Kidder Mathews

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DISTRESSED CRE ASSETS

AS THE PANDEMIC CONTINUES, DISTRESSED CRE ASSETS EXPECTED TO SURGE

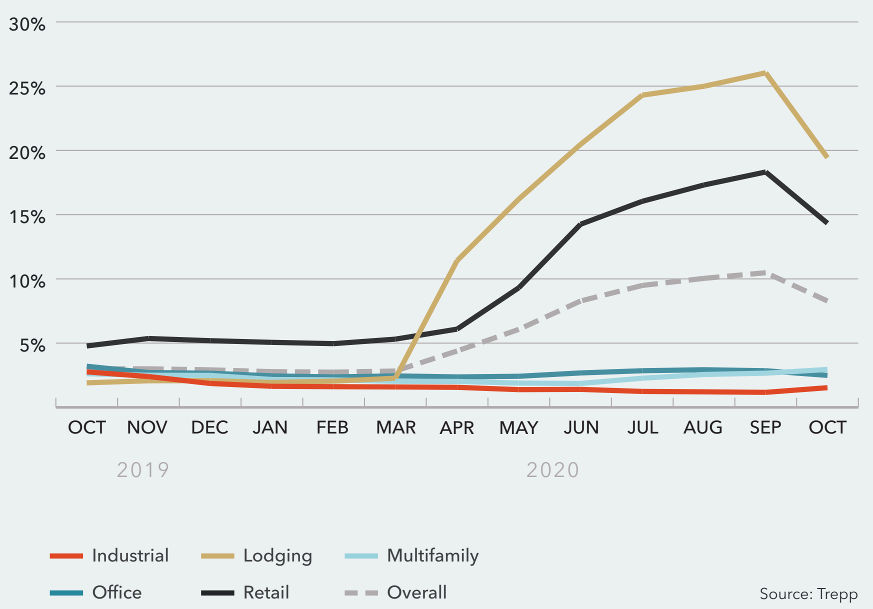
By John Fioramonti, Senior Market Analyst

In the early stages of the COVID-19 pandemic shutdown, there was a lot of optimism that the aggressive action taken by the federal government in the $1.8 trillion CARES Act would help avoid a tsunami of personal and business defaults.

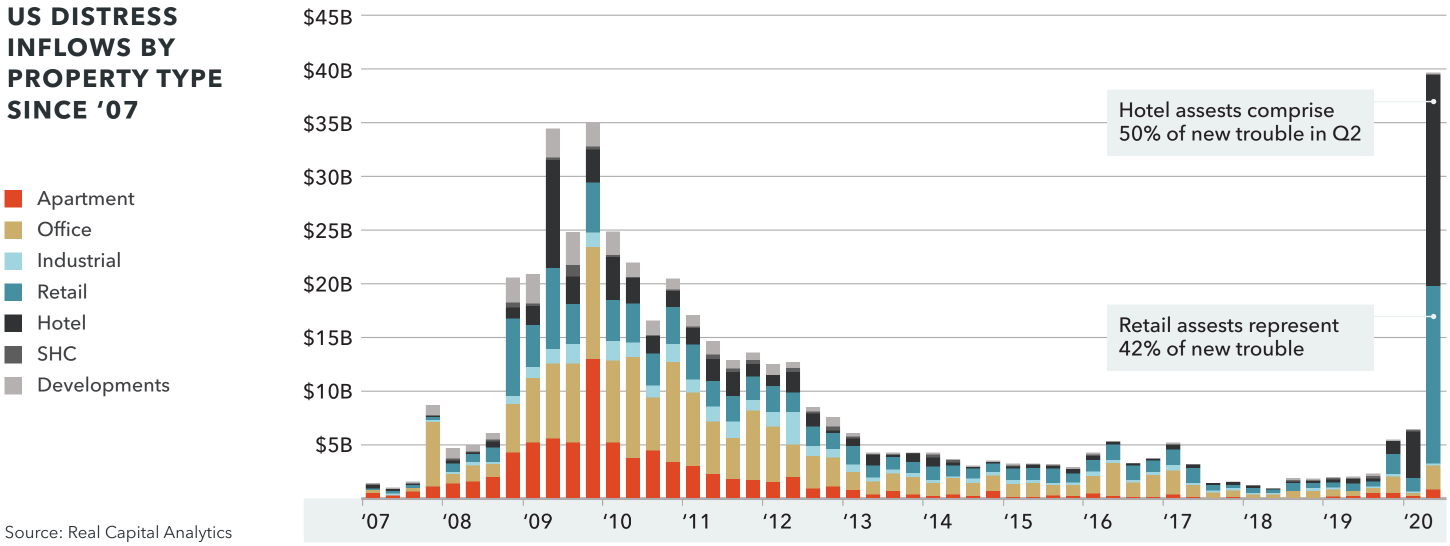
The Small Business Administration was given $350 billion to fund loans to small and medium sized businesses and the Federal Reserve allocated $454 billion for loans, loan guarantees and investment to support eligible businesses, states and municipalities. The hope was that the infusion of capital through the CARES Act would allow businesses to pay their employees and maintain their overhead—including mortgage obligations—for what was anticipated to be a short national shutdown.

