MILLER CANFIELD

Summary of Information from the 2019 Commercial Real Estate Finance Council Winter Conference

Miller Canfield participated in the Commercial Real Estate Finance Council (CREFC) Winter Conference in Miami in January 2019.[i] The conference offers a candid insider's view that looks both backward and forward and has proven to be reliable in its assessments and projections.

Our summary of conference highlights includes insights gleaned from nearly three days of extensive meetings, discussions and presentations, and is certainly not exhaustive. The entire conference presents the views and experience of CRE industry executives – including lenders from all sectors, banking, life companies, investments bankers, GSEs, private equity and debt funds, REITs, servicers, rating agencies, consultants, law firms, accounting firms and national brokerage organizations. We encourage you to contact us to discuss any matter in greater detail.

Overall – Cautious, Guarded Optimism

As at last year's conference, there were differences of opinion as to the direction of CRE fundamentals in the coming year. Nonetheless, the general consensus was as follows:

(i) The U.S. economy should be stable, with some deflationary pressures, while the global economy will be declining.

(ii) The U.S. CRE property market will be relatively stable but with downward pressure on values.

(iii) Short-term interest rates, the move away from LIBOR and regulatory and legislative changes are generally anticipated to have modest potential impact in the year ahead. In the longer term, interest rates and most cap rates (including multifamily, office and retail, but perhaps not industrial) are projected to rise, although most believe that the Fed will somewhat moderate its pace of interest rates increases.

(iv) According to Crittenden, "experienced, well-capitalized borrowers will be key. As interest rates creep up, equity requirements will also increase. Borrowers will see 60% to 70% loan-to-cost. Lower leverage floating rate loans will see the best pricing, starting around Libor-plus 200 bps. Debt fund and private money lenders will provide the highest leverage and non-recourse money, but with higher pricing. There may develop some renewed bank interest, as loans they made three to four years ago start to get paid off."

(v) CRE finance volumes will hover between stable and slightly growing, but not equally across products, providers and geographies. Selective secondary and tertiary markets will continue to attract debt capital, some carefully and some not, in a search for yield. Primary markets are evidencing some property price leveling, and in some instances reductions, from all-time highs, but continue to absorb competitively priced and structured high dollar loans.

(vi) Fannie Mae/Freddie Mac multifamily lending in 2018 was at an all-time high, particularly for Freddie, and more likely than not some growth is expected there, particularly with expanding market offerings.

(vii) Somewhat more growth than declines in originations is expected for bank and life and pension companies, although most indicate that increases will be marginal on the whole. The greatest growth is expected from alternative lenders (such as mortgage REITs and debt funds), particularly in connection with transitional properties and warehouse lending.

(viii) In short, while we remain in the late stages of this market, we seem to be holding in place for the moment, with a decline in the rate of growth.

(ix) A continuing excess of capital liquidity in the markets will also continue to chase muted-to-lower yield. Treasuries continue to be a losing investment, so risk becomes a necessary pricing factor, placing competitive pressures on maintaining spreads, cap rates, LTVs, debt service coverage and loan structure at prudent levels in certain segments.

(x) This competition, the memory of the recent past, and bank regulation have had a particular impact upon lenders - including many larger regional and national banks as well as life companies - who have become and remain more cautious and disciplined in their allocations, targets and underwriting. Indeed, while the banks have never been better capitalized against the risks of a recession; have in hand more meaningful information regarding their loans and borrowers; and continue to perform a great deal of portfolio stress testing, 8-10 of the largest banks were flat-to-down in the last year's CRE lending. Most larger banks have been cleaning out riskier loans and improving the quality of their remaining CRE portfolios. However, the related risk didn't just disappear. Instead, it was simply transferred to other market participants who have taken on those loans and assets.

(xi) Other lenders, however, have loosened standards. There is a decided movement to interest-only terms (around 80% of Q4 2018 CMBS collateral pools) and other liberalized loan structuring, and "covenant light" lending. Indeed, many new entrants, particularly in the private equity space, appear to "price loans to perfection," with little margin for error. As always, a few (including some banks, particularly at the local level) seem to simply shape their lending to what the customer demands.

(xii) For the most part, though, risk tolerance remains moderate, with guarded, cautious optimism prevailing, and prudence and safety at least espoused. However, it was noted that while everyone is working harder for less, "caution never produced a bonus…"

(xiii) Traditional balance sheet lenders continue to move away from construction loans and toward short-term bridge loans on existing transitional assets in place. For many, the construction space has largely been conceded to other capital market players. However, the historic exits through life company or equity takeout are far in the past. Today's exits are more tenuous, market-sensitive and potentially more like postponement, such as bridge-to-bridge. Is this perhaps "stupid money"?

