PHOENIX AMERICAN

TRENDS OUTLOOK REPORT
MAY 2020

CRE & COVID-19

Winners, Losers & The Road Ahead

Our Vantage Point

As the administrator for a wide variety of commercial real estate investment funds, Phoenix American has a unique perspective on the unfolding impact of recent events on this asset class. From our role as fund administrator as well as from consultations with sponsors, investors and partners in the industry, we have seen the shock of the economic shut-downs absorbed and addressed by real estate fund sponsors of every size, with portfolio assets of every property type in regions throughout the United States.

From what had been a strong beginning to the year, we witnessed unprecedented challenges for fund sponsors emerge in the wake of the COVID-19 pandemic crisis. From this one cause, we see a variety of effects emerging for commercial real estate funds going forward.

Heading into 2020, commercial real estate asset values were at new heights, driven during the long economic expansion by persistently low interest rates, an influx of capital and strong fundamental performance. Equity capital gravitates to a product that provides dividends well in excess of sovereign and corporate bonds, tax efficiency and good prospects for appreciation. Commercial mortgage debt also rose to an all-time high $3.7 trillion, with stellar performance on loans originated after 2009. Market demand for commercial space was strong as well. Rents grew steadily – depending on the asset class – at a moderate to robust rate. The only part of the market not busy in recent years has been workout specialists and high-yield vulture funds, who have had very few assets from which to choose.

The COVID-19 pandemic changed everything. States enacted shelter-in-place policies to stop the spread of the virus, forcing everything from businesses, schools and entertainment, to medical and personal care establishments to close throughout the country. Through mid-May, more than 33 million Americans had filed for unemployment benefits, pushing the unemployment rate to a staggering 14.7 percent.

Executive Summary

After a decade of prosperity, commercial real estate is facing a crisis that was entirely unforeseen. What's the early prognosis for how it will fare? Although the downturn is in its early stages and the full extent of the downturn may not be clear for months, we can draw some initial conclusions.

To a much larger degree than in past recessions, the impact will vary greatly by property type and location. Multifamily and industrial are better positioned to weather the storm than office, while retail and lodging are facing serious obstacles. Metros that have more diversified and tech-centric economies are better positioned to weather the storm.

Suburban single family home rentals have emerged as perhaps the most resilient sector, with new demand from tenants hesitant to buy, given the economic uncertainty, but eager to move from the contamination risk of urban apartment buildings. The decade-long "Wall of Capital" that kept prices afloat has weakened, but not cracked. Sales and loan activity will take a hiatus, although more due to the difficulty of pricing with so much economic uncertainty than a lack of capital. Some institutional capital sources have put activity on hold, but opportunistic funds are looking to step in.

