

A Post-Pandemic World: Getting from Here to There

By Jamie Woodwell

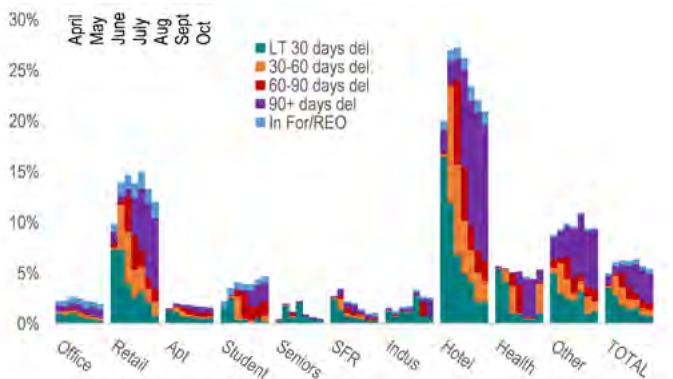
When the Covid-19 pandemic hit the United States in March, it raised two fundamental questions for owners, lenders and others involved in commercial real estate: a) How would properties get through the pandemic and recession and b) What would the "new normal" be for the sector post-pandemic? One thing became crystal clear early on - the answers to those two questions would vary dramatically by property type.

Getting Through the Pandemic

Within a month of the pandemic's onset, two property types - hotel and retail - became ground zero for Covid-related distress. Our collective vacation from vacations (and business travel) meant that hotel occupancy plummeted, particularly at leisure and conference-related destinations. At the same time, various state and local shutdowns closed retail stores across the country. According to the National Council of Real Estate Investment Fiduciaries, net operating income at retail properties owned by institutional investors fell by one-third between the second quarter of 2020 and the year before.

The strain flowed immediately, and directly, through to mortgages backed by lodging and retail properties. By April 20, 20 percent of the balance of hotel-property loans was delinquent, with 16.5 percent - more than three-quarters of the total - newly delinquent that month. Among retail loans, 9.8 percent was delinquent, with 7.3 percent newly delinquent.

Delinquency Status, by Property Type, Share of Total Unpaid Principal Balance (April-October 2020)

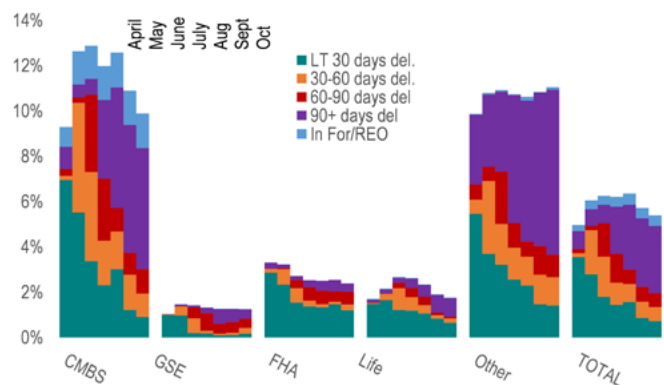


Source: Mortgage Bankers Association

Other property types remained far more stable, particularly given the distress in the labor market and other parts of the economy. By June, "just" 2.7 percent of office property loan balances were reported as non-current, as were 1.9 percent of multifamily balances and 1.7 percent of industrial. Some of that stability had to do with lease structures, with office-lease expirations often spread out over a decade. Some also came from the extraordinary government support provided by expanded unemployment insurance, federal stimulus checks and more. That helped households through a period when the unemployment rate broke 14 percent.

The varied stress by property type meant varied stress by capital source, as well. The share of mortgage balances that were not current in the CMBS market, which relies more on hotel and retail loans than do other capital sources, increased to 12.9 percent in June. That compares to just 1.4 percent of the balance of Fannie Mae and Freddie Mac multifamily loans, 2.7 percent of multifamily and health care loans guaranteed by the Federal Housing Administration and 2.7 percent of life insurance company commercial loans.