But the shutdown was not as short as expected and as the health crisis persists, commercial property owners are running out of options to cope with the rapidly growing income loss. The natural consequence is an increase in distressed assets. The industries most immediately impacted were hospitality and retail and the potential magnitude of the distress in the commercial real estate sector became apparent. In the two months between March and May, the percent of hotel mortgages sent to special servicing jumped from 2.27% to 16.21%. By September, that rate jumped to 26.04%. Retail mortgages sent to special servicing grew from 5.31% in March to 18.32% in September. According to Real Capital Analytics, these two sectors represented 92% of the new troubled assets in the second quarter. According to Trepp, the large drop in the delinquency rates for hotel and retail assets reflected in October's report comes as the result of the high number of forbearances being granted and borrowers being authorized to use reserves to bring debt service payments current. Those actions helped push the overall CMBS delinquency rate down 64 basis points from September to 8.28% in October.

MONTH-OVER-MONTH CMBS SPECIAL SERVICING RATES



US DISTRESS INFLOWS BY PROPERTY TYPE SINCE '07

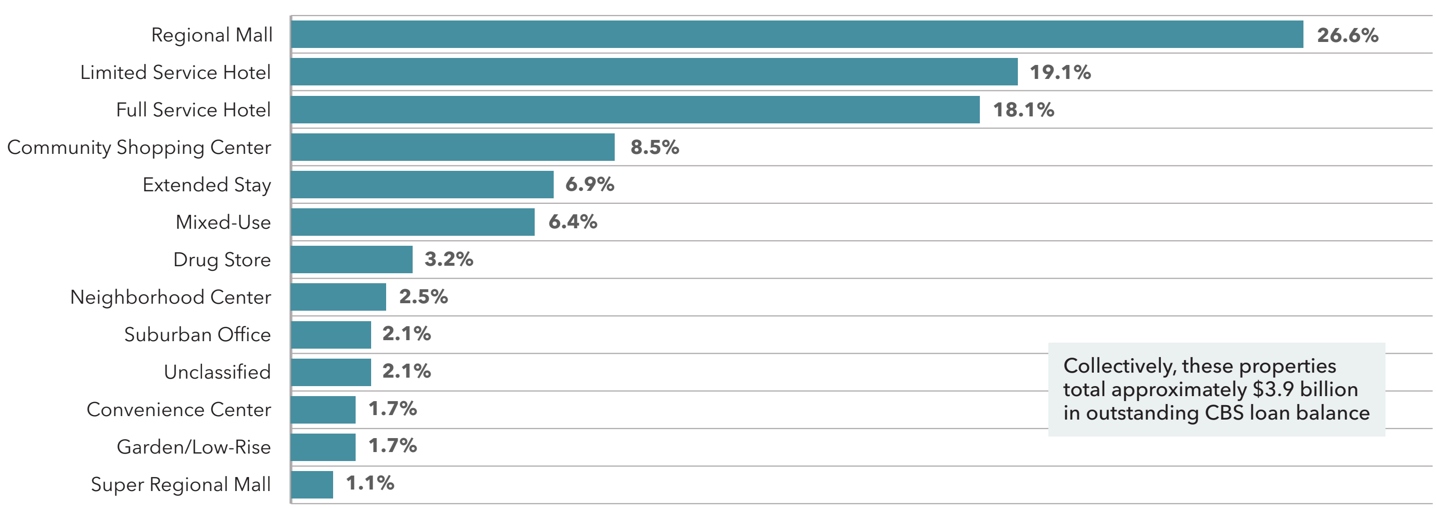


Source: Real Capital Analytics

While distressed assets are now starting to come to market, it is still early in the cycle. The current economic upswing is encouraging many lenders to continue working with borrowers who have the potential to turn the situation around. And through October, the industrial, office and multifamily sectors are not yet showing any significant signs of market distress.

There are differing opinions among real estate investors as to where the distressed asset market will go over the next 12 to 18 months. One school of thought is that this recession is fundamentally different than the Great Recession of 2008 in that the strong market fundamentals that existed before the recession coupled with the current pace of recovery will create fewer distressed properties in most of the asset classes than existed in the 2008-2010 period. Others believe that the sharp economic decline resulting from the nationwide lockdown caused a greater immediate disruption of the commercial real estate market than that experienced in the Great Recession which, over the next year, will drive more properties in more asset classes to distressed sales than was seen in 2008-2010.

PROPERTY SUBTYPES OF BORROWERS WILLING TO TRANSFER COLLATERAL TO LENDERS (AS OF 10.21.20)



Source: Trepp

Distressed CRE Assets

For a perspective from brokers on the front line, we asked brokers in both the Southern California and Phoenix offices of Kidder Mathews Commercial Real Estate who follow the commercial distressed assets market how they see the market developing in the coming months.

