Celebrating 20 Years

The Linneman Letter

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The following is an excerpt from the Spring 2021 edition of The Linneman Letter.

Real Estate Capital Markets

So far, we have been right about bank forbearance for both real estate and non-real estate borrowers. As we predicted, the result has been few distressed investment opportunities unless there is negative NOI or a non-bank lender. The primary source of the limited number of distressed sales continues to be non-banks (including CMBS). We anticipate that the Fed will continue to push banks to forbear throughout 2021.

In February 2020, investors wondered when — not if — everything would go back to normal again. They speculated about when people would travel, shop, and return to the office again, and they made real estate valuation assumptions based on those recovery expectations. But even if cash flow expectations for 2023 and thereafter are unchanged versus those held in February 2020, there is a risk that things will never return to normal for some sectors. This is a concern that did not exist in February 2020.

As the Butterfly Recovery continues, it seems prudent for most investors to stay patient. Medical, economic, and social uncertainties remain, though positive vaccine news gives hope for the second half of 2021. Until things settle, large bid-ask spreads will remain, with owners seeking pre-shutdown prices and buyers wanting big discounts. Remember, it is hard to predict a butterfly's trajectory. Recovery will take time, but the real estate industry can find some solace in the fact that real estate is no longer a highly targeted villain in national politics. This is in marked contrast to the 1980s. Today, the national villains are big tech, pharma, and major medical. This suggests that real estate will gain or lose by actions taken by Democrats, but this will not be because real estate was targeted.

Real estate demand generally remains weak except for industrial space. Few leasing decisions are being made, particularly in the office and retail sectors. Leases that are being renewed are primarily 1-2-year extensions with no tenant improvements or leasing commissions. For assets where the risk of non-normal recovery is largely gone (tech, industrial, etc.), values have fully rebounded. In contrast, for office, retail, and hotels (as well as airlines, cruise lines, etc.), values are being dragged down primarily due to much higher discount rates associated with this greater risk. This is in spite of low base interest rates. Only as the near-term weak NOIs are in the rear-view mirror, and people actually shop, travel, and go back to the office will discount rates fall, driving values notably upwards for these lagging property sectors. Until then, expect their values to languish.

Key to real estate acquisition opportunities will be how long and in what ways lenders, particularly banks, will forbear. Short-term loan extensions at near-zero interest rates to challenged borrowers buys time until lenders refuse to give 1-2-year loan extensions at

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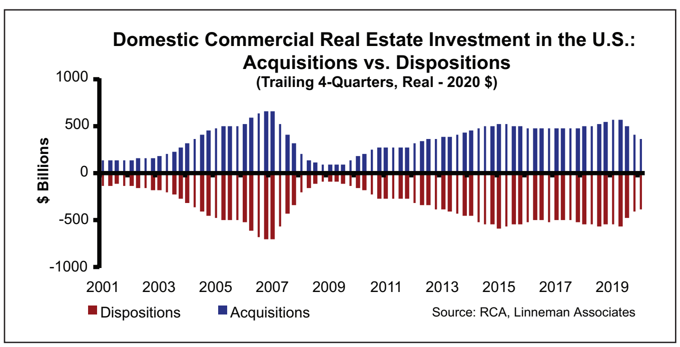
1-2.5% interest rates. Otherwise, there will be few dislocation opportunities. It is too soon to tell, but we suspect that the most promising opportunities in 2021 will be where forbearance is difficult: CMBS loans and negative NOI properties. This is because CMBS loans are not structured for easy forbearance, asking lenders to fund negative NOI is a stretch. This means that lesser quality properties secured by CMBS loans, lots of full-service hotels, weak retail properties and low occupancy office buildings will be in the vanguard of dislocation opportunities.

We may see many bankruptcies occurring among office property owners depending on how long it takes to achieve widespread vaccinations. If it takes five years before it is safe to return to work, the financial survival of office building owners will be challenging. But if it only takes this year, we will see fewer office bankruptcies.

Lender forbearance avoids the needless destruction of valuable companies and households facing liquidity issues. But when practiced for prolonged periods, it reduces growth by keeping capital with those who had it rather than allocating some to new borrowers. This eventually drags down real growth. Similarly, giving free money to the federal government creates negative economic arbitrage, as political spending replaces higher return private spending.

There will be no dramatic upward movement in the economy until around August 2021. The economy will stumble forward as people wait to travel, shop, and return to the office until there is widespread vaccination. At 30 million vaccinations per month, we will reach 200 million vaccinated by the end of July 2021. This will lead to office, hotel, and retail sector rebounds, but until then, these sectors will be stagnant.

After Labor Day, there will be a dramatic return to offices as long as we reach this level of vaccination. People will want to get out of their homes, get a break from their families, and increase work productivity. As that happens, we will embark on a three-year recovery window. Demand will go beyond normal, as tenants need to retrofit spaces that were too tight for both productivity and health. Rents will show improvement in the first half of 2022 and will really pick up steam in the second half. By 2023-2025, cash flows will be close to what people expected in 2019.



