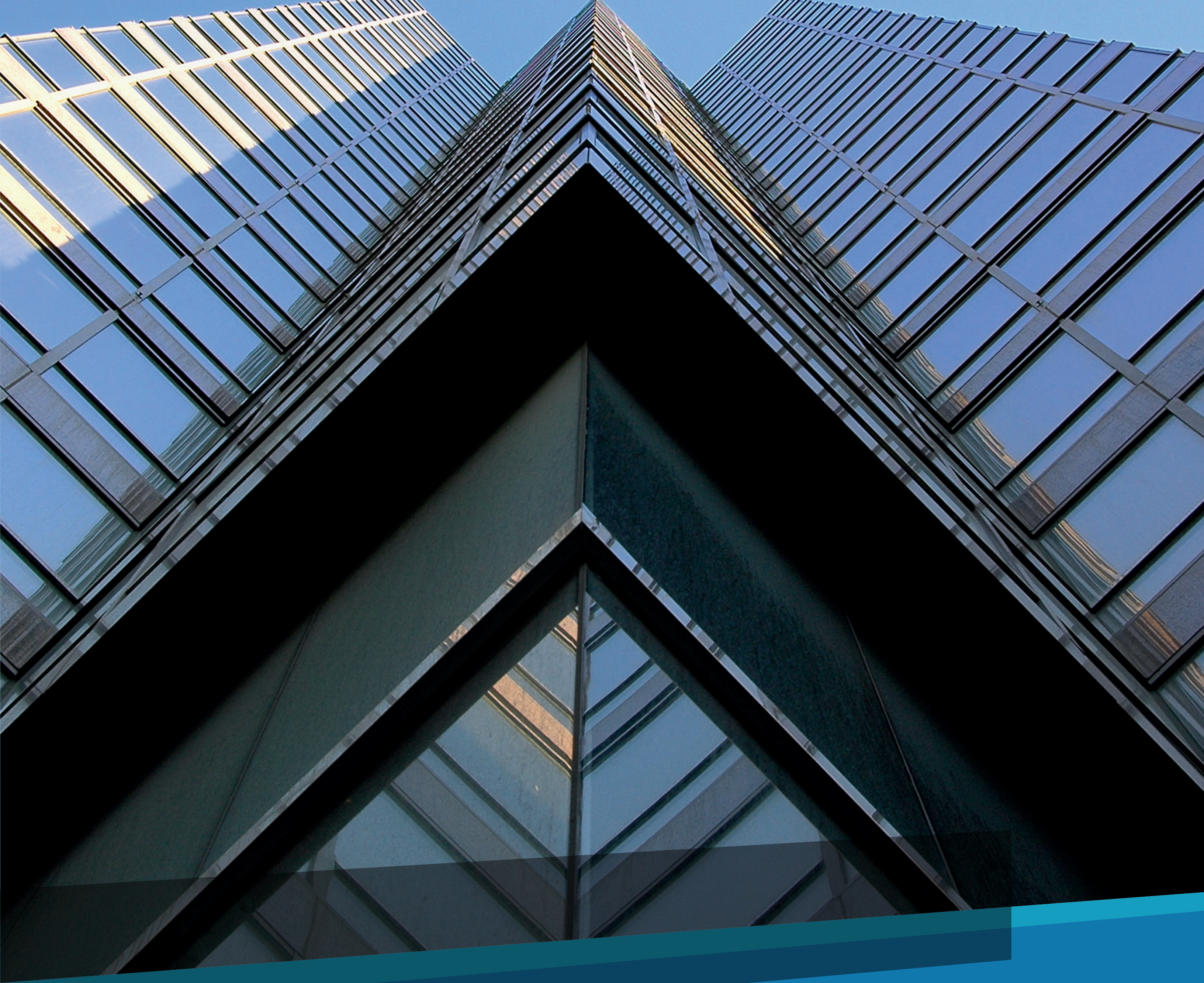


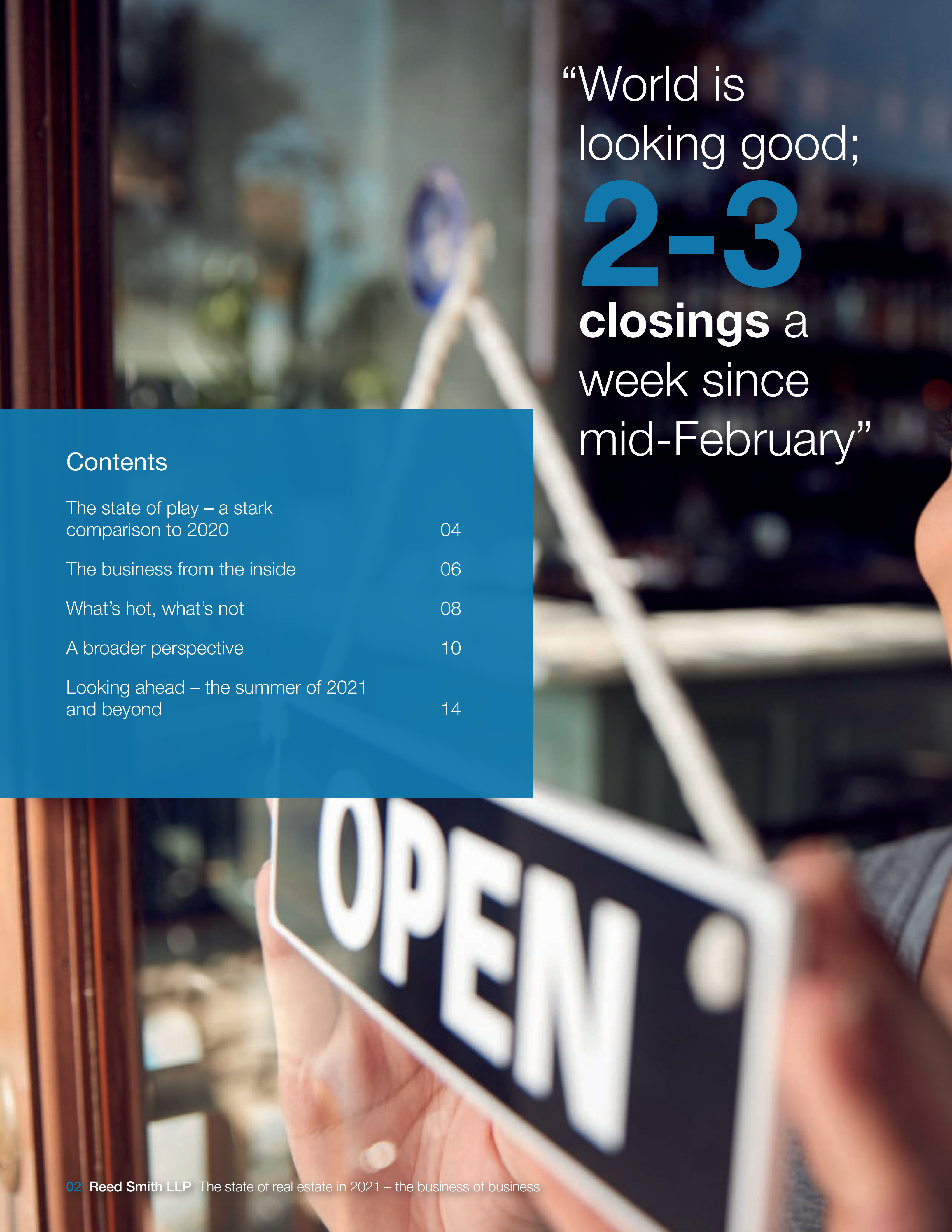
The state of real estate in 2021: the business of business - a regional perspective

2021 Virtual Roundtable Series

May 2021

ReedSmith

Driving progress through partnership



"World is looking good; **2-3** **closings** a week since mid-February"

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A cautious optimism as we adapt to a model...

