CONFIDENTIAL – Presentation Briefing

Date: May 29, 2020

Re: Real Estate Investment Advisory Council
Second Quarter Presentation: **Debt Capital Markets**
via Zoom

On Thursday May 28th, The Real Estate Investment Advisory Council departed from its usual format to present the 17th Annual Debt Panel, an informative and realistic look at the debt markets today in the midst of COVID.

Longtime moderator and friend of REIAC, Brian Olasov, led our expert panelists through a wide-ranging conversation of the national economy, reaction and recovery from COVID, impact on lending practices, and the changing patterns of real estate, from tenants to investors.

The REIAC audience across the internet was treated to the high-level expertise and experience of:

- **Victor Calanog,** Head of Commercial Real Estate Economics for Moody's Analytics REIS
- **Marc McAndrew,** Executive Vice President of PNC Real Estate
- **David Brickman,** Chief Executive Officer of Freddie Mac
- **Brian Olasov**, Moderator, Adjunct Professor Real Estate Capital Markets, New York University Schack Institute.

The Economy

First question to be answered (to address the obvious) – Yes, we are in a recession, since mid-March.

This recession differs from the 2008 Great Recession in that this downturn was more of a sudden car crash vs. steadily sinking into recession. The economy will contract 1.5x compared to the previous recession.

The 2008 recession lasted six quarters; it is pure speculation how long this one lasts. As opposed to asking, "what inning are we in," the question is "what letter-shape will the recovery be?" A "V" or a dreaded "W" or more likely, a Nike "swoosh."

Also added to the post-COVID lexicon is the word *hysteresis*; meaning, once you remove the problem, you still have the consequences persisting. In the case of the pandemic, a vaccine will eventually eliminate the virus, but what will be left of the economy, given the deep unemployment and broad-based insolvencies?

Thus, high-level conversations of how to deal with the economy are more of an epidemiological discussion than a fiscal or monetary policy cure.

And it is also a behavioral issue. The longer our "norm" is different, the longer our patterns are changed. And over time, new patterns become fixed habits.

For example, whither retail? We are re-opening the economy, but will still have COVID, uncertainty and less spending. Prior to March, ecommerce comprised 11.4% of all retail sales; since then, it has jumped to 16.4%. When COVID ends, does retail revert back to the bricks and mortar, or will ecommerce persist as consumers habituate to the convenience of at-home shopping?

Based on speculative forecasts, retail will suffer the most value loss (after the hotel sector), topping the comparison at 20% drop. The remaining food groups, in declining order of value loss:

Office:	-16.8%
Industrial:	-10.2%
Apartments:	-7.8%

Office is not in the news as much as retail. But what does working from home mean for our future office footprint? Every CEO is asking themselves that right now. Will dense urban areas be the losers? And will suburban office therefore gain at urban's loss?

The Banks

Banks remain the single largest source of commercial real estate financing. So what if you have a new deal to finance right now? The banking community is in various stages of response.

First, many banks are still caught in the "shock and awe" phase, trying to figure out what and where their problems are. Borrowers with new loan requests won't get much attention there.

Then there are the banks that are past that stage, but realize they have no money to lend. So they go dormant for a while. Interestingly, such banks are seeing their real estate portfolios growing nonetheless: existing borrowers are drawing down all their lines of credit to weather the storm, and not paying off any balances. So the portfolio grows larger without anyone doing any work.

Finally, the banks with money are lending only to existing good clients. Even then, the banker will ask the existing client "what other services have you let me provide?" meaning, good clients are ones that also have treasury management, depository accounts and wealth management with the bank as well.

If all those stars line up, then the banker asks himself, "I would lend 65% of value at a 1.25x debt service coverage ratio, but I don't know what 'value' is any more, and who knows how predictable cash flow will be so as to determine 1.25x of that number…"

Of the two variables, though, banks lean into cash flow, which is measured monthly, vs. the elusive 'value' which is, for the time being, just an opinion.

A mounting issue: deferral requests. How do banks sift through the wave of deferral requests? Three quick questions the banker will ask the borrower:

1. How much cash have you taken out of this property over the last two years?
2. Was this loan a cash-out in the first place?
3. What other banking services have we been able to provide to you?

Going through that decision tree leads to about a 50% forbearance granting. But only for 90 days. And a quick 80 days from now, borrowers will be nervous, because the next 90-day deferral request will be very painful.

Are there bargains to be had in a bank's loan portfolio? Not really; it's too early for the "dry powder vultures" to get a good deal, at least at the nation's large banks. It will take several more quarters for those opportunities to materialize, if at all. Maybe at the smaller community banks, but the bigger/better clients found at the large banks can figure out how to fix their problem real estate and handle downturns. We are at least a year away from note sales at big discounts.

Freddie Mac

Multifamily performance has been a bit of a pleasant surprise, but with caution. The government has been putting out so much capital the past two months, that one must ask if this has been a false bottom; what happens in July when all the aid runs out?

Nonetheless, Freddie Mac is a mission-based GSE, with an obligation to provide liquidity to the housing market. Even with no more PPP or a double-dip "W" recession, Freddie Mac will continue to be in the market. Nor is Freddie impacted by geographical issues, i.e., northeastern US vs. the sunbelt, urban vs. suburban.

Home ownership has been on the decline in the US since the Great Recession, but COVID will not necessarily swing that pendulum back to single family. There are too many other factors that favor apartment renting over ownership: downpayment availability (or lack thereof), increasing housing prices, and demographics which point to "phase of life" decisions favoring the flexibility of renting.

It should be further noted that "shock trends" tend not to stick. Recall that 9/11 had office owners fearing that rents for higher-up floors would decrease. A year later, rents for those floors picked up where they left off, and no one thinks twice about being on the 50^{th} floor.

Further, the single-family rental market is skewing the "own vs. rent" measurement. This growing market blurs the line between those who want a complete home and those who want the flexibility of renting.

Telecommuting – It is still undetermined how the recent lockdown will alter "work from home or office" patterns. Freddie notes that in its own operations, it has remained very productive despite its staff sheltered at home. At this point, 50% of its people would like to remain at home, and 50% really miss being in the office. But a vaccine cure may change those preferences.

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:

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