Delinquency Status, by Capital Source, Share of Total Unpaid Principal Balance (April-October 2020)

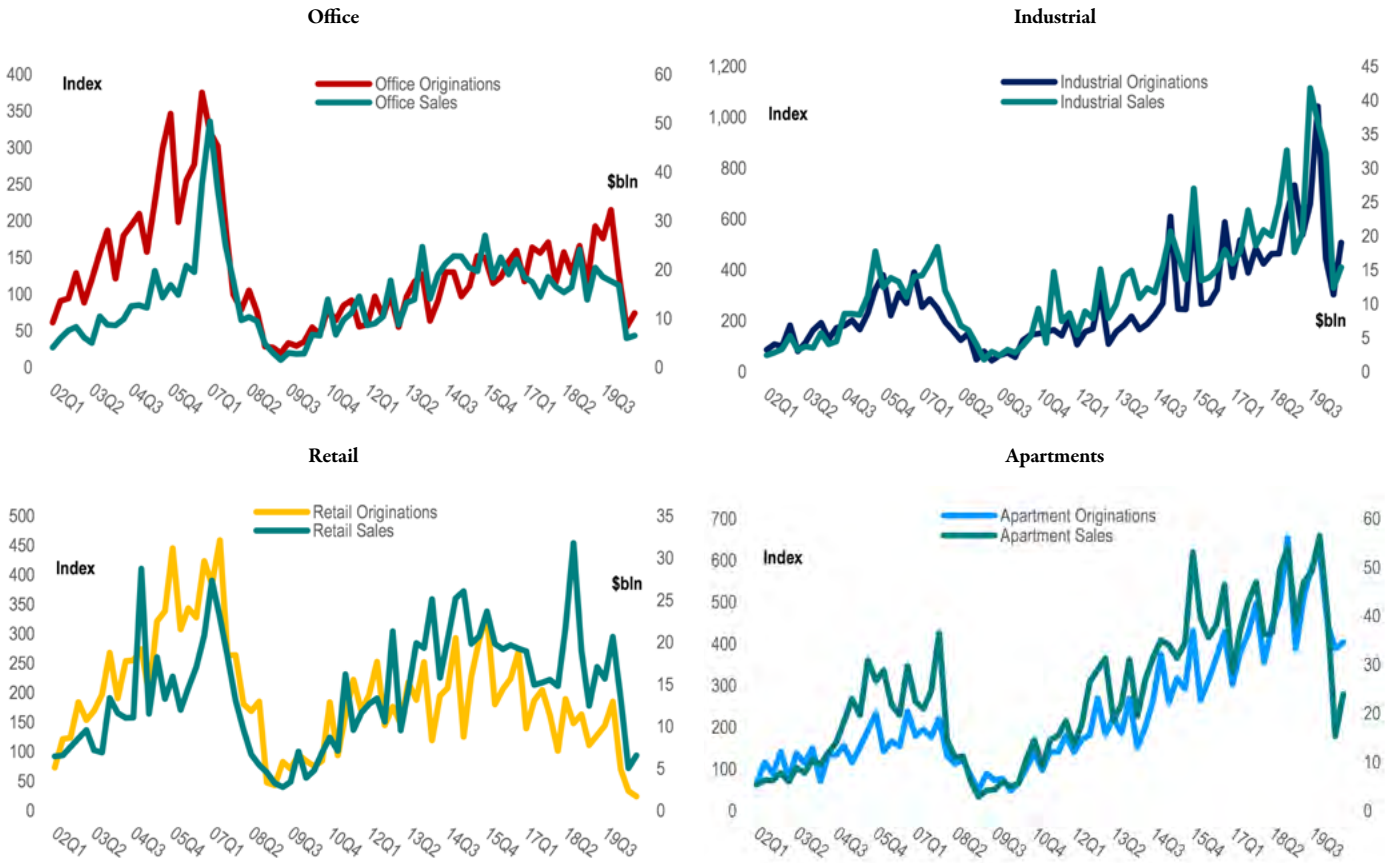


Source: Mortgage Bankers Association

The general market uncertainty and instability led to a dramatic fall off in property sales activity, mortgage borrowing and lending. According to Real Capital Analytics, property sales in the second quarter of 2020 were 65 percent lower than a year earlier. They also were 57 percent lower in the third quarter. The drop was seen across property types.

