* (CONTINUED FROM **PAGE 6**)

As an alternative to the traditional quarterly collection of articles that readers might set aside intending to read someday when they have time (which too often is never), *Real Estate Issues* differentiates from its peers by focusing each edition on a specific article or topic that allows readers to quickly assess whether the topic warrants their time and immediate attention. The reader can always retrieve, review and print all articles that have appeared in the journal during the course of the year (2018 is Volume 42) since they are indexed and available in a format similar to the former print publication via the website. An online archive of previous articles is also available which can be retrieved by author, topic, or title. The current plan is to publish a compendium print edition at the end of each year.

How is *REI* working with the academic community?

HENTSCHEL: While academic journals often tend to focus on the findings of theoretical research, *Real Estate Issues* is oriented to practical applications. As a result, *REI* is reaching out to and working with the academic community to assist with transforming theoretical to applied research and become the preferred channel for communicating the results. The digital

format also makes *Real Estate Issues* more readily accessible at no cost to university faculty and students thereby providing an early introduction and exposure of CRE to the real estate profession's emerging and future leaders.

Why is the publication now available free of charge to non-CRE subscribers?

HENTSCHEL: The subscription fee was never a major revenue source. Elimination of the subscription fee and more frequent publishing schedule provides an opportunity to reach a broader audience in order to promote CRE brand awareness and enhance recognition of the CRE designation among practitioners, consumers of counseling services, and other constituencies and audiences (e.g. civic and community leaders, as well as leaders in government, business, finance, legal/accounting, development/construction, etc.). Readership and the number of non-CRE subscribers and page views have been rapidly increasing each month, a trend that is expected to continue and accelerate over the coming year.

Subscribing to *REI* (or *The Counselor*) is free and easy at cre.org/subscribe. You can send a link to this page to your colleagues to invite them to subscribe. Or,

you can email REI@cre.org a list of people you'd like to invite to subscribe.

Has the change in format influenced the organizational structure of *REI*?

HENTSCHEL: Producing a publication like *Real Estate Issues* is a business that requires not only the structure and rigor of a business plan but also the organization and deployment of labor to accomplish it. The former editorial board structure has been replaced with a proactive panel of volunteer CREs from around the world who serve in the capacity of peer reviewers, and Topical Associate Editors who are responsible for monitoring a specific industry sector (e.g. industrial, retail, office, housing, hotel), discipline (for example, law, finance, technology etc.) or region of the world. Each Associate Editor is responsible for identifying trends, resources (books, software, information platforms, etc.) and current topics of interest within their respective spheres, and thereafter soliciting articles from those best suited to write about them. While the editor in chief now focuses on content, a new post of Executive Editor and Publisher provides oversight and concentrates on business issues such as external relations and increasing circulation and readership.

(CONTINUE ON **PAGE 8**)



The Opportunity for Increased Institutional Investment in Public Real Estate

Volume 42, Number 4

By Roy J. Schneiderman, CRE,
and Michael McGowan



Black Swans – The Original Rara Avis

Volume 42, Number 5

By Hugh F. Kelly, PhD., CRE



Housing Demand is About to Change – Here's Why

Volume 42, Number 6

By Paige Mueller, CRE

How can people get involved?

HENTSCHEL: We are always interested in receiving manuscripts and/or suggestions about topics of interest and authors who would be best suited to write them (including members and nonmembers). As a corollary and supplement to CRE's popular Top Ten Issues Affecting Real Estate™, manuscripts that drill down

and detail various elements and facets of the Top Ten Issues are of particular interest. Likewise, while the Top Ten Issues identifies emerging problems and opportunities, *REI* is working to identify specific topics for which, through member involvement and contribution, *REI* and CRE can develop and publish recommended solutions. •



Market Value in Use is Not an Oxymoron

Volume 42, Number 7

By Kerry M. Jorgensen, MAI



Housing Demand and Immigration Trends

Volume 42, Number 8

By Norman G. Miller, Ph.D.;
Paige Mueller, CRE; and Michael
J. Dinn, CRE



Investor Primer: U.S. Data Center Market

Volume 42, Number 9

By Chris R. Miers, CRE, and
Michael McGowan



Data Governance: Cybersecurity Oversight and Strategy for Commercial Real Estate

Volume 42, Number 10

By Marie-Noëlle Brisson, CRE,
and Michael Savoie, Ph.D.