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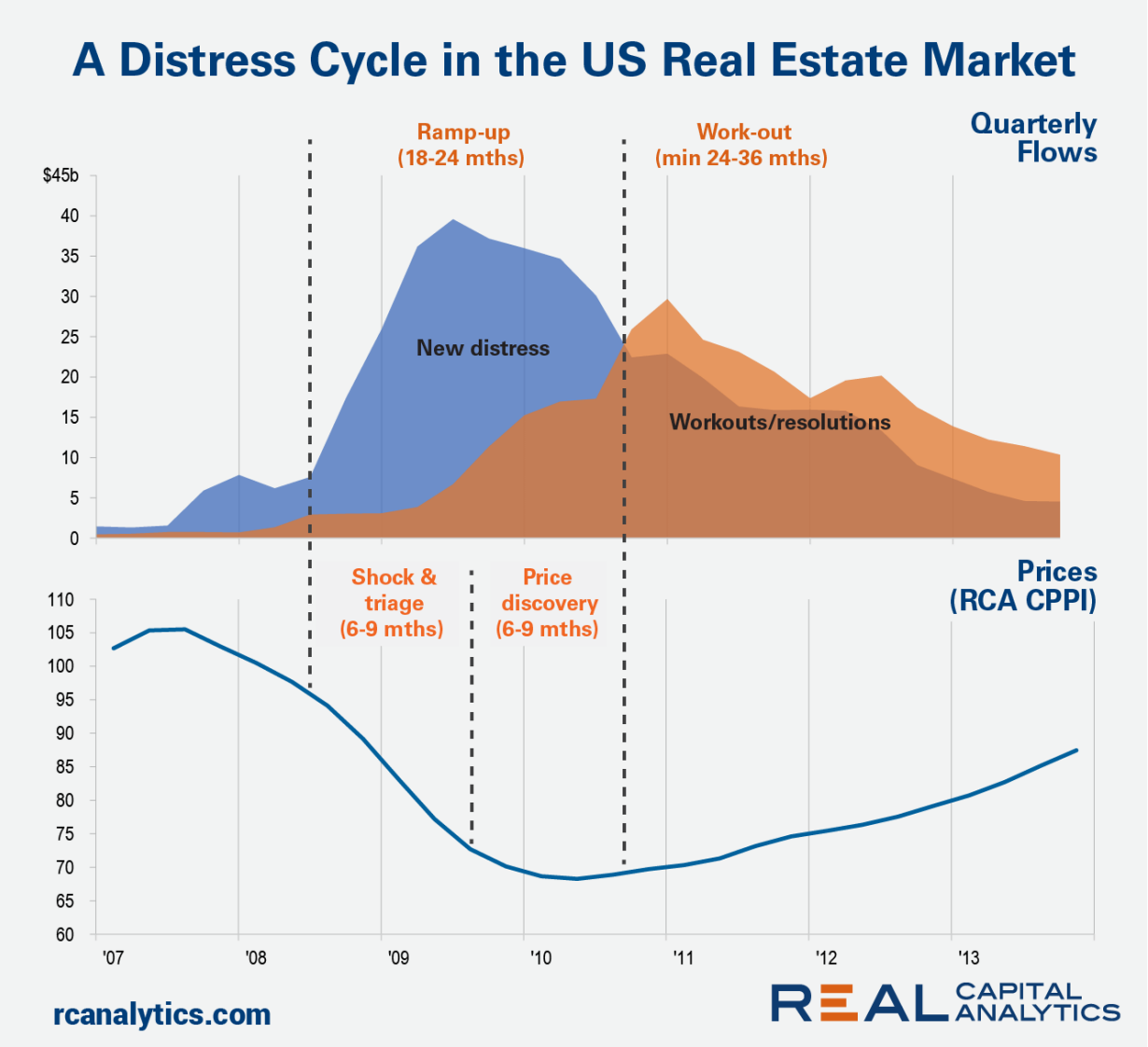
Public policies are important to the recovery. Emergency unemployment aid, for example, has enabled tenants to pay rents at a rate close to pre-pandemic levels. Federal aid has also helped small businesses to pay rents, at least temporarily. Federal Reserve support has helped rescue Fannie Mae and Freddie Mac and commercial MBS, although support is needed for loan servicers and property owners. Policy will play an important role in the recovery.



In the near term, the industry will be focused on operations more than deals. Property owners are working with tenants on navigating reopening policies and payment schedules. On the debt side, lenders are focused on servicing and negotiating terms of forbearance with borrowers.

In terms of timeline, Real Capital Analytics has drawn on data insights from the 2008 distress cycle, which can provide a point of reference for this cycle's potential duration and magnitude.

Multifamily

Multifamily started the pandemic from a position of strength, with five years of rent growth above the 2.5 percent long-term average and occupancy rates at a solid 95 percent. Suddenly the industry faces declining demand, lower rents and increased concessions, uncertainty about rent payments and a slowdown in development activity, all amid an imperative to refocus operations on cleanliness and the need to socially distance.

With so many workers losing paychecks, and rent strikes being organized in many cities, market pros worried that rent payments would plummet. But two months into the downturn, those fears are not materializing. Some 92 percent of tenants made rent payments in April, only 4 percent less than the same month a year ago, according to the National Multifamily Housing Council. The trade group said that 80 percent of tenants made rent payments through the first week of May, only 1.5 percent less than a year ago.