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Year-Over-Year Changes in Property Incomes (NOI) and Unemployment Rates



Source: Mortgage Bankers Association

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Borrowing and lending experienced similar declines, with one exception.

Given extremely low rates, relative stability in the apartment markets, and the availability of government-backed loans from Fannie Mae, Freddie Mac and FHA, multifamily lending held up far better - driven by refinancings.

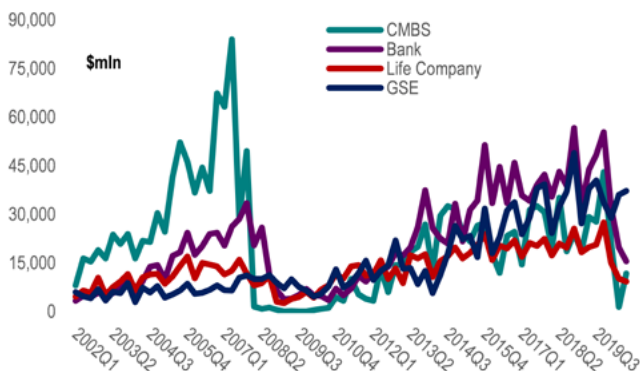
Through the third quarter of last year, commercial and multifamily mortgage originations were 35 percent lower than a year earlier. But multifamily originations were down only 17 percent, with lending by the government-sponsored enterprises down only 3 percent. FHA origination volumes,

meanwhile, were almost 1.5 times greater than in 2019.

Unlike during the Global Financial Crisis (GFC), when rising capitalization rates contributed to commercial property value declines of 30 percent to 40 percent, cap rates and property values so far appear to be more stable than underlying pandemic-driven cash flows.

There is still a great deal of uncertainty ahead, but a slate of vaccines now look to bring health and economic relief sometime in mid- 2021. With that knowledge, it is becoming clearer what it will take for individual properties to get through the pandemic, giving many owners' incentive to feed their properties and work with their lenders and servicers. A key exception are properties whose prospects have changed for the worse in light of the post-pandemic "new normal."

Estimated MBA Commercial/Multifamily Mortgage Originations



Source: Mortgage Bankers Association

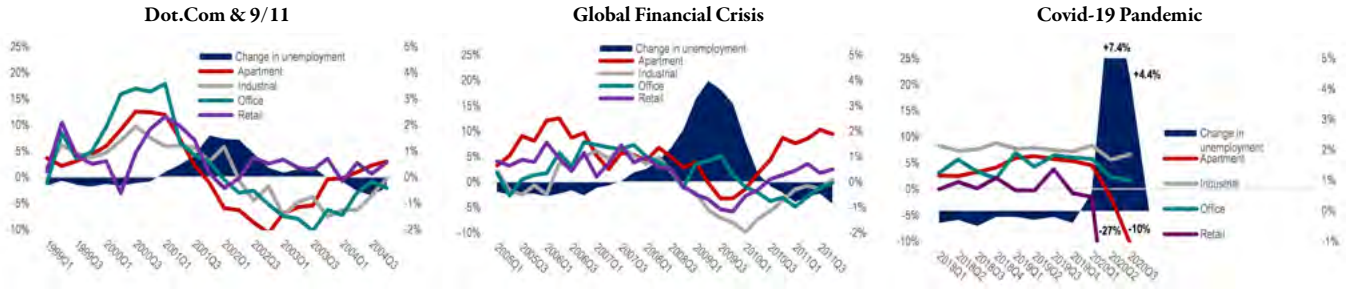
The Post-Pandemic "New Normal"

Every economic downturn is different. And those differences mean that commercial real estate works through each recession in varying ways. The dot-com recession of 2001 affected apartment and office property cash flows much more than the GFC did. But the spread between property cap rates and the 10-year Treasury grew during the GFC, pressuring property values far more during that period than during the 2001 downturn.

