REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE®

2021/2 TOP TEN ISSUES AFFECTING REAL ESTATE®

The Counselors of Real Estate®

Capital Markets Risk: Looking for Clarity in the Face of Uncertainty

Volume 45, Number 20

August 4, 2021

By Constantine Korologos, CRE

Photo: Panuwatccn/Shutterstock.com

Bifurcation of Capital Markets was listed as the #10 issue in the 2021-22 Top Ten Issues Affecting Real Estate® by The Counselors of Real Estate®.

While we may not be experiencing the steep drops on our roller coaster ride since March of last year, the ride is far from over. When we look at what the capital markets are, we tend to think of debt and equity, capital structure, and the cost of capital. Capital is priced (or should be priced) based on risk-adjusted returns, and given the last15 months, the risk part has been a bit challenging to measure, with one definition being an uncertainty that exists around return expectations in the future. The probabilistic view of returns and the deviations of that return shed light on what risk is. Types of risk can include market risk, credit risk, liquidity risk, operational risk, and business risk. When we think about 2020 and 2021 we have all those risks present, front, and center. It is not unreasonable to look at the period before the "great pandemic" and feel that those risks were more measurable. Assigning a probability for various return outcomes was easier then as compared to now, and that is never an easy task. Are we moving away from uncertainty where estimating returns and probabilities are not truly measurable to some level of predictability? Maybe, but I don't think the ride on the roller coaster is quite done yet.

ABOUT THE AUTHOR

Constantine Korologos, CRE, has worked in the real estate industry for 37 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. In addition to his own consulting business as founding principal of Leonidas Partners, LLC, he is a managing director with Eyzenberg and Co. where he is involved in the placement of real estate debt capital, ground lease and C-Pace financing, and a managing director with Frontstage Capital, where he is a FINRA registered representative executing securities transactions through their affiliate broker dealer, Moody Capital. Complementing his professional experience, he is a full-time Clinical Assistant Professor, teaching graduate real estate finance, capital markets and portfolio risk courses with the New York University Schack Real Estate Institute, where he has been on the faculty for over 27 years.

WHAT HAS STRUCTURALLY CHANGED, AND WHAT GOES BACK TO "NORMAL"

When we look back at the last 15 months, what becomes clear is how different this market-changing event were compared to prior market corrections. Less travel and shopping during prior market corrections was common. Not as many business travelers visited clients or attended conferences, people maybe didn't shop as much, and many businesses reduced employee count which reduced the amount of office space that they needed. Those adjustments seem more measurable when trying to predict future expectations, but this time was clearly different. No travel, very limited shopping at the retail centers unless you were an essential business, and no one going to the office. Business meetings and even industry conferences we're done virtually. Shopping virtually for almost everything became the norm, and if you did go to a retail center to shop, the restrictions were significant and very limiting. Working from home, despite all the challenges associated with internet connectivity and finding a quiet space to meet online without the distractions of barking dogs and crying children, still allowed businesses to function. How much of those modifications go back to the old ways, and how many changed forever? Understanding what is structurally different can help us assess risk and returns but doing that with any measurable level of probabilistic predictability still seems unlikely at this time. How many supermarket visits remain virtual and how many restaurant meals involve GrubHub? How many people attend industry events in person as compared to before? While all property sectors have experienced varying degrees of change and data that is now being considered to access risk and pricing, I focus on one sector, the office market.

Some of the metrics that we consider now include employee turnstile swipes at the office, ridership on public transportation, and even Apple Mobility metrics which track the amount of people walking around cities like New York (now at 95% of pre-pandemic levels). We track tenant reboarding plans to reopen their offices, work from home expectations, and increases or decreases in proposed occupancy spend per-square-foot/per-employee. Here are some figures from recent research on New York City.

Based on data from Newmark Research and the MTA (Metropolitan Transit Authority), subway and bus ridership is down 58% and 44% versus pre-pandemic levels, but up 432% and 163% from their pandemic lows.[1] Long Island Railroad and Metro-North ridership for suburban NYC commuters is down 54% and 45% versus pre-pandemic levels, but up 1215% and 574% from their pandemic lows. MTA bridges and tunnels traffic is up 1% from pre-pandemic levels and 204% from the low point. All represent significant improvement from the lows, but in some cases still significantly off pre-pandemic levels.