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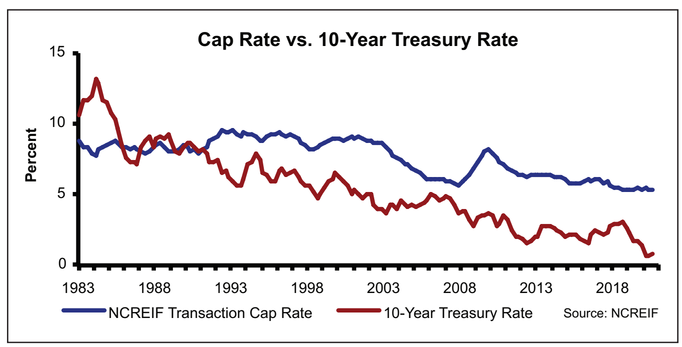

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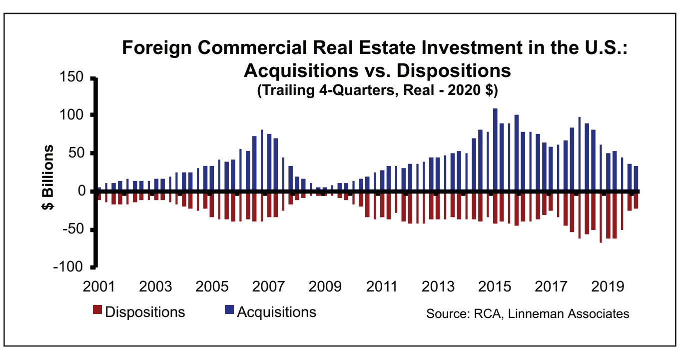

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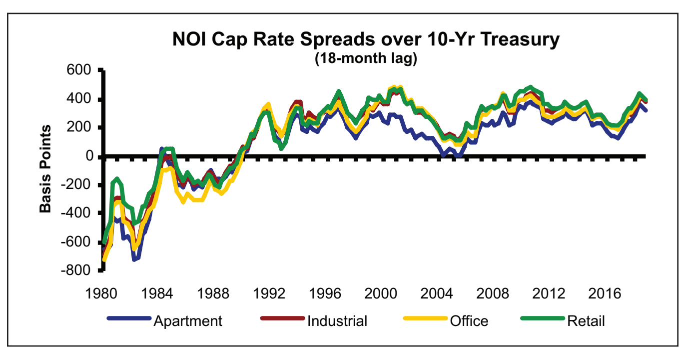

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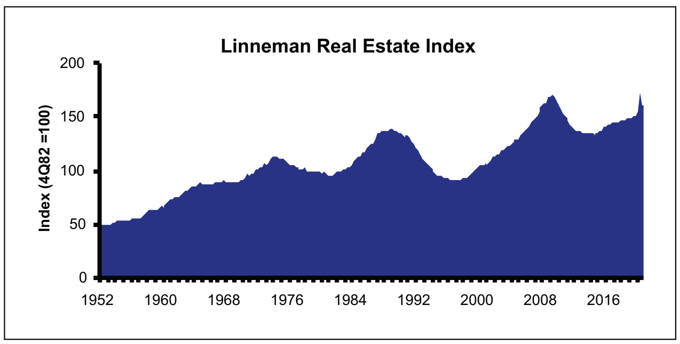
Because of the large excess reserves of money center banks, QE Infinity, and the record-high $324 billion in global real estate private equity dry powder, we expect cap rates to revert to pre-COVID levels by mid-2022. REIT valuations are an exercise in discounted cash flows. They fell as we witnessed the dissolution of near-term cash flow expectations and increased levels of risk, raising discount rates. Investors do not have nearly as much confidence in their future cash flow estimates as when people went to the office daily. If people start to come back to offices in late 2021 and early 2022, investors will become more confident in their cash stream projections and values will rebound rapidly.



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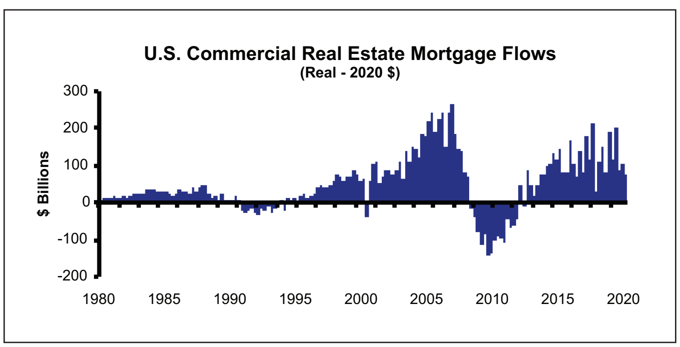
According to Preqin, 283 real estate private equity funds raised $118 billion globally in 2020, down from $179 billion raised by 494 funds in 2019. Preqin reports that global private equity real estate volume in 2020 covered 5,979 transactions valued at $222 billion. This compares to 9,848 sale transactions valued at $444 billion in 2019. Private real estate sales will be weak in early 2021 as bank forbearance prevails, and low rates discourage sales due to prepayment penalties.

