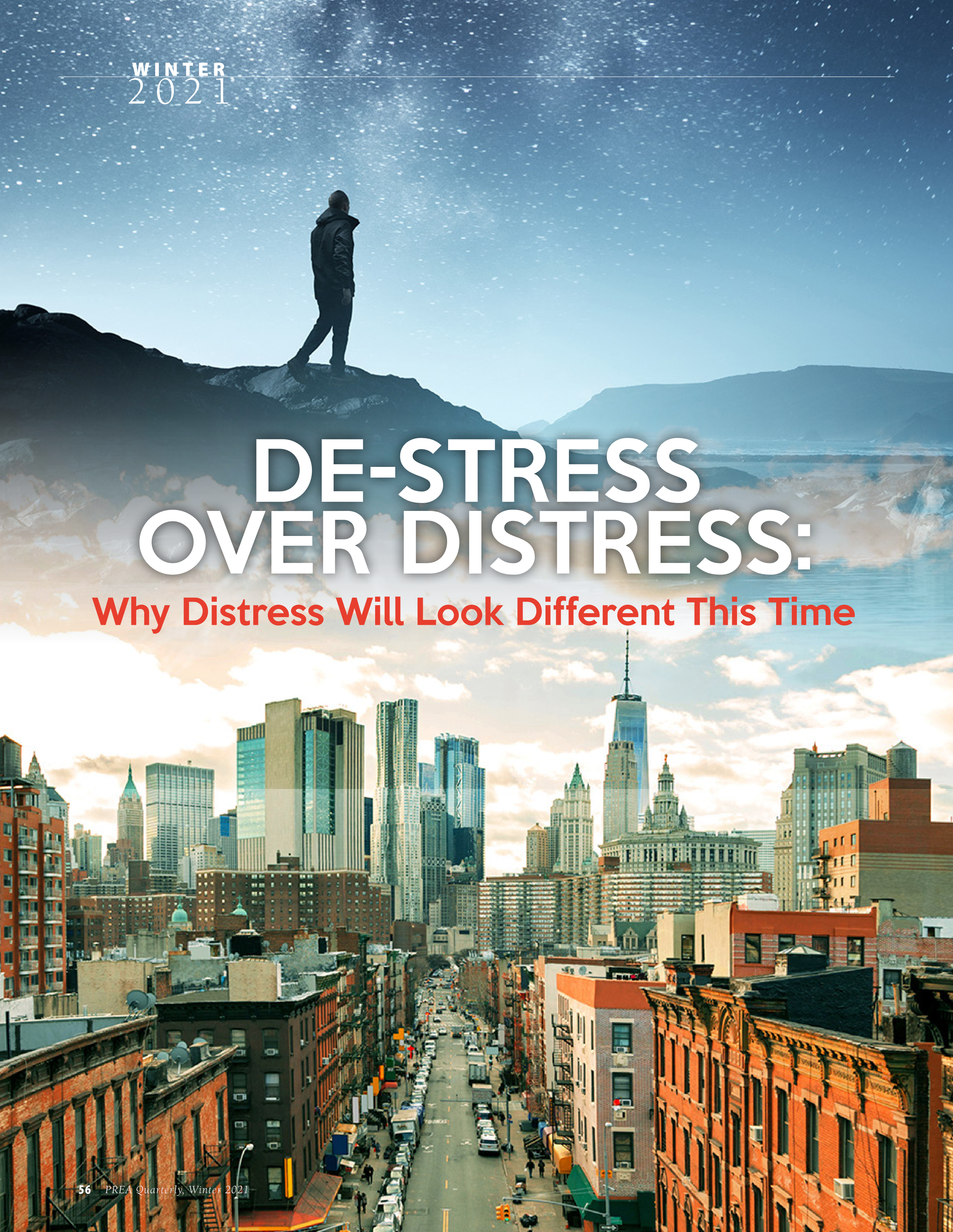
WINTER 2021

DE-STRESS OVER DISTRESS:

Why Distress Will Look Different This Time



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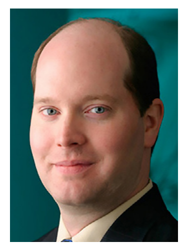

Jon Southard
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Investors who successfully scooped up discounted properties following the 2008–2009 or early-1990s recessions are once again raising capital in hopes of repeating those efforts and riding the recovery to opportunistic returns. While it is not surprising that many such investors would look to a similar playbook, this downturn and the ensuing recovery may not play out the same way previous ones did.