Disney Declares WARA

Volume 42, Number 11

By Todd D. Jones, CRE, MAI, FRICS,
and Michael J. Mard, CPA/ABV,
CPCU



The Devastating Impact of Storm Surge on Coastal Communities

Volume 42, Number 12

By V. Lynn Hammett, Ph.D., CG;
Elaine Worzala, Ph.D., CRE, FRICS;
and Tom Springer, Ph.D.



Vibrancy and Property Performance of Major U.S. Employment Centers

Volume 42, Number 13

By Emil E. Malizia, Ph.D., FAICP,
and Yan Chen

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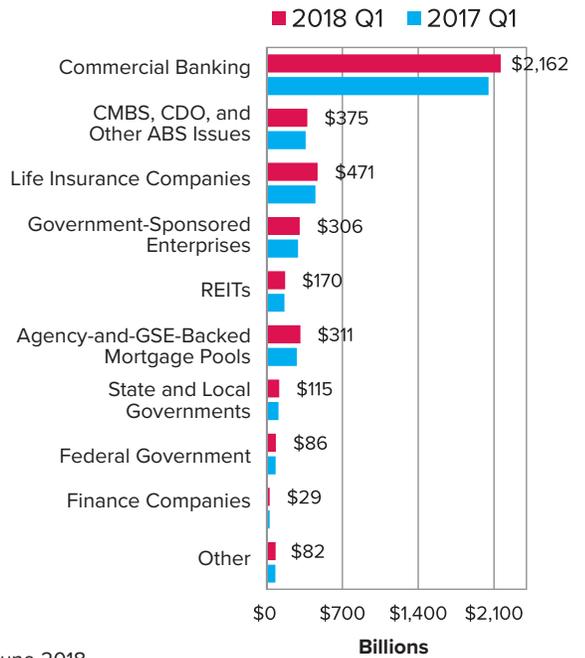
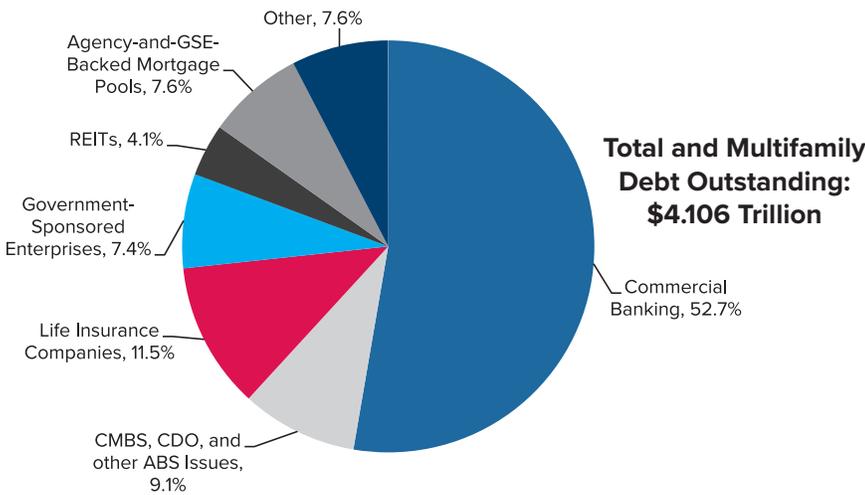
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Figure 3: Commercial and Multifamily Mortgage Debt Outstanding



Sources: REIS, Inc. ©2018. Used with permission. Federal Reserve, latest data available as of June 2018.

If one portion of the capital pipeline clogs, a backup occurs disrupting all commercial real estate finance. What kind of future clog? A disruption in permanent debt markets from implementation of FASB “Lease Accounting” at the end of 2019 could result in major real estate tenants like Amazon, Wal-Mart, national banks, national restaurant or drug store chains, Fortune 500 companies, etc. pulling back from long-term lease structures disrupting the NNN lease market and attractiveness of office, retail and industrial buildings with shorter duration leases (5-year lease terms versus the current 10-20 year duration structures).