Real commercial real estate mortgage debt outstanding increased by 4% year-over-year through the fourth quarter of 2020, to $3.1 trillion. CMBS issuance was a net positive source of real estate capital, while life companies and government-sponsored entities (GSEs) continued lending. New lending is limited as lenders focus on forbearance, workouts, and restructurings. CMBS loans, for which forbearance is difficult, will be the main source of forced sales in 2021.

The Linneman Real Estate Index (LREI) monitors the supply of real estate capital, as proxied by the aggregate flow of commercial real estate debt (the nu-



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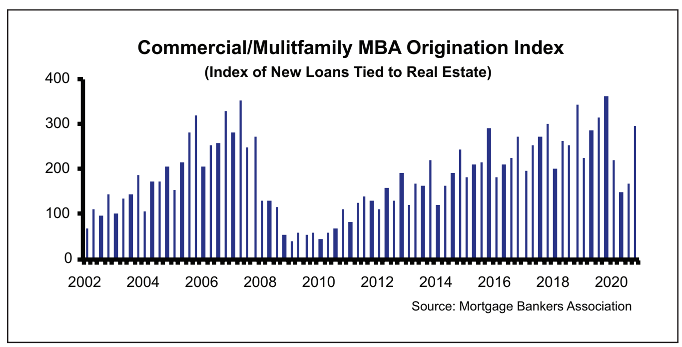

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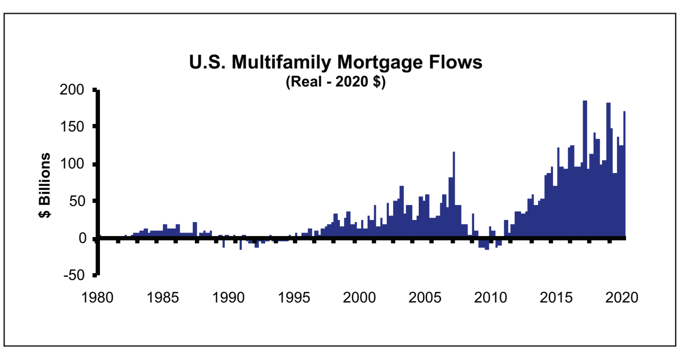

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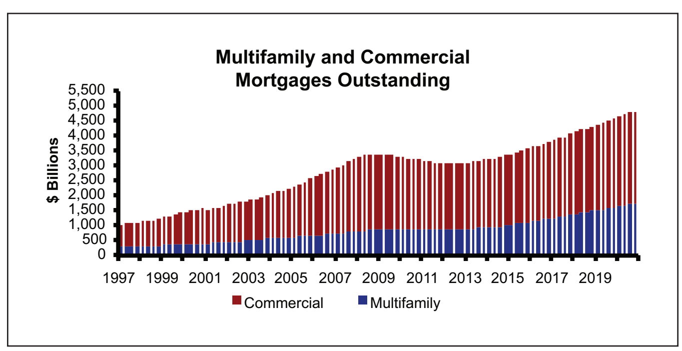

figure 9

merator), with the fundamental demand for space, as measured by nominal GDP (the denominator). Excluding net real estate equity flows from the numerator modestly understates capital oversupply situations and overstates an undersupplied market. The LREI captures whether debt for commercial real estate is growing more quickly or slowly than the economy. When the index is rising, mortgage debt available for commercial real estate is rising more rapidly than the economy, and when it is declining, money is tight relative to economic growth. The index is set to 100 in the base year of 1982.

We remind readers that our research indicates that this metric is the key determinant of cap rates. See our article in the Fall 2020 issue co-authored with Matt Larriva of FCP entitled, "If Interest Rates Determine Cap Rates, Where Is the Evidence?" This research shows that a 100-bp increase in the LREI results in a 22-bp and 65-bp decline in multifamily and office cap rates, respectively.

The LREI proxies the availability of capital to an inherently capital-intensive asset class. The LREI peaked at 170 in 2009 and bottomed at 134 in 2014 (a 21% decline) as the Financial Crisis drove substantial deleveraging of commercial real estate. Because banks subsequently resumed lending, the index had risen to 155 through the first quarter of 2020. Due to the extreme contraction in GDP during the shutdown, the LREI shot up to 173 in the second quarter but reverted to 162 in the third and fourth quarters of 2020 as restrictions were loosened. As a result, the LREI increased 6.7% year-to-date through the fourth quarter of 2020. That means there is, as the Fed intended, lots of liquidity. This is in marked contrast to previous downturns. It is noteworthy that the LREI was up only 2.1% in 2016, 1.4% in 2017, 0.9% in 2018, and 2.4% in 2019, indicating remarkable lender discipline prior to the shutdown depression. This was a rare condition at the end of a strong recovery period and was due to both heightened regulatory scrutiny of banks and high construction costs limiting development. This discipline now provides lenders far more leeway for forbearance and restructuring.

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For nearly four decades, he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, now in its fifth edition. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.

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