Office occupancy rates based on key fob swipes (freight on board) for NYC versus the U.S. major market 10-city average indicate that 17% of the workforce in NYC has returned versus 28.8% for the 10-city average, up from approximately 7% and 21% respectively as of June 2020.[2]

When it comes to indications of future reboarding, the messages remain mixed. For the months of May through October 2021, companies like JP Morgan, Facebook, Apple, Amazon, Salesforce, Omnicom, Google, Prudential, American Express, and Millennium Asset Management announced a hybrid return of 1-4 days in the office per week, while firms like Goldman Sachs, Newmark, Sullivan & Cromwell, Wells Fargo, and the New York Times have announced a full return. The City of New York, Blackstone, Nixon Peabody, Jeffries, Ropes and Gray and Bank of American have not made public decisions.[3] Manhattan office sublease space has almost doubled since the beginning of the pandemic, with an estimated 23.8M square feet either coming to or currently on the market as of April 2021. The prior peak during the GFC was 16.2M square feet. [4]

These metrics, which had not been part of risk management or capital markets decision making, now warrant consideration. They all present some degree of comfort in positive trending, but still leave us with significant questions about what the long term holds for risk and its pricing.

Figure 1

	2019	2020	2021 (Forecast)	2022 (Forecast)
Personal Consumption Expenditures	2.40%	-3.90%	7.30%	4.00%
Unemployment Rate (4Q Avg.)	3.60%	6.80%	5.00%	3.90%
			5.70%	4.80%
			4.70%	4.10%
Consumer Price Index (4Q/4Q)	2.00%	1.20%	3.30%	2.40%
			4.00%	4
			3.80%	2.80%
10-Year Govt Bonds (4Q)[8]	1.80%	0.90%	2.00%	2.50%
			1.60%	1.96%
			2-2.5%	2.25-2.75%

Sources: Morgan Stanley, Oxford Economics, Comerica Bank, Wells Fargo

DEMAND DRIVERS AND CONCERNS ON THE HORIZON

While some of the other Top Ten Issues focus in greater detail on the economy and drivers impacting future growth, I will briefly touch on a few just for context in the remainder of my discussion. Some relevant points worth visiting include personal consumption expenditures, unemployment rate, the Consumer Price Index (CPI), and interest rates. **Figure 1** presents year-end 2019 and 2020 measurements as well as 2021 and 2022 forecasts.[5, 6, 7]

We experienced unprecedented volatility during 2020, particularly around employment. While year-end 2020 settled to a more modest 6.8% unemployment rate, it had peaked in April at 14.8%, 400 basis points above the prior 70-year peak of 10.8%.[9] Consumption (negative), CPI, and the 10-year declined, but forecasts for 2021and 2022 indicate increases, with inflation becoming more of a concern. Spending recovery, employment growth, inflation, and interest rates affect cost of capital, risk premiums and demand for space.

DEBT CAPITAL MARKETS

The debt capital markets have seen significant volatility, particularly in the public markets like CMBS (commercial mortgage-backed securities), Mortgage REITS, and GSE Agency CMBS (government-sponsored enterprise agencies Freddie Mac and Fannie Mae). Swings in risk premium spreads have felt like a roller coaster ride. For CMBS and Agency CMBS, we experienced year-end 2019 new issue Senior AAA spreads over the comparable term swap spreads of 82 and 55 basis points, and by the end of the first quarter of 2020, they widened to 200 and 95 basis points respectively. In the second quarter of 2020 they widened to, 105 and 45 basis points, and as of first quarter 2021, 70 and 9 basis points.[10] One could take away from that that the market has significantly reduced its expectations for risk premiums to below pre-pandemic levels. I would propose a different observation, a question as to why risk has a pre-pandemic cost. We looked at indicators of risk based on office trends, and similar metrics would indicate concerns in retail and hospitality. Looking further into the performance of these sectors, we see where delinquencies and loan modifications stand today.