So which capital source will be most impacted? It’s the banks, again. Why? If bank construction loans become 100% loan-to-value because of higher construction costs or higher cap rates, who will refinance these loans? Not life insurance companies or CMBS without more equity in the loan. Developers will end up having to renegotiate these loans and more commercial real estate debt will back up in the banks.

Then, the bank regulators will panic with commercial real estate concentration levels of 60 percent or more and declining values from a reset of cap rates due to both a higher interest rate environment

and less valuable lease structures. Figure 2 shows MBA data at mid-2018 and Figure 3 shows the total commercial real estate debt pie from REIS heading into the second half of 2018.

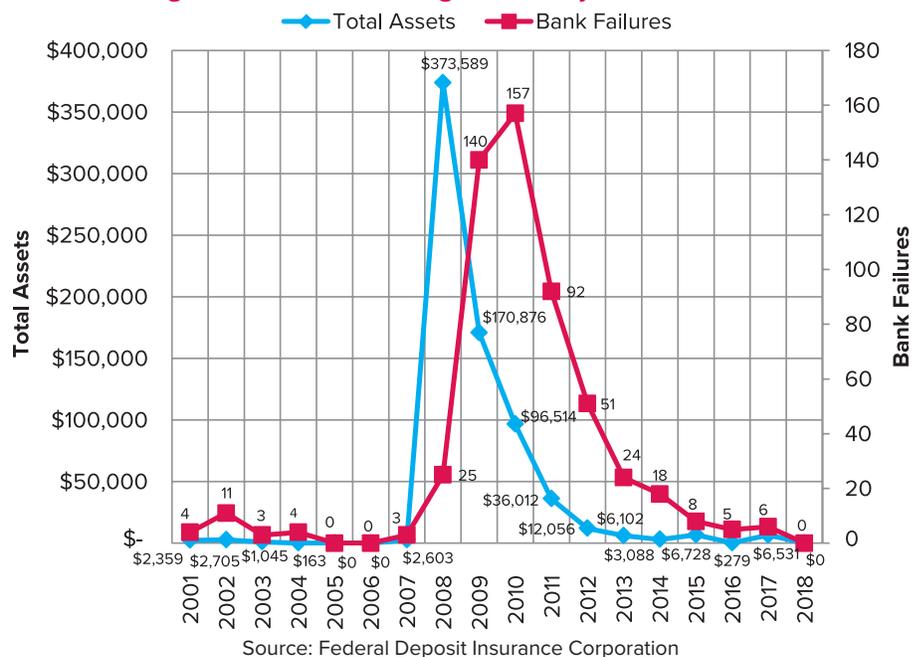
This commercial real estate concentration concern/risk becomes amplified in the second half of 2018 and 2019 when one considers the contraction in banks since 1990. In both the 1980-1988 period and the 2009-2015 period, the FDIC

closed approximately 500 financial institutions during each contractionary period – which were then followed by a wave of financial institution consolidations that have resulted in **the number of U.S. regulated financial institutions declining by more than two-thirds over the past three decades** (from more than 16,000 in 1990 to 10,000 in 2000 and just 5,500 at mid-2018).³

(CONTINUE ON PAGE 10)

3. Source: FDIC Statistics

Figure 4: Bank Closing Summary 2001 to 2018



Recognizing that the number of financial institutions holding commercial real estate debt has contracted by more than 10,000 financial institutions since 1990 and by approximately 50 percent since 2000, **real estate concentration risk is still high within U.S. banks.**

Commercial real estate concentration risk has not been solved by the Federal Reserve, through its enhanced supervisory authority or bank stress tests; Congress, via Dodd-Frank legislation; nor the real estate lending market modifying behavior after 500 bank failures (2009-2017).