Aid that provides an additional $600 per week to state unemployment means that in

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most states, jobless workers are making more than the average state wage. That should help boost rent payments through the end of the summer, when the additional aid runs out.

There are downsides for the segment. Demand is historically correlated to jobs, and household formation is likely to weaken with so many out of work. Young people that moved to urban areas to work might move back with their parents if jobs don't re-materialize soon.

Developers will have problems leasing up new luxury units, forcing property owners to offer concessions and/or lower rent to fill vacant units. Rent growth will flatten or turn modestly negative in many metros the rest of the year. That said, the regression should be shallow and the prognosis for recovery is good.

Industrial

Industrial has been arguably the hottest segment in commercial real estate in recent years, revolutionized by the rise of e-commerce and growth of global trade. Development of modern logistics facilities close to urban populations has been going at a furious pace for years. The average vacancy rate of industrial properties as of the first quarter of 2020 was 4.5 percent, near an all-time low, while rents rose 4.8 percent year-over-year, according to real estate services firm CBRE.

The pandemic has, if anything, accelerated the e-commerce evolution. More consumers are going to buy products online than ever before, and demand for new space that meets the needs of retailers continues. The pandemic also has created an increase in online grocery shopping, which CBRE estimates is likely to produce demand for somewhere between 75 million and 100 million square feet of cold storage facilities.

We expect absorption and rent growth will slow down over the next few quarters. Companies are pausing decision-making on space needs amid economic uncertainty and the problem of keeping employees safe. According to CBRE, net absorption of industrial space was 34 million square feet in the first quarter, which is strong but well below 50-60 million square feet absorbed per quarter in recent years. Industrial deliveries average more than 200 million square feet per year, so even though long-term trends favor industrial real estate, it will take longer to fill new space delivered under the current economic environment.

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Office

Offices have been evolving over the last two decades to encompass more amenities, collaborative and coworking space, and generally less square footage per employee, but the pandemic is a twist that will force another round of rethinking. Offices are closed amid shelter-in-place orders, but as the economy restarts office workers are unlikely to return to cubicles en masse.

Post-COVID offices must account for worker safety, which means that in the near-term companies will have to focus on sanitary conditions and keeping workers spread out. Corporations have established work-from-home protocols that have proven to be effective, and many will continue to allow employees to work from home – or at least have the option if they wish – for months or even years into the future. A recent survey by CoreNet Global, an Atlanta-based corporate development firm, found that 69 percent of companies said they plan to take up less office space going forward. Although working from home has limits, and could be a drag on productivity, now that the forced experiment is generally proving successful, companies will embrace it.

As demand for total space declines, effective office rents are likely to drop by 10-20 percent in many metros. The pandemic also means a new stage of evolution for the coworking industry, which has grown to 93.2 million square feet, or 1.7 percent of total space, in the top 50 office markets in the U.S. Coworking has met the demand for flexible leases, shared spaces and amenity-rich features that attracted start-up technology firms and independent contractors that desire a social setting. The short-term nature of coworking leases is a problem for coworking firms have lost big portions of their income. Many are scaling back by reducing space and cancelling deals that were in the works.

However, the demand for flexible leases and amenity-rich space will only be exacerbated by the conditions brought about by the pandemic. To take advantage, the coworking business model will increasingly evolve from a lease-sublease model into a partnership model with building owners and tenants. The model should thrive long-term despite the near-term shake-out of providers.

Retail

The retail sector has been struggling with e-commerce and overdevelopment for a long time, and the pandemic has dealt a major blow to the industry. More than half of the retail outlets in the U.S. were ordered shut down by states and bringing them back may be an impossible challenge. Most retail landlords are collecting only 20 to 40 percent of rent payments, according to CBRE. Moody's Analytics forecasts retail rents to fall by an average 11 percent in 2020.

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One major issue is that the retailers themselves can't survive an extended period with no income. In one week in May, J. Crew, Neiman-Marcus and Gold's Gym filed for bankruptcy, and the list of failed retailers is likely to be long by the summer. Department stores, which anchor regional malls, are especially vulnerable. Smaller tenants also lack the financial wherewithal to stay in business with no income for months.