For three of the major product types of CMBS, Conduit (multi-borrower pools of loans), SASB (single-asset single borrower large loan deals) and Agency CMBS (Freddie Mac), we see where performance stands. As of May 2021, over $41.1B in Conduit loans out of $382B, $7.36B of $172.9B in SASB loans and $1.9B out of $338.9B of Freddie Mac were non-current, a total of $50.4B. When looking at the loan modifications and forbearance for the same product types, $49.6B in Conduit loans, $24.27B of SASB loans and $8.9B

of Freddie Mac loans had been modified, a total of $82.7B.[11] Both measurements are relevant as they reflect loans not current and a potential problem today, and modified loans which are a potential problem tomorrow. Many of the non-current loans are also in the modification count but not all, while some of the modifications show up as current because the new terms extending payment obligations to a later date are not late. How many of the loans revert to current and viable loans on income-producing properties will be driven by performance, the impact of changes in e-commerce, travel, and office use and demand.

Mortgage REITs (mREITs) took a significant hit early in the pandemic, with the FTSE NAREIT Equity Mortgage Commercial Financing Index declining from its previous peak of $ 26.65 in January of 2020 to $11.32 on March 1, 2020, to $24.33 on May 1, 2021. Some of the recovery was driven by mREITs restructuring their credit lines and paying down credit facilities that experienced margin calls.

Debt funds that issued short-term transitional bridge and mezzanine loans had experienced stress, much of which came from their financing costs. The market continues to be flush with debt capital liquidity, despite property type and market uncertainty.

Commercial banks experienced a slight uptick in delinquencies on commercial real estate loans, hitting 1.13% at the end of 2020, up from .68% at the end of 2019. The Fed provided flexibility to banks to extend short-term modifications without reclassifying the loans as TDRs (Trouble Debt Restructures). Performance of bank commercial real estate loans will also be subject to the impact of post-pandemic trends discussed before.

Looking out to the remainder of 2021 and into 2022, performance will dictate the amount of distress and losses, and risk management should dictate markets, property types, leverage, loan structure, and pricing for mortgage debt. The one observation that is easy to make is there is tremendous liquidity from debt funds for transitional lending, construction financing is not as difficult to secure, and there is even liquidity for office and hotel. The liquidity is not for everyone, every market, or every property type. If you were part of a COVID-resilient sector like multifamily, self-storage or industrial, the competition is fierce to provide debt capital and terms are even better than pre-pandemic levels. The next year should also tell us if commercial real estate debt was too rich and whether perceived risk underestimated where pricing should have been.

EQUITY CAPITAL MARKETS

In last year's capital markets Top Ten Issues discussion, we had already seen significant declines in the valuations of publicly-traded REITs. The remainder of 2020 into the beginning of 2021 continued to display asset value volatility, with several sectors increasing and decreasing on a weekly basis and sometimes at double digit levels. As of March 16, 2020, all the FTSE NAREIT U.S. Real Estate Index Series components experienced significant double-digit declines except for infrastructure and data centers, which were down 6.96% and 4.18% respectively. Year-to-date in just two weeks, the major property type sectors declined at never-before-seen levels.

Figure 2

REIT Sector	March 16th, 2020, YTD	Year End 2020	YTD 2021 Through May 21st
Office	-33.41%	-18.40%	12.30%
Industrial	-27.64%	12.20%	16.60%
Retail	-42.43%	-25.20%	27.00%
Residential	-24.33%	-10.70%	21.30%
Hospitality	-59.06%	-23.60%	14.10%

Source: NAREIT

REIT capital markets were also active during 2020 with $106.1B in total capital raised, $73B of which was unsecured debt. The only year in the prior seven years where more capital was raised was in 2019 with $112B raised. The strong demand has continued into the first quarter of 2021 with over $22.2B raised by the sector. Expectations for 2021 are favorable with improving fundamentals with the vaccine rollout, low-interest rates, and attractive pricing in property sectors that were significantly impacted in 2020.

Institutional private real estate ownership trends measured using NCREIF's NPI index, presented a first-quarter 2021 market value of just over $716.6B, up 1.72% from the end of 2020 and 2.61% since Q1 2020. The components of these aggregate numbers reflect a divergence in performance based on asset type, with the strongest 1-year performance coming from industrial properties (14.11%) and declines in both retail and hotel of -5.96% and – 23.95% respectively.

Private equity funds have raised significant capital to deploy over various real estate strategies, with $371.8B in dry power available as of May 2021 based on data from Preqin. Opportunistic, value add, and debt strategies round out the top three with approximately $280B available to deploy. Top fund managers like Blackstone Group, Lone Star Funds, Brookfield Asset Management, The Goldman Sachs Group, and Starwood Capital Group have $70.78B of dry power and are continuing to raise capital.