Risk number two is that real estate is not immune from business cycles, economic recessions, or disruptive “Black Swan” events – such as interest rate spikes, a trade war, currency crisis, or cyber terrorism. Since the mid-1800s, the United States has weathered nearly three dozen recessions as defined by the National Bureau of Economic Research (NBER). As Figure 5 from the St. Louis Federal Reserve Bank’s FRED website shows, these **recessions have become less frequent but more severe in nature.** This observation is quite evident over the decades since 1980. And the adverse impact from these less-frequent-but-more-severe economic disruptions has resulted in more severe commercial real estate finance disruptions and value volatility. The S&L crisis of the late 1980s and most recent 2008-2009 Global Financial Crisis are cases in point.

If the current economic expansion continues beyond Q2 2019, it will be the first time since 1857 that the United States did not experience a recession in a decade. History is against the odds.

National Bureau of Economic Research (NBER): The U.S. has experienced 33 recessions since 1857. On average, a recession occurs every 4.9 years and lasts 17.5 months. And, there has been at least one recession in every decade.

Peak Month	Trough	Duration
Jan. 1980	Jul. 1980	6
Jul. 1981	Nov. 1982	16
Jul. 1990	Mar. 1991	8
Mar. 2001	Nov. 2001	8
Dec. 2007	Jun. 2009	18

A look back at prior commercial real estate finance disruptions from the past 5 decades reveals an important observation that is lost due to complacency in the market today. That observation is that:

Commercial real estate finance disruption may look like prior ones when graphed, but each occurrence has very different root causes and outcomes.

In the 1970s, the real estate finance disruption was caused by inflation and unprecedented high interest rates. Interest rate volatility and spikes tend to create commercial real estate finance disruptions. In the 1950s and 1960s the

Prime Lending Rate was maintained in a stable 2.0%-5.5% range - and was conducive for real estate finance. In the mid-1970s through to 1981, interest rates rose sharply from 5.25% in 1972 to a Prime Lending Rate of 20.5% in the summer of 1980.

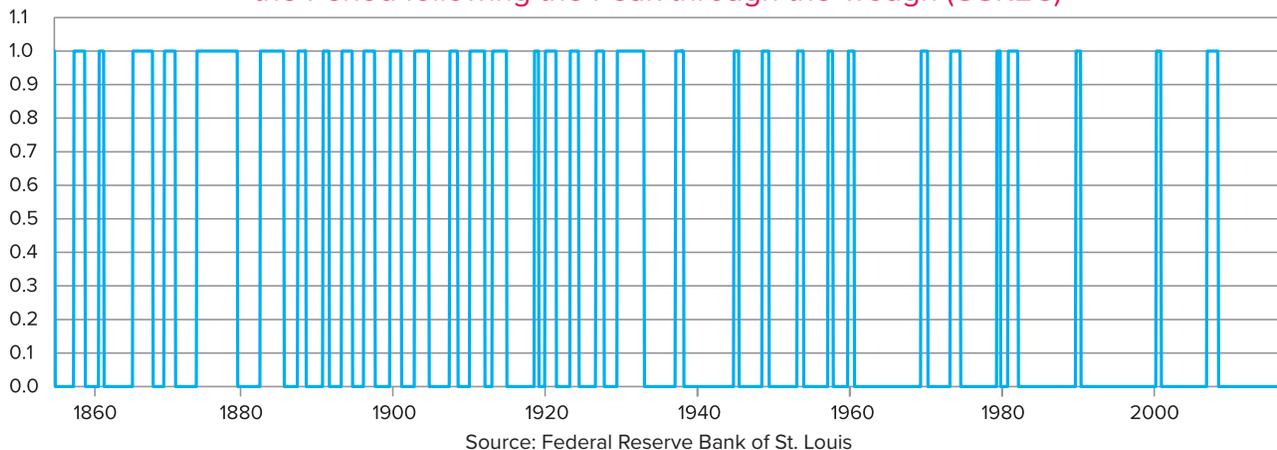
In the 1980s, the 1986 tax law change triggered the disruption of a critical commercial real estate finance source, savings and loans. And leading into the housing and financial crisis of 2007-2009, the Federal Reserve raised interest rates 16 times between Q1 2004 and Q2 2006 pushing the 10-Year Treasury rate back to 5.0 percent. We all know what followed.