(xiv) While we haven't yet returned to excessive pro-forma underwriting, there is a growing segment of the capital market that is financing a business plan more than the fundamental underlying

real estate asset, despite the fact that the cost of their own capital has become more expensive, their returns more modest and the margin for error much reduced.

(xv) Many smaller regional banks, which in the past provided short-term debt, were forced to close or were absorbed by larger banks following the 2008 financial crisis. Those banks that survived the recession rarely provide short-term financing in the current market due to a combination of caution and more restrictive regulations. This has created a gap in the credit markets for short-term bridge financing, and an opportunity for debt funds, particularly those providing leveraged transitional, bridge, bridge-to-bridge, warehouse lending, and CLO/CMO[ii] financing.

(xvi) Indeed, there is far too much sovereign and private equity capital in the market, particularly of late in these leveraged transitional, bridge, bridge-to-bridge, warehouse lending, and CLO/CMO segments. Given the opportunistic investment perspective of these lending capital sources, a significant downturn will likely dry them up as sources of market liquidity. While we don't appear to have a market credit challenge at the moment, the creeping lack of discipline in this space and its potential knock-on dynamic could drive a significant market liquidity crisis that in turn quickly gives rise to a market credit crisis. This is most likely to first occur in these targeted segments, where sponsor and lender quality, liquidity, patience and strategic depth are crucial to the persistence of the market and the survival of the underlying CRE assets. In that event, where is the exit? Where does the take-out come from? How can a workout proceed in a manner that lets both lender and borrower protect their investments?

(xvii) Interestingly, the corporate debt space has more to worry about than CRE, based on the former's comparatively higher (and increasing) leverage and movement to covenant-light facilities. Some concern was expressed regarding the potential for risks in those markets bleeding over to the CRE space.[iii]

(xviii) Existing regulation, proposed modifications (including adoption of CECL accounting[iv], proposed changes to HMDA[v] and the issuance of final rules for HVCRE loans[vi]), will not overwhelm the space. However, there will be a greater focus on the so-far unregulated private capital space, from which risk is perceived to be gathering.

(xix) Absent significant economic disruption, there is an expectation that loan defaults will remain relatively subdued in 2019.

(xx) There will be another recession. Neither soon nor too far distant. However, it shouldn't be as severe as the last, given the much greater dispersion of the inherent risk among market participants.

Wild cards affecting downward pressure and expectations are driven by the usual suspects: (i) an anticipated slowdown in the broader domestic and global economies; (ii) volatile equity markets; (iii) high CRE property valuations and localized overbuilding; (iv) over-dependence on a cautious but less predictable Fed for banking liquidity, and an expectation of rising interest rates over the long term; (v) CRE finance's continued blind spot (at its core a 10-year business with a 5-year memory); (vi) excessive lending competition, particularly from new entrant sources, including too many private equity and debt funds that target transitional assets; (vii) Brexit knock-on effects; and (viii) instability regarding, and difficulty in anticipating, the Trump administration, particularly in connection with trade wars and pending investigations. All that being said, another year of much the same is generally and favorably, though somewhat tempered and nervously, anticipated.

CRE Property Type Expectations

- **Multifamily** – Although it is late in the economic cycle, the outlook remains very good for the multifamily sector. Underlying this projection are the following expectations: (i) a greater market balance resulting from a fall in construction starts vs. completions; (ii) increased net absorption driven by continuing favorable cyclical and secular trends (i.e., delayed marriage and child-bearing and a preference for renting to maintain financial flexibility and mobility); (iii) modest increases in both rent growth and vacancies; (iv) continued high levels of investment and debt capital; and (v) increasing demand for workforce housing.

- **Office** – Office demand remains somewhat uneven, depending on markets, with tertiary markets lagging. Office employment is anticipated to continue to grow, albeit at a slower rate. Construction levels remain below previous high cycles, permitting a better balance in market supply, which is nevertheless high. Tenants continue to downsize their footprint through flexible space, and seek lease structures adaptable to changes in the economy and their needs.

- **Retail** – Despite a positive holiday season for many retailers, retail properties continue to be a challenge for many owners and a less desirable lending alternative. Malls continue to be avoided in the main, unless they have a demonstrated social purpose beyond mere retail and do so in a demographically integrated location. Department store space continues to be a challenge, particularly for repositioning of shuttered space. Landlords with good demographics and both available space and capital will increase significant redevelopment and re-tenanting activity. However, the “Amazon effect” is very much in play at all levels, and yet to be resolved. Major retail bankruptcies continue to roil the market.