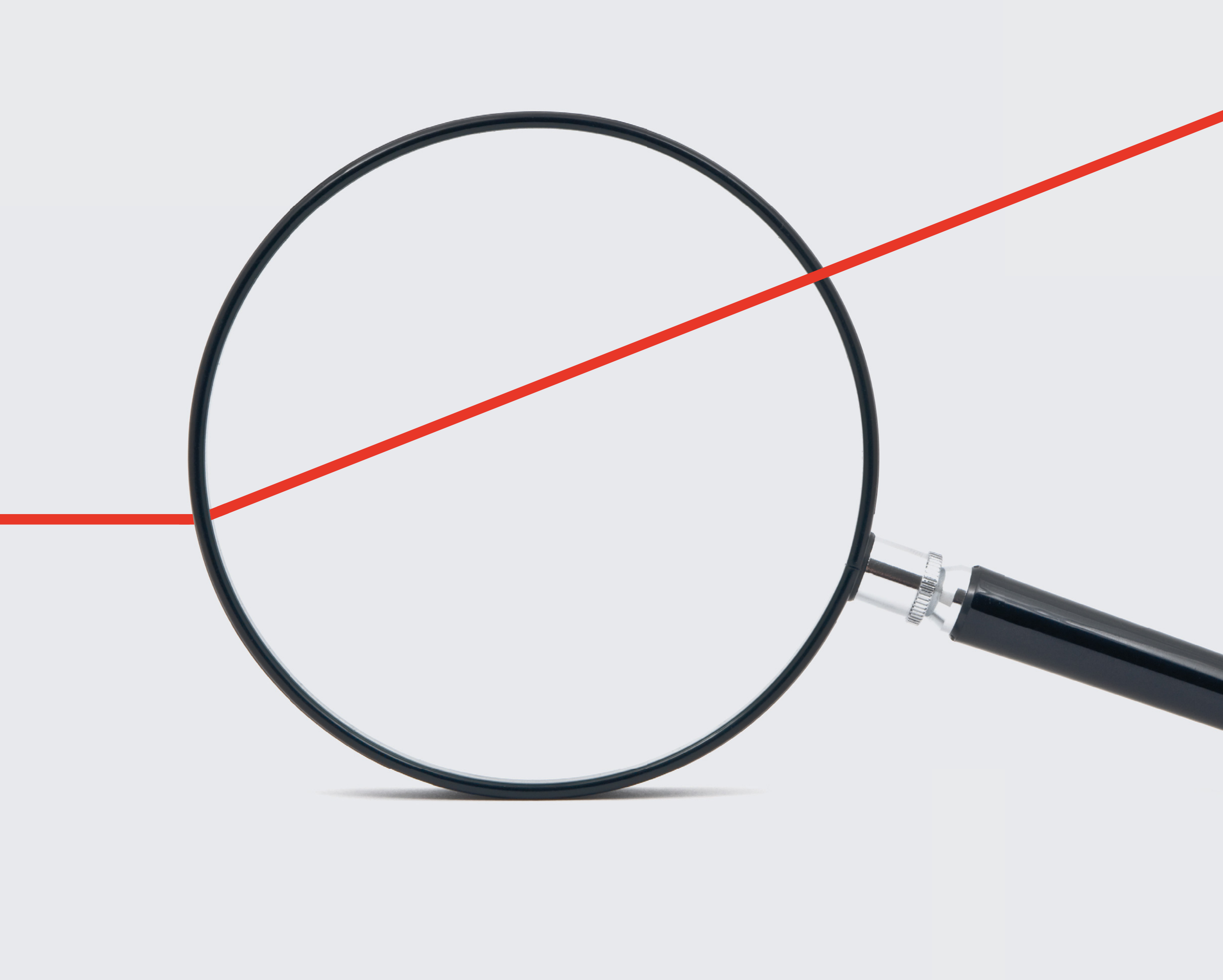
Past downturns saw distress in real estate spilling over to the banking world. In 1992, the Resolution Trust Corporation (RTC) took over the assets of mostly small banks and then liquidated them or got them into safer hands. In 2008–2009, the global financial crisis led to "fire sales" of assets when motivated sellers prioritized getting assets off their books over waiting for prices to recover. While the story of this cycle is still developing, Clarion Partners believes that differences from those past two events point to less distress this time for a number of reasons.