"I think we're still in the early stages of sorting out the good and bad deals, (which assets will survive the current environment and which will need fresh sponsorship & capital at a new value basis) but we are seeing the first wave of buying opportunities. We've transacted a handful of real estate sales and loans since April at roughly 30% 'discount pricing' from year-end 2019 underwritten pricing. But generally, there is still a big disconnect between buyers and sellers on valuation which is keeping sales volume low for now." notes Peter Beauchamp, Senior Vice President, Shareholder.

Darren Tappen, Senior Vice President and Managing Director, pointed to the differences between the Great Recession and the current recession. "The Great Recession was caused by a collapse of the housing market, banks and other financial institutions driven by excessive risk taking like the subprime home loan market. It affected all real estate sectors including commercial real estate. The stimulus programs passed (for example, T.A.R.P.) were not specifically targeted for commercial real estate so it took several years for the commercial real estate distressed market to peak. This recession is entirely different. Rather than a financial-related cause, this recession is the result of a public health crisis. And the rapid stimulus response in the CARES Act with provisions specifically targeting commercial real estate has, so far, prevented widespread commercial mortgage delinquencies. I'll be watching the size and sector mix of the market as moratoriums, forbearance agreements and other concessions begin expiring into the first quarter of next year. I do expect we'll see a larger inventory of distressed assets come available for sale at that time."

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"What I find interesting in this cycle is the dichotomy of the current distressed asset inventory," said Nathan Thinnes, Senior Vice President of Investments. "It is very unusual to have two sectors—hotel/lodging and retail—experiencing serious mortgage delinquencies while the other major sectors are performing. I suspect that is explained by the nature of this recession. The lockdown has hit those two sectors the hardest and the longest. As the pandemic drags on and these two asset classes continue on limited use restrictions in most states, the pain in these sectors will grow. Without additional assistance, it is likely that we will see a huge sell-off of these assets next year."

So far, the brunt of the impact from the pandemic has been felt primarily in the hotel/lodging and retail sectors. But uncertainty is the current theme as it is too soon to assess the scope or extent of the distress across all property types as the public health crisis grinds on. What seems certain is that there will be a growing inventory of distressed commercial properties in the near-term with a window of growing opportunities for capital to acquire those properties at discount pricing.

Contact

GARY BARAGONA
Director of Research
415.229.8925
gary.baragona@kidder.com

Written by John Fioramonti
Kidder Mathews Research

KIDDER.COM

Kidder Mathews