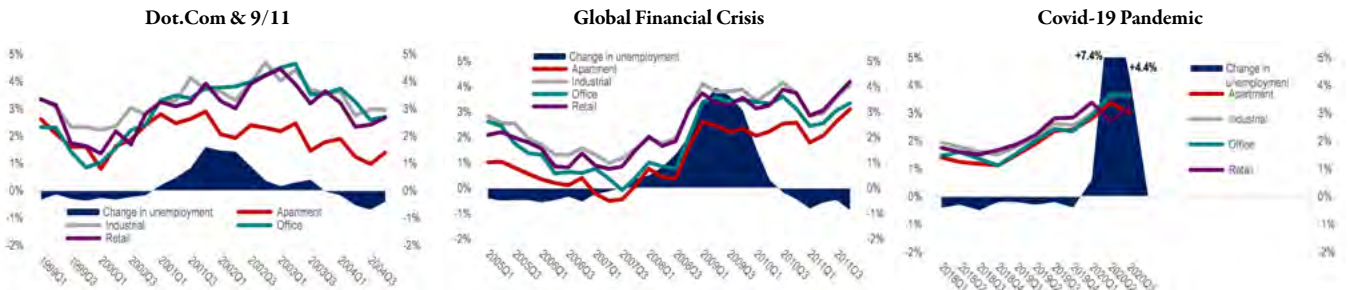
This pandemic-recession is equally unique. A key question facing the commercial real estate industry is which impacts

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Year-Over-Year Changes in Property Incomes (NOI) and Unemployment Rates



Cap Rate Spreads and Year-Over-Year Changes in Unemployment Rates



Source: Mortgage Bankers Association

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will be fleeting, and which will be more long-lasting. In discussions about the pandemic and its effects on commercial and multifamily properties, investors and lenders generally put properties into four groups:

Counter-cyclical: property types that are benefitting from the pandemic and our collective economic and social responses to it. Examples include industrial, self-storage and single-family rentals.

Accelerated Change: property types that were facing changing conditions prior to the pandemic, and have seen the onset of those changes accelerated. Examples include retail - malls, in particular - and suburban apartments.

Fundamental Change: property types for which the pandemic has changed the basic relationship with the use of space. Examples include offices, both from a potential increase in work-from-home and a change in the type of space needed.

Speedbumps: property types that were "chugging along" before the pandemic hit and may be negatively impacted during the downturn, but that are expected to return roughly to normal after the crisis has passed. Examples include the apartment and hotel sectors.

These are, of course, generalizations, with individual properties defying the norm and some property types, and subtypes, falling into different or more than one category. For example, there was a move to "experiential retail" prior to the pandemic that has been, perhaps temporarily,

reversed. But the categories are also at the heart of how investors and lenders are thinking about putting money into properties despite continued uncertainty. As with many elements of commercial real estate, cash flows and cap rates - as discussed earlier - may be the keys.

Outlook

The effectiveness of vaccines that now are being produced would seem to indicate that by this summer, a large share of Americans will have been vaccinated against Covid-19, allowing a more widespread re-opening of the economy. That would be a welcoming reprieve for some of the hardest hit sectors of the economy and for the commercial real estate industry, in particular the retail, leisure and hospitality sectors. But there is still a great deal of uncertainty ahead, and a difficult period between "here" and "there." In the short-term, the expectation is for continued challenges for some, and opportunities for others, before we get to our new post-pandemic normal. ■

Jamie Woodwell is a vice president in the research and economics group at the Mortgage Bankers Association.