Massive Government Intervention

The first difference, especially compared to the 2008–2009 financial crisis, is the robust government policy response during the COVID-19 pandemic in both speed and magnitude. Before an unraveling of capital markets could take hold, Congress, the Treasury Department, and the Federal Reserve worked together to implement such policies and programs as the Coronavirus Aid, Relief, and Economic Security (CARES) Act, zero interest rates, and virtually unlimited quantitative easing. Capital markets subsequently witnessed a sharp recovery after an initial panic. There has been no major bank failure or credit crisis, both the hallmarks of previous financial crises. Additionally, the federal government's $3 trillion in coronavirus aid, including enhanced unemployment benefits and business loans that could be put toward rent payments and may be converted to grants, has clearly had a positive impact.

Just as important as the financial distress in the commercial real estate assets are the lenders' decisions and financial conditions. In the early 1990s, small banks were overleveraged, and in response to the resulting downturn, the federal government formed the RTC to take the loans from insolvent banks. The RTC then had an interest in clearing the billions of dollars of loans into the market as quickly as possible. Similarly, during the 2008–2009 crisis, distress in the shadow banking world of securitized loans as well as bank distress emanating from single-family loans put pressure on lenders to reduce their loan portfolios, with both loan and equity pricing suffering substantially as a result.

Investors active during the financial crisis may remember the controversy over "pretend and extend." Critics at the time accused lenders of looking the other way as values dipped below amounts borrowed and accused regulators of allowing them to do so. In hindsight, permitting forbearance likely allowed some lenders to avoid fire sales and resulted in less generalized distress than ruthless defaults on distressed borrowers. Government intervention this time around has had the effect of preventing defaults



Identifying potential that others may overlook

At Clarion Partners, we bring the broadest possible perspective to real estate investing to uncover the true drivers of long-term value. We know the importance of understanding bricks and mortar and of being on the ground in local markets. It's how we identify potential that others may overlook and seize opportunities that others may not always see.

With nearly 40 years of experience developing, owning, and operating real estate, we don't merely acquire value. We create it.

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1,300+
COMMERCIAL PROPERTIES

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that might have resulted from distress emanating from the COVID-19-related downturn. Lenders' behavior and willingness to provide forbearance during the pandemic so far indicate that they see managing their relationships with borrowers as a more effective avenue than simply taking over real estate. Regulators have allowed such decisions.

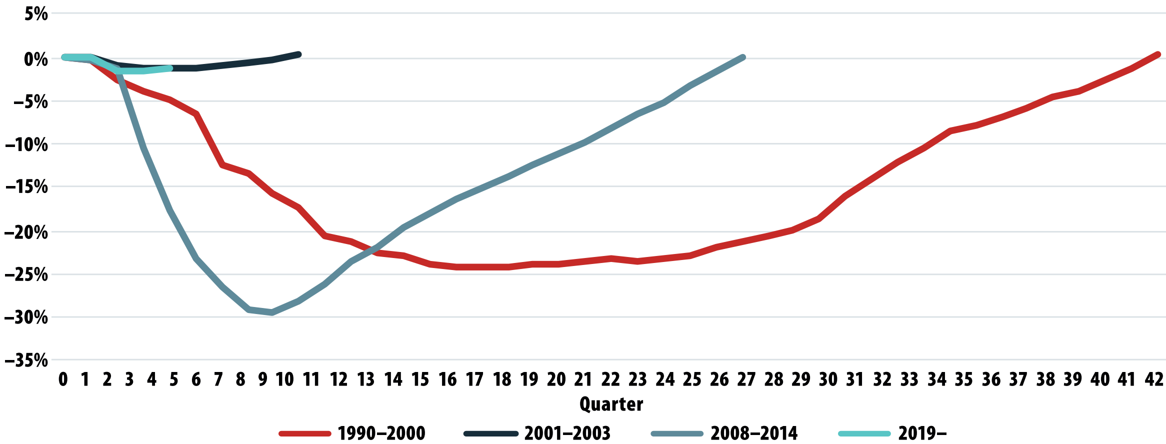
The ability to give borrowers time to recover is a luxury earned through better capitalization. For the largest financial institutions, the creation of stress tests run by the Federal Reserve over the past several years has increased confidence that losses can be weathered without risking bank insolvency. This has increased focus on decisions for how best to minimize losses on individual loans. For a high-profile example, take the Mall of America, which fell behind on payments during the height of preventative closures in the spring of 2020. Its lenders were able to work with mall ownership to reduce loan payments to interest only, in effect betting that a post-vaccine recovery would allow the owners to repay the loan even if immediate income was lacking. These types of loan-by-loan decisions are expected to limit the number of loans and properties that reach the point of a distressed sale.