Retail properties have evolved in recent years as consumer spending habits have changed. Malls and shopping centers have more tenants focused on experiences such as gyms, restaurants and theaters. Those types of activities may be the most difficult to draw customers when shops re-open, as people will try to avoid crowds and potential infection until a COVID-19 vaccine becomes available.

The upshot for retail is that many poorly located and poor-quality properties will fail over the next 12 to 24 months. Since the cause of failure is weak demand, many of those centers must be repurposed into other types of assets, such as apartments or warehouses.

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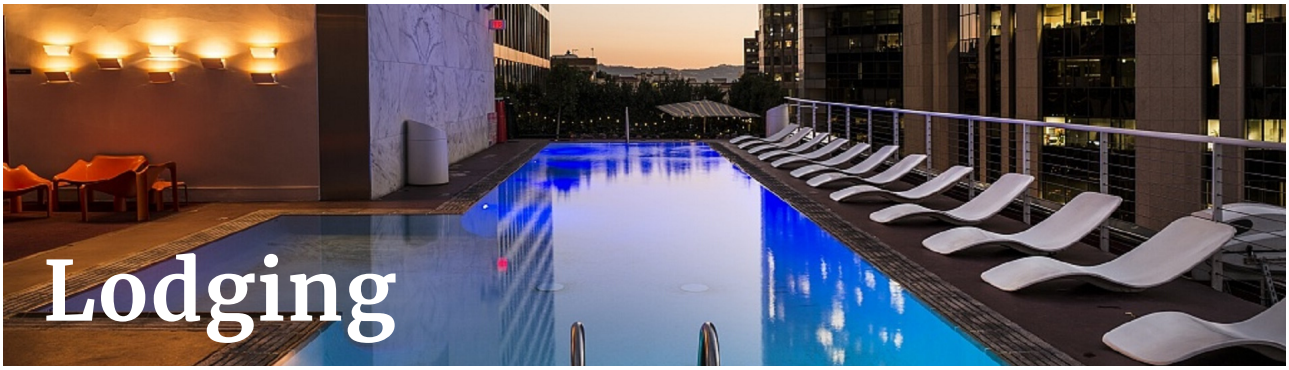

Lodging

Both the numbers and the outlook for lodging is grim. Many hotels are not open for business and those that are open have little demand.

During the first week of May, the average hotel occupancy rate was 28.6 percent, down 58.5 percent year-over-year, according to STR, a hotel data service based in Nashville. STR said the average daily rate during that week was $74.72, down 44 percent year-over-year; while revenue per available room was $21.39, down 76.8 percent.

The figures paint a devastating picture of an industry that posted positive performance for 10 straight years following the 2008-09 recession. Among commercial property types, hotels have the shortest leases and thus react most quickly to economic shocks.

The drop in travel is extreme and it remains unlikely to bounce back until there is confidence that the virus is contained. Corporations are holding meetings online, business conferences have been shut down indefinitely and few people are traveling for leisure.

Hotels present an opportunity for vulture investors, but only at steep discounts and transactions would likely have to be done all cash, since lenders will be unwilling to write loans on hotels.

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Capital Markets

The year started strongly, with $116.5 billion of transactions in the first quarter, up 8.1 percent year-over-year, according to CBRE. However, deal flow largely dried up at the end of the quarter and the drought will continue in coming months.

That's not because of a lack of capital. Although many large institutions typically put new investments on hiatus during periods of uncertainty, opportunistic vehicles abound and are looking to invest.

Coming into the year, private equity commercial real estate funds had more than $300 billion of dry powder, and vulture investors are on the prowl looking for bargains.

Not many deals are getting completed, though. The logistical elements of transactions (appraisals, site inspections, work crews, etc.) are one impediment. Plus, there is uncertainty in underwriting future cash flows, leading to a gulf between buyers and sellers. Buyers want a discount that sellers are unwilling to give this soon into the downturn.