Interest rates matter, and the Federal Reserve has been raising interest rates directly for two years - and indirectly by means of selling down its \$4.2 trillion balance sheet accumulated during the Global Financial Crisis. **From just an interest rate perspective, commercial real estate finance faces a headwind in the second half of 2018 and 2019.**

Risk number three is that the market is complacent. Once again, the commercial real estate finance industry is ascribing to a mindset that the trends and patterns we observe in 2018 – such as a 3.0 percent GDP, sub 4.0 percent unemployment rate and sub 3.0 percent 10-Year Treasury yield - will continue into 2019 and 2020.

(CONTINUE ON **PAGE 11**)

Figure 5: NBER based Recession Indicators for the United States from the Period following the Peak through the Trough (USREC)



The market is not prepared for the effects of a 3.5 percent — let alone 4.0 or even 5.0 percent — 10-Year Treasury and what that would mean to cap rates and commercial property valuations.

Memory is short. Between Q1 2004 and Q2 2006, the Federal Reserve raised interest rates 16 times before the onset of the Financial Crisis a full 18 months later. Properties purchased in the first half of 2018 assuming a 2.75 percent 10-Year Treasury could justify a sub-6.0 percent cap rate, but properties purchased in 2019 with a 3.5 percent to 4.0 percent 10-Year Treasury rate environment will not be able to justify a price based on anything below a 7.0 percent cap rate.

COMMERCIAL REAL ESTATE IS NOT IMMUNE FROM DISRUPTION

The growth in commercial real estate finance has not been without pain and additional disruptive regulation. And, that pain and regulation is far from over. More will come with the next unforeseen market or economic aftershock that rattles commercial real estate finance. In both the 1980-1988 period and the 2009-2015 period, the bank regulators exacerbated the commercial real estate finance disruption by injecting new regulation from FIRREA in 1991 to Dodd-Frank in 2010. And now we have LIBOR sunsetting in 2021 and Lease Accounting on the horizon (end of 2019). Each of these two disruptions will have possible watershed impacts on commercial real estate finance.

And then will come more regulatory intervention despite the failings of preceding regulatory intervention. Keep in mind that the results of regulatory and accounting intervention in commercial real estate finance have produced a contrarian result. Commercial real estate finance has become more complex, more volatile, and certainly more expensive. And the primary concerns, such as commercial real estate concentration risk, have only worsened. Compound the aforementioned with new commercial real estate ownership and use

structures like co-working and WeWork, co-warehousing, and experiential retail, and we are ripe for some disruption in the near future.

THE COMMERCIAL REAL ESTATE FINANCE OUTLOOK FOR 2019-2020

Let the good times roll, what could go wrong now? If the current economic expansion continues beyond Q2 2019, it will be the first time since 1857 that the United States did not experience a recession in a decade. History is against the odds so we need to begin thinking about what could go wrong. High on the list of what could go wrong is **commercial real estate concentration risk**. It is bursting at the seams with no margin of error for anything to go wrong. Commercial real estate concentrations are worse today in banks than before the 2009 financial crisis, and assets are priced to perfection at record low average cap rates below 6.0 percent. The amount of commercial real estate debt has grown in aggregate, and banks still hold the largest piece of the

\$4.1 trillion commercial real estate and multifamily debt pie.

Next up on the list of “what could go wrong are: i) rising interest rates and unwinding of the QE (Quantitative Easing) experiment; ii) emerging currency crises (already surfacing in Italy, Turkey, and Argentina); iii) tariffs and trade wars (like those burgeoning with China and European/NATO allies); iv) over-leveraging assuming continuation of sub 6 percent cap rates and a 10-Year Treasury below 3.0 percent; v) changes to tax code following the November mid-term elections.

All the aforementioned triggers have been present in prior disruptions. Is history about to repeat itself and is a commercial real estate finance disruption likely in the 2019-2020 period? The answer is yes. The probability of a disruption in the next 6-18 months is as elevated as it was for much different reasons pre-2007-2008. As you look forward, keep in focus that **the next commercial real estate finance disruption will be for different reasons.** •



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