Better Overall Real Estate Performance

An unusual aspect of the COVID-19 downturn is that its cause is not all that complicated economically. Because of the virus, people have been staying home for community health, which has in turn negatively affected many industries. Many economists believe the recovery could be just as simple. A successful nationwide vaccination campaign would result in resumption of many activities, helping the hardest-hit industries.

While it may be an overstatement to say that life will return to a pre-COVID-19 normal, it is not hard to believe that in addition to properties that have performed well throughout the pandemic, another large group of assets will improve enough post-vaccine to avoid distress. Downtown apartments, grocery-anchored retail, and many office assets, all of which were financially well off before the pandemic, are likely to recover and generate income

Exhibit 1: NCREIF Market Value Index: Each Recession Is Different



NCREIF Downturn	MVI Decline	Peak to Trough (Quarters)	Trough to Recovery (Quarters)
1990–1994	–24.3%	16	26
2001–2002	–1.3%	4	5
2008–2010	–29.4%	8	18

Source: NCREIF; as of 4Q2020; MVI = NCREIF Market Value Index

more comparable to pre-pandemic levels than to the levels seen while in-person interaction is minimized. Even the especially hard-hit lodging sector should surely see greatly improved income as travel restarts.

Increasing the possibility of a quick turnaround is the state of the market entering the recession. Pre-COVID-19, most property types and markets had recent histories of strong rent growth and vacancy rates well below average. Not all past downturns have started from as favorable a point. Additionally, capital markets themselves in the early-1990s and 2008–2009 recessions were different. What made those cycles ideal for distressed investing was that capital markets displacement exceeded deterioration in commercial real estate fundamentals. The distress in small banks in the early 1990s and in large banks and the shadow banking world of securitized assets in 2008 led to ideal conditions for opportunistic acquisitions from sellers that had strong motivation to dispose of assets at a discount.

US real estate pricing during COVID-19 has held up surprisingly well overall.

It can even be argued that capital markets might have overreacted in those two severe market downturns. Capital markets react to distress by assuming greater risk going forward. Lending markets may require higher spreads over Treasury rates, and equity markets may require a higher risk premium, translating to higher cap rates. The reverse of this process is that distressed investors benefit from a recovery in the capital markets as well as recoveries of the economy and real estate fundamentals. US real estate pricing during COVID-19 has held up surprisingly well overall. From 4Q2019 to 4Q2020, the NCREIF Market Value Index declined by less than 2%, similar to the mild decline in the 2001–2002 tech bubble downturn but very different from the steep declines in the 1990s and 2008–2009 downturns (Exhibit 1).

Capital markets too are governed by supply and demand. Crises in the banks in the early 1990s and 2008–2009 meant lending for equity purchases was less available, giving funds with ample liquidity the upper hand; bids on the many assets in which sales were forced were less contested than they otherwise might have been, leading in certain extreme cases to effective fire sales.

Well-Capitalized and Patient Investors

Equity markets today appear to be lacking in the same imbalances. With relatively few assets coming to market as owners wait to see the post-vaccine landscape and the healthy fundraising for distressed funds, this downturn is a different situation. PERE reports that distressed debt funds have raised $40 billion over the past two years and has elsewhere estimated that distressed debt and equity funds overall had set fundraising targets of $297 billion early in the pandemic. According to Preqin, a record amount of dry powder remains on the sidelines.