- **Industrial** – CBRE projected that this sector will continue to evolve in 2019 given the integration of logistics and retail. Major markets with large population centers and complex supply chains will continue to capture much of the logistics demand. However, significant growth prospects are also evident in secondary markets with strong demographic shifts. Owner/occupier demand is expected to remain strong in 2019, although a lack of available logistics space will challenge expansion or relocation plans. Consequently, absorption gains may soften while average asking rents rise.

- **Hotel** – As observed by S&P, the nearly decade-long upswing in the otherwise volatile lodging industry is anticipated to moderate, driven by demand from corporate, group and leisure travelers as discretionary income and corporate spending have risen. Supply has accelerated, though somewhat constrained. Both RevPAR[vii] and ADR[viii] growth have slowed, while wages (which can command about 40% or more of hotel revenue) and operating expenses have increased and are expected to outpace revenue increases in 2019, stressing already low hotel net cash flow margins. Hotel properties are also subject to both industry-wide and local market factors. Moreover, at virtually all levels, rising quality expectations and brand requirements require greater ongoing periodic capital investment for property improvements and soft goods replacements in order to maintain competitive positioning, even the “flag.” These all weigh on a waning appetite for hotel lending, although lodging underwriting appears to have become somewhat more aggressive of late.

- **New Products** – A decided interest has been developed by some in certain markets for so-called co-working or co-living space properties. WeWork (now rebranded as The We Company), based in New York, is the most significant player in this product. It currently has a $45 billion market cap based on

SoftBank's November 2018 equity commitment. WeWork designs and builds both physical and virtual shared workspaces for "technology startup subculture communities," and provides related services for entrepreneurs, freelancers, startups, small businesses and large enterprises alike. It is currently the largest tenant in NYC with over 10 million sq. ft. under management there, plus offices in 77 other cities in 23 countries. In the WeWork business model, it is the master space tenant, from which it operates spaces and provides related services for it's over 100,000 "members." Co-living spaces are similarly operated, in a sense reimagining communal living in cities where residents share interests, intentions or values based on community and convenience – in some iterations not unlike the comprehensive senior living centers for retirees, but for younger cohorts. However, most lenders continue to have a wait-and-see approach to both products – more curiosity than investment at this moment.

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[i] We have also added occasional color from other sources contemporaneous with this conference, including from the Mortgage Bankers Association's 2019 Commercial Real Estate Finance Outlook Survey, Crittenden's daily reports from the conference, CBRE's 2019 U.S. Real Estate Market Outlook and Standard & Poor's industry reports, among others.

[ii] Collateralized Loan Obligations (CLOs) are structured financing market investment vehicles that combine diverse pools of generally senior secured loans made to businesses that are rated below investment grade. Collateralized Mortgage Obligations (CMOs) are similar vehicles, although comprised of mortgage loans. They have more recently proliferated, in a relative sense, in the leveraged transitional CRE markets, and have attracted capital from multiple sources seeking the more leveraged yields provided by the generally more risky underlying assets.

[iii] Indeed, one major national law firm noted that they are adding material headcount in their corporate debt workout group in anticipation of increased demand for those services.

[iv] Current Expected Credit Loss (CECL) is a new FASB accounting standard that changes how financial institutions account for expected credit losses and related reserves, applied from the moment of loan origination. CREFC has been engaged in discussions with regulators to avoid double counting (both reserves and anticipated losses) that would penalize otherwise compliant institutions.

[v] The Home Mortgage Disclosure Act (HMDA) requires extensive publishing of loan data reporting for residential loan applications, originations and loan purchases, administered by the Consumer Financial Protection Bureau (CFPB). A final CFPB rule, effective in 2018, mandates this reporting for both single and multifamily properties, provided that with respect to multifamily loans, an institution has made at least 25 such loans in each of the prior two years. CREFC and other industry representatives assert that the required reporting, however, does not fit multifamily properties, nor does that property segment logically fall within the HMDA reporting goals, that it is unduly burdensome, and continues to seek an exemption for business-to-business multifamily mortgage loans.

[vi] High Volatility Commercial Real Estate (HVCRE) loans are all credit facilities used for the acquisition, development and/or construction (ADC) of real property prior to its conversion to permanent financing, unless they fall into an exempt category. Under Dodd Frank and its regulations, a bank must reserve more capital when a loan is characterized as HVCRE, and thus of greater risk. For instance, as a general rule, most corporate loans carry a risk weight of 100%, while HVCRE loans carry a risk weight of 150%. Thus, a bank must reserve $6 million in capital to make a $50 million HVCRE loan, rather than $4 million if that loan were a typical CRE loan. The final rule is expected this year and is not expected to provide relief.

[vii] Revenue per available room.

[viii] Average daily rate.