With public, institutional, and private equity capital providing the market with a view of valuation and pricing, we have still not had an active transaction market. The Green Street CPPI is a weighted time series index based on property values that capture current transactions of institutional real estate. The all-property index indicates a 5% decrease from pre-COVID levels, but a wide dispersion based on asset type. Malls, strip-retail, office, and lodging were down 20%, 13%, 9% and 11% respectively, while industrial and manufactured home parks had solid increases of 20% and 8% respectively.[12] Transaction volume continues to slowly recover, but still well below pre-COVID levels. Year-end 2020 transactions were 30% below the same period in 2019, and while the pace is accelerating, sectors like industrial and multifamily are driving the activity. Specialized sectors like single-family rentals, life science, and studio properties have seen transaction growth with multi-billion-dollar investments from private equity. Price discovery continues to be limited, and buyers and sellers are holding their ground on the bid-ask for assets that are still viewed with uncertainty as owners look to the vaccine and timing on a return to normal. With cities like New York announcing the elimination of COVID restrictions, there is more measured optimism rather than unconstrained enthusiasm. The market has not seen the volume of expected distress sales, but there is significant but selective liquidity for the right opportunities.

WHAT DOES THE NEAR-TERM HOLD?

People are generally trying to feel better about where we are today. Travel is increasing, restaurants and bars are starting to get crowded and Broadway is going to open in the fall. Universities like NYU are planning to hold classes in person in September. The conference circuit is starting to return to in-person, and I look forward to a day where I do not have to log on to Zoom. The market "vibe" is a critical part of recovery, but we still have a lot of questions that need answering. Do the gateway city markets gain back some ground while the suburbs and markets like Austin, Nashville, Atlanta, Tampa, and other net positive migration cities continue to grow? How do we measure and price capital markets risk when we aren't sure about retail and e-commerce, work from home, and business travel? All the previously discussed Top Ten Issues affect the capital markets and the measuring and pricing of risk. ESG affects capital expenditures in the near and long term. Housing affordability, technology, and infrastructure are perfect examples of the interconnectivity of all these issues and the cost and liquidity of capital. For now, there is plenty of liquidity depending on the property type and the market. Office and lodging owners cheer for a return to the office. For industrial, it's about as good as it gets. Single-family rentals continue to draw both debt and equity capital, including from institutional sources, and demand for life science space continues to drive performance and transaction activity.

As we move through 2021 and 2022, the need to monitor the capital markets and continue to refine how we measure and price risk will require more focus and real-time risk management beyond what we have needed to do in the past. Models, data, due diligence, creativity, thinking outside the box and, of course, our judgment are now more important than ever. •

ENDNOTES

1. New York City Office Market Data. Newmark Research, May 21, 2021, p.1.
2. *Ibid,* p. 2-3. Ten-city Average includes Austin, Dallas, Houston, Chicago, Los Angeles, Philadelphia, Washington D.C., SF and San Jose, California
3. *Ibid,* p.4.
4. *Ibid,* p.7.
5. U.S. Consumer Chartbook: 2Q 2021. Morgan Stanley, p. 3.
6. "2021 Midyear Outlook." Wells Fargo. https://www08.wellsfargomedia.com/assets/pdf/personal/investing/investment-institute/2021_Midyear_Outlook_ADA.pdf (accessed August 3, 2021).
7. "U.S. Economic Outlook, June 2021," Comerica Bank. https://www.comerica.com/content/dam/comerica/en/insights/assets/economic-commentaries/2021/jun-06/USEconomicOutlook_0621.pdf (accessed August 3, 2021).
8. Global Data Workstation, Oxford Economics.
9. "Unemployment Rate (Unrate)." Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org/series/UNRATE (accessed July 29, 2021).
10. CMBS Spreads, J.P. Morgan Securities.
11. TreppWatch, Trepp.
12. Commercial Property Price Index. Green Street, May 2021.

THE COUNSELORS
OF REAL ESTATE®

www.cre.org

This article/submission represents the opinions of the authors/contributors and not necessarily those of The Counselors of Real Estate® or its members. The Counselors assumes no responsibility for the opinions expressed/citations and facts used by the contributors to this publication regardless of whether the articles/submissions are signed.