As we progress through 2021 and move into the second summer of this pandemic, we carry forward the experiences and lessons learned from the past year and look to a brighter future.

Reed Smith recently hosted several decision-makers from our commercial real estate finance clients based in the northeastern United States to informally chat about the evolution of businesses in various-sized markets over the past year. They have worked together in the past and shared their candid thoughts on current debt, strategies and debt and equity trends as we move through 2021. We are grateful to our participants for sharing their insights which we have sought to capture in this report.

This roundtable was part of a wider series of Reed Smith events hosted for senior business leaders, general counsel, legal and business teams, and senior management to share experiences, discuss live issues, and explore strategic ideas for the future. We are grateful to our clients for their participation and look forward to continuing the dialogue.

Our roundtables are held under the Chatham House Rule, and, accordingly, all comments are not attributable.

Joe Sarcinella
Partner
New York

The state of **play** – a stark comparison to 2020

Clients have observed an interesting dynamic this year, in relative contrast to 2020.

While last year was generally rough for the business and particularly for multi-family and industrial properties, 2021 has seen a steady turnaround, and it is a busy time.

Things are busy…
"I leave early and work late – on the phone until **11:00** *at night."*

The group described how they were pushing through the pipeline and closing deals.

"I closed all of 2020 [pending deals] in Q1 of 2021."

"We just closed the biggest 'headache deal' after working on it for four years."

For one participant, the rate of closings has significantly increased.

"Currently running at two to three a week since February, up from one a month not so long ago, and it doesn't look like it is slowing down."

"They are giving up the keys [to hotels] in New York."

The business from the inside

Looking beyond the comfort zone

Currently, there is not much activity in northern regions such as the Washington, D.C. – New York – Boston corridor, with a few small exceptions on the sales side. Investments in gateway markets like Austin and Charlotte are doing well due to credit tenant office buildings with solid long-term leases with good tenants. However, underwriting deals remain a challenge for multi-family and industrial properties as *"pricing expectations have gotten so low since there is so much capital available."*

Selective multi-family and industrial deals are on the upswing in certain markets, as are opportunities in the hotel space. Servicing current hotel loans in certain regions tends to be challenging and time consuming when current capacity is limited. One client commented, *"we're doing a bunch of hotel work-outs – special servicing hell… and have been making the best efforts to get out of servicing."* For the hotel assets in another client's portfolio, they *"have been pressing the hotels to do better than most – meaning 30 to 35 percent occupancy."*

“There is movement toward quality assets - it can’t just be stock inventory.”

Flashback to another crisis?

The commercial mortgage-backed securities market is in a situation similar to 2008-2009, and there is not much current activity, particularly on the distressed side with few opportunities. *“No one wants to take back the asset”* and chase recourse obligations. With servicers overwhelmed, firms are holding back to see how the market evolves over the next three to four months. *“Things could look dramatically different.”*