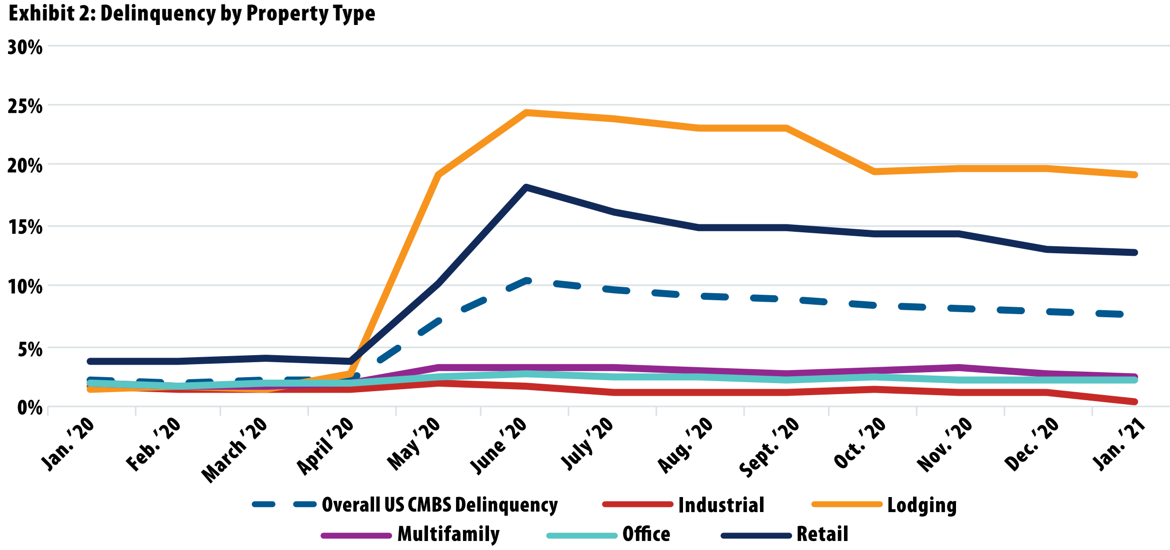
Such abundant liquidity also works its way into the real estate equity market. Distressed investment relies on an imbalance of liquidity in which sellers, especially when overleveraged, outnumber well-capitalized buyers. Those who have most successfully executed the distressed playbook have been able to tap liquidity in times when liquidity for real estate is scarce. As liquidity returns, investors in distressed investments would typically benefit as the imbalance in capital normalizes and equity and debt funding is generally available.

Whether the eventual amount of distress exceeds, matches, or falls short of fundraising amounts is too early to tell at this point. Despite some of the worst negative headline statistics on GDP and employment on record, many investors began the downturn well capitalized and are under little pressure to sell today. REITs and institutional investors certainly took the lessons of the financial crisis to heart and have mostly avoided many of the high-leverage strategies that fueled the crisis in 2008–2009.

Divergence Between Property Sectors

Although every economic downturn is unique, the medical nature of the COVID-19 downturn makes it an almost entirely different character. Notably, without the capital markets dislocations described previously, distress will likely appear more selectively and be very asset-specific. This is reflected in the unprecedented pattern of distress across property types, as illustrated in CMBS delinquency data

Exhibit 2: Delinquency by Property Type



Source: Trepp; as of Jan. 2021

The dramatic surge in e-commerce has rocketed demand for distribution warehouses, and funding for life sciences research has escalated, fueling demand for lab space.

from Trepp (Exhibit 2). While overall delinquency has risen dramatically, the rise is disproportionately explained by the lodging and retail loan categories. It's no coincidence that these are the property types in which revenue has been severely impacted by the onset of COVID-19 and associated restrictions.

Meanwhile, large parts of the real estate universe have seen little distress and often even improved their ability to pay off debt. Industrial, suburban apartment, and several alternative property types such as life science/lab office, single-family rental, and manufactured housing have seen revenues increase since March 2020.

Just as the pandemic has negatively affected certain property types, it has positively affected others, in many cases clearly accelerating preexisting trends. The dramatic surge in e-commerce has rocketed demand for distribution warehouses, and funding for life sciences research has escalated, fueling demand for lab space. Remarkably, unlike in prior periods of capital markets distress, many loans have become safer during this downturn.

A limited portion of the overall commercial real estate market is likely to wind up facing distress. Enclosed and apparel-focused malls, some hotels that could be impacted by shifts in business travel, and some office properties that might be negatively impacted by prolonged work-from-home policies could see long-term reductions in income. In these cases, the distress is very much in the properties themselves, and the opportunity would be to buy the properties' debt and equity at reduced prices.

Any prospective distressed investor should understand these differences from past recessions. Unlike when picking up assets during an economic or financial crisis, achieving returns today is not necessarily a matter of benefiting from the improvements in the economy and capital markets. Investors will need to avoid properties that have structural headwinds that may not abate with a recovering economy. Even time may not be enough to generate recoveries for some assets with economic use that has passed, such as lower-quality malls where business has been eroded by e-commerce.

De-Stress Over Stress

To be sure, more distress is likely to come to the market over the next 12 to 18 months, especially in hotel and retail properties. Nonetheless, the unique nature of this COVID-19 downturn and the robust policy responses suggest that this recession will weigh less heavily on real estate equity funds than the capital markets–driven downturns in previous recessions. This downturn's concentrated nature compared to the broad-based, risk-aversion characteristics of previous recessions creates the prospect for portfolios with the right sector and geographic allocations to generate outperformance. While an economic downturn is rarely a good time for real estate investors to be unconcerned, those expecting a repeat of past distressed opportunities ought to temper their expectations this time. ■

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