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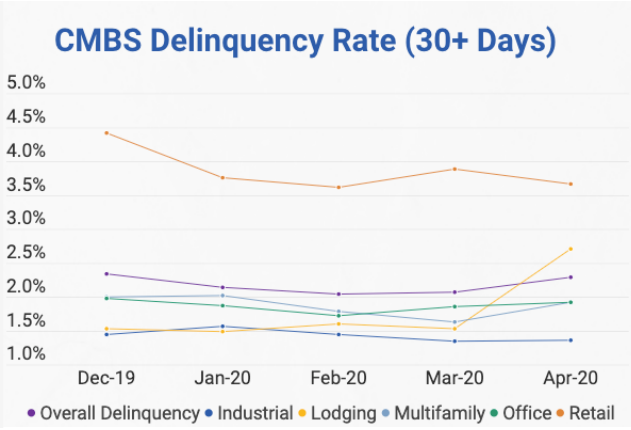
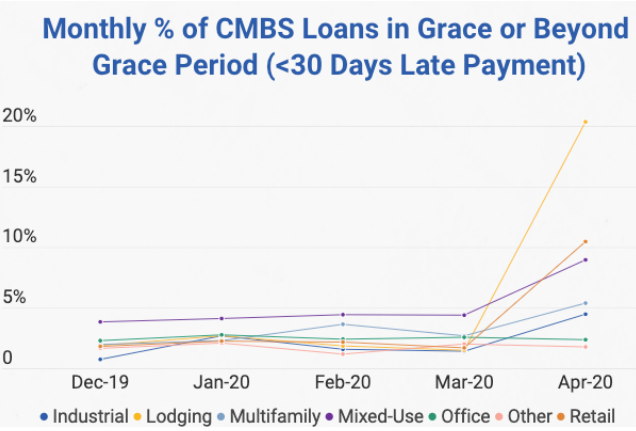
What's more, acquisition financing is more difficult to line up. Portfolio lenders and the government-sponsored enterprises (Fannie Mae and Freddie Mac, which lend only to multifamily), are still quoting loans, and rates are low by historical standards.

However, lenders are providing only conservative leverage and are also requiring borrowers to fund reserves of nine to 18 months, which leaves out all but the most well-capitalized. While opportunities exist and vulture investors are raising capital, for the next three to six months deals will be hard to identify and even harder to execute.





Lenders are focused on negotiating payment schedules with borrowers – particularly in retail and lodging – whose cash flows are falling short of what is needed to service loans. Highlighted in Trepp's recent market commentary and analysis on COVID-19, as of mid-April, more than 20 percent of hotel loans and 10 percent of retail loans in CMBS pools were more than 30 days late, according to the CRE Finance Council, and the extent of the problem is expected to worsen in coming months.

The pandemic has been particularly hard on securitized lenders and debt funds. CMBS spreads widened in the wake of market volatility, which raises the cost of capital for securitization programs and essentially leaves them out of the market.

The Federal Reserve included legacy CMBS in its bond-purchasing program, which helped to stabilize the market for triple-A CMBS, but not enough to jump-start new lending. Debt funds and mortgage REITs have proliferated in recent years, but the sources of their funding – mostly repo facilities and collateralized debt obligations – have dried up so those lenders are now of the market as well.

Bottom line: commercial real estate will not escape the effects of the pandemic, but investors can find opportunities if they remain patient and pick the right spots.

Closing Thoughts

For commercial real estate fund sponsors, COVID-19 has prompted a rethink of both investment strategy and management operations to an extent and with an urgency no-one could have predicted. Now, three months into the crisis, solutions are emerging to address new challenges to fund raising, cash flow and asset acquisition while old questions are being reexamined around operational preparedness and risk mitigation with a new appreciation for potential economic disruptions.

Phoenix American clients are implementing a number of innovative solutions to meet the challenges and pursue the opportunities of the new economic environment. Providing clients a robust and flexible back-office infrastructure, the benefit of our long experience and comprehensive connectivity throughout the industry, Phoenix American facilitates these solutions and helps sponsors navigate the challenges of this critical time.

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