Seeking smaller deals – the path less traveled

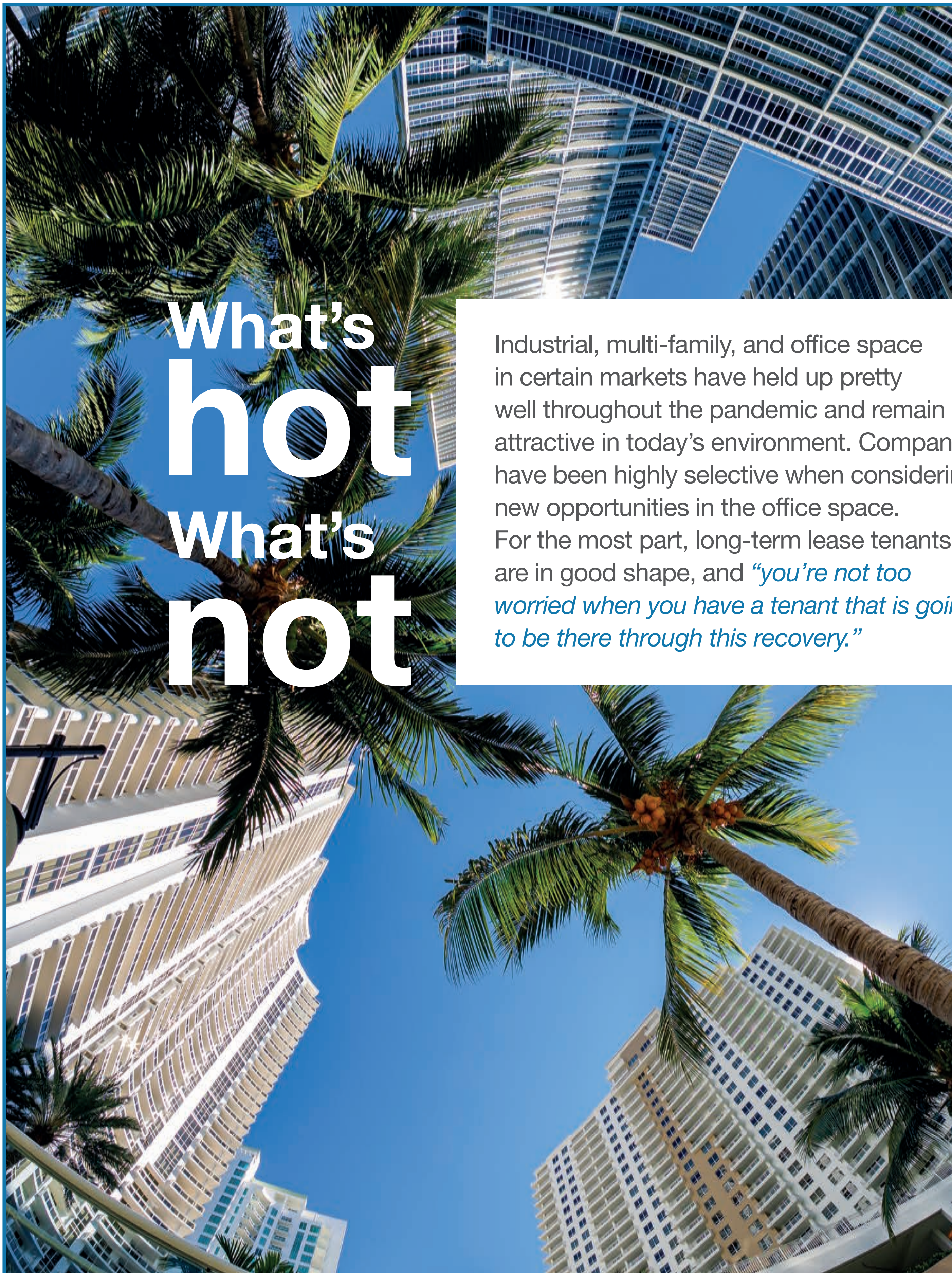
There is too much capital chasing multi-family and industrial, hence investors are looking at other assets. A prime target is the smaller deals in the submarkets (neighborhood/market within a large city) in the $20 million to $35 million range. Commodity office deals are few. There is growing interest and activity in the hotel space in the southern United States with institutional equity investment and limited servicing needs. *“We have a lot of acquisitions going on right now with four hotels deals all down south.”*

Finding opportunity in the Sunbelt

Business is growing in the southern United States where the majority of the acquisition activity is taking place. Hotel investment is generally up relative to multi-family and industrial properties. Leisure properties in the *“Red State drive-to destinations”* are doing well; *“there is far more liquidity in the market, and it has picked up over the last 60 to 75 days.”* It has been fairly difficult for the debt funds to meet their return thresholds, and *“they have begun to tack elsewhere to find returns and meet their parameters.”*