Published by The Counselors of Real Estate, a not-for-profit organization, 430 N. Michigan Ave., Chicago, IL, 60611. Copyright 2021 by The Counselors of Real Estate. All rights reserved. (Published online at cre.org/rei).

Real Estate Issues is a registered trademark of The Counselors of Real Estate, a not-for-profit organization.

The Counselors of Real Estate®, established in 1953, is an international group of high-profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on complex real property situations and land-related matters. Membership is selective, extended by invitation. The organization's CRE® (Counselor of Real Estate) credential is granted to all members in recognition of superior problem solving ability in various areas of real estate counseling.

REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE®

Since its launch in 1976, *Real Estate Issues* has been the premier forum in which the world's foremost real estate thought leaders present innovative ideas, novel strategies, and intriguing commentary on all matters relating to real property.

Visit www.cre.org/rei to view the digital archive of *Real Estate Issues* articles.

Subscribe at www.cre.org/subscribe to receive digital or print editions of *Real Estate Issues*.

Please submit any comments to the *Real Estate Issues* Executive Editor (or Board) on this article to rei@cre.org.

2021 EDITORIAL BOARD

EXECUTIVE EDITOR AND PUBLISHER
John J. Hentschel, CRE
Hentschel Real Estate Services, LLC
Abingdon, Md., U.S.

EDITOR-IN-CHIEF
Deborah C. Nisson, CRE
Real Estate Consultant
Shady Side, Md., U.S.

CONTENT EDITOR
Cassandra J. Francis, CRE
KARIATID
Chicago, Ill., U.S.

ACADEMIC EDITOR AND LIAISON
Elaine M. Worzala, Ph.D., CRE
The George Washington University
Washington, D.C., U.S.

LIAISON VICE CHAIR
Casey R. Kemper, CRE
K4 Real Estate Group
Brewster, Mass., U.S.

2021 CHAIR OF THE BOARD
Michel Couillard, CRE
Busac Real Estate
Montréal, Que., Canada

MANAGING EDITOR, DESIGN/PRODUCTION
Alyssa Bray
The Counselors of Real Estate

PRESIDENT AND CHIEF EXECUTIVE OFFICER
Mary Walker Fleischmann
The Counselors of Real Estate

MANAGING EDITOR, CONTENT
Larisa Phillips
The Counselors of Real Estate

TOPICAL EDITORS AND REVIEWERS

Melissa Bach, CRE
Cushman & Wakefield
San Francisco, Calif., U.S.

Paul Briggs, CRE
Bentall Kennedy
Boston, Mass., U.S.

Joshua Harris, Ph.D., CRE
Skanska USA Commercial Development
New York, N.Y., U.S.

Andrew Nelson, CRE
Nelson Economics
San Francisco, Calif., U.S.

Roy J. Schneiderman, CRE
Bard Consulting, LLC
San Francisco, Calif., U.S.

Daniel L. Swango, CRE
Swango International
Tucson, Ariz., U.S.

Jason Bergman , Esq., CRE
Benchmark Title Agency, LLC
White Plains, N.Y., U.S.

Mary C. Bujold, CRE
Maxfield Research & Consulting
Golden Valley, Minn., U.S.

Constantine Korologos, CRE
New York University | Leonidas Partners, LLC
New York, N.Y., U.S.

James Nelson, CRE
Avison Young
New York, N.Y., U.S.

Thomas Joseph Shircliff, CRE
Intelligent Buildings LLC
Charlotte, N.C., U.S.

Hans Vrensen, CRE
AEW Europe LLP
London, United Kingdom

Massimo Biasin, Ph.D., CRE
Biasin & Partners
Bolzano, Italy

Tilman Thomas Gates, Esq., CRE
Law Offices of Tilman Thomas Gates PLLC
Charlotte, N.C., U.S.

Daniel Lesser, CRE
LW Hospitality Advisors LLC
New York, N.Y., U.S.

Shane Rayman, CRE
Rayman Beitchman LLP
Toronto, Ont., Canada

Phil Stone, CRE
Bentall Kennedy (Canada) Limited Partnership
Toronto, Ont., Canada