The allure of off-market lending

There is some reticence in investing in off-market assets – however, off-market acquisitions with limited servicing are popular, especially on the smaller size. *“I am generally a skeptic on off-market, but everybody is getting things off-market.”* In some cases, institutional equity investors are going in and handling the franchise agreements. One panelist commented on a Florida property they are looking at with $22 million of debt. *“It’s limited servicing and not a heavy lift for us – we don’t want to be looking down at the end of a franchise agreement.”*



What's hot What's not

Industrial, multi-family, and office space in certain markets have held up pretty well throughout the pandemic and remain attractive in today's environment. Companies have been highly selective when considering new opportunities in the office space. For the most part, long-term lease tenants are in good shape, and *"you're not too worried when you have a tenant that is going to be there through this recovery."*

“It’s all down south - Red State drive-to leisure market is hot.”

The hotel market

Exposure to the hotel industry has been a double-edged sword. As in other sectors, properties doing well prior to the pandemic have been able to survive. Lenders are working with property owners to reduce exposure by providing one-year extensions, *“giving us the reserves to carry it another year.”* Owners are also investing equity into their properties. *“We think we’re gonna be OK... keeping them on a short leash for now.”*

One investor spoke about recently adding the hotel sector to their portfolio and is preparing their first hotel construction loan in Florida where there was limited demand previously. *“It’s an asset right on the beach next to another that has done very well historically.”* In spite of this, our panel generally agreed that there is not much funding currently available for hotel construction. Another participant commented that even though he has *“no hospitality in the fund, now is the best time to do it.”*

It is a very different story for hotels already struggling before the pandemic. “*People are giving up keys left and right in the city.”* The boarded-up buildings along Lexington Avenue in midtown Manhattan are indicative of the devastation hotels suffered as a result of the pandemic. *“A deal may make sense if you are willing to take the keys.”*

Many New York City hotels had their equity wiped out, and investors are acquiring distressed properties from banks and finance companies. *“They will buy the note, and we will finance the note buy.”* Then, once the keys are handed over, it is converted to a mortgage loan. The leverage on such deals can be as much as *“the whole thing – 100 cents on the dollar.”*

Show me the money – who’s lending

Our clients are working closely with lending banks (majors and regionals) on deals as they are *“pulling things down”* and asking for stricter terms – reducing leverage and adding recourse and pledges to contracts.

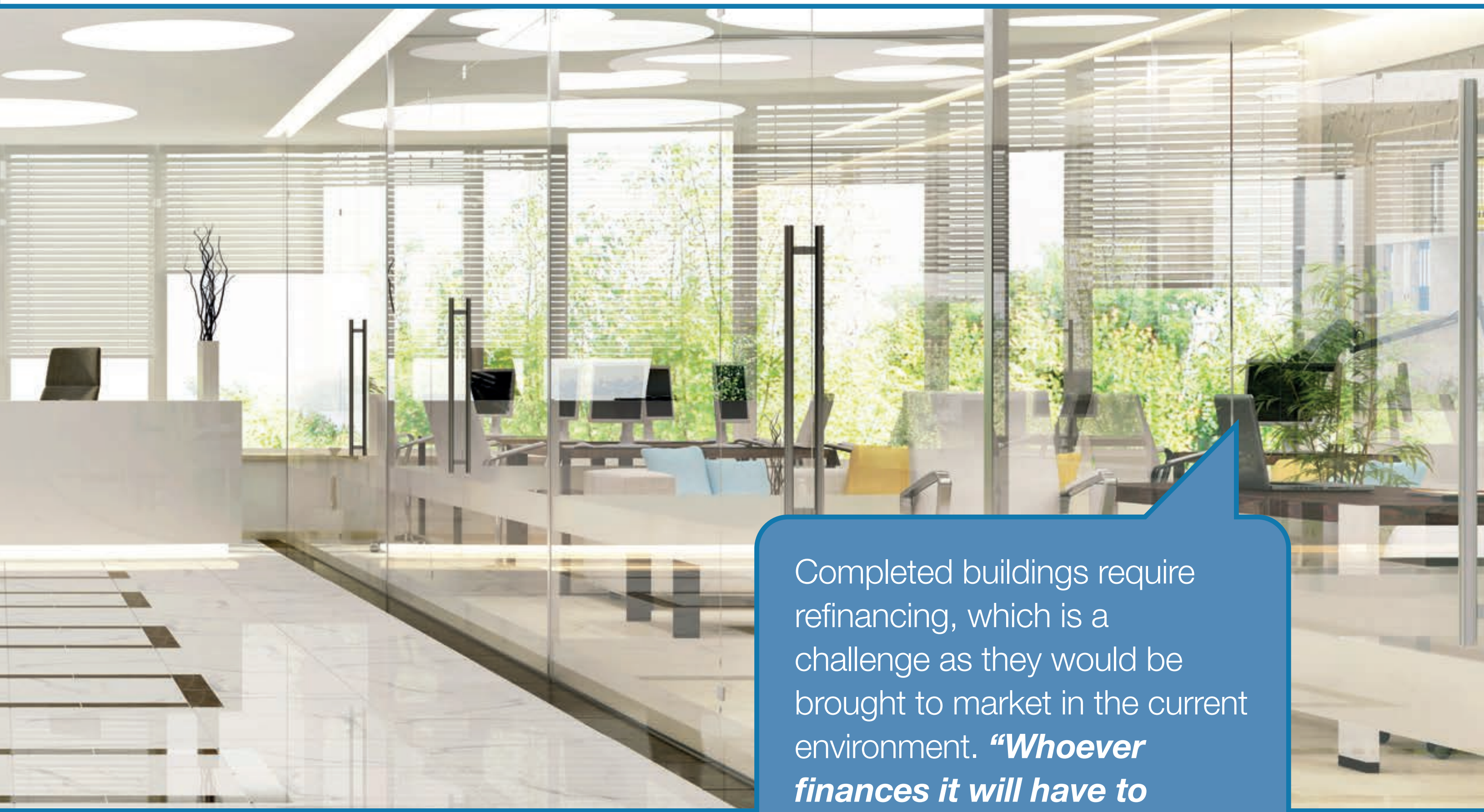
Deals have also been coming through credit unions with a loan-to-value (LTV) ratio of 75% to 80%. *“They are flush with cash and will do what the banks won’t.”* One panelist commented that their company has done $80 million in credit union financing, and they are working more with credit unions. *“When they are good, they are great.”* A prime example is an 80 percent LTV single-tenant, industrial-property financing with terms fixed at 3.6 percent for 10 years with no recourse. Credit unions are *“actually conservative”* and in this case *“blew the socks off the banks.”* They are also seeing loans written in syndication with multiple credit unions, which can be,

“challenging when there are as many as 23 loan participants at the closing.”

A broader perspective

The smart money is with ***"deals that touch different areas of the market"***

Clients continue to explore new ways of working with sponsors and obtaining deal flow. One participant discussed working with a private equity sponsor in Asia, which is likely to be the basis for similar types of transactions to follow. There were challenges conveying the deal structure in a way the sponsor could easily understand – while ***"we all know our rights and remedies and how to get to the collateral,"*** it took a comprehensive effort to walk through the process using flow charts. There were ***"lots of boxes and arrows, and I think we are getting close."***



Completed buildings require refinancing, which is a challenge as they would be brought to market in the current environment. ***"Whoever finances it will have to assume the lease-up over the next 12 to 18 months."***

New York's rental prognosis for the next 12 to 18 months depends on the submarket numbers per square foot. Bulk commodity office rent has *"dropped significantly"*, whereas rents for the smaller floor plans remain relatively static and are *"not a factor for hedge funds and family offices and the like."*

A significant challenge for investors in the current environment boils down to the *"net effective rent at the end of the day."* With property managers deferring maintenance *"and running razor thin"* in an effort to maintain positive cash flow after taxes and insurance, lenders now require additional language, inserting clauses to ensure larger *"interest reserves at closing, with replenishment guarantees."* Not taking these actions *"could lead to a downward spiral that would come back to haunt lenders."*

There are currently few, if any, commodity office deals ***"that you can't get done right now unless it's recourse."***

Projects tend to be smaller in size and located in work–play neighborhoods ***"in proximity to where decision-makers live."***

Speculative repositioning deals are being underwritten in New York, and ***"there is some demand."***

COVID's effect on underwriting

Participants reflected on how the pandemic has directed and continues to direct their underwriting strategies. The current view is to underwrite projects or a product type where rents would have been pre-pandemic and where there is *"rationale for a bounce back."*

Bulk office deals in *"office corridors where sublease space is being given up are hard to underwrite"* since there is no indication as to when a recovery will begin. On the other hand, *"1 Vanderbilt [Avenue in New York City] is at 75 percent to 80 percent occupancy and has continued to lease throughout the pandemic."* This reflects a movement toward quality assets, where new tenants *"will pay up for the latest construction,"* looking for the latest safety and HVAC systems. The market is proving that with a typical older Manhattan office building, *"you need to really differentiate yourself. It can't just be stock stuff."*

Clients find that there is still value in financing across the construction and leasing spectrum. Opportunities vary. Two major banks are purported to be refinancing a construction loan in New York for 166 percent of the original loan amount. *"It shows you there is value there, but it has to be something a little different."*

Another deal involves a partially occupied property undergoing major renovation *"quasi-spec,"* which requires reserves to cover interest risk as the revenue just covers operating expenses and taxes. *"There needs to be a good story."*

On the contrary, financing on a purely a speculative basis *"will be tough for us anywhere – it doesn't matter where it's located."* Spec projects would require heavy structuring with recourse and assumptions on how to lease-up the building. *"There is nothing in my portfolio right now that is traditional office; it is a tough story right now."* That said, there are smaller attractive projects in secondary cities *"in life sciences."*

Underwriting multi-family properties looks unchanged from 2019 in terms of rental figures that sponsors are achieving. On the surface, *"things seem to be unaffected, but we have to dig deep to figure that out."* It comes down to concessions…

Concessions

Rental concessions and other incentives to attract new tenants and retain current renters have been a significant driver for sponsors managing multi-family and other rental properties. *“Concessions in this market have been out of hand”* even though *“they are not budging on the rental price, but concessions are crazy.”*

For sponsors, as much as 20 percent of revenue has been put into rental concessions while the *“face rents don’t change.”* It is a challenge when the sponsor is paying several months’ rent as an incentive while highly leveraged. The solution for investors has been to *“stress the underwriting a bit more”* with larger interest reserves and replenishment guarantees.

Offering concessions has been the trend even for *“top-quality sponsors in marquee locations where people are willing to pay more to live”* and in gateway cities. *“Developers will pay the rent themselves in Philadelphia and other markets.”* While still offering extremely attractive terms like *“three to four months free rent for the first year,”* concessions are now beginning to *“come down”* generally and certainly for the higher-end properties in markets such as New York and Los Angeles.

Foreign investment

Foreign investors are *“picking up the choice assets”* in the hotel and leisure and industrial space. Investment is coming in from Canada, primarily focused on the West Coast and the Sun Belt. British Columbia investors are buying properties from Southern California up through Seattle. Ontario-based investors are more focused on opportunities in the South. South American investor interest has also has also picked up in both hotel and industrial, however, in many cases, the targets are *“not cheap enough… We keep waiting for the bottom.”*

"We think we'll be ok at the end of it..."

Looking ahead the summer of 2021 and beyond

Heading back to the office – industry adapting to the *"future office"* and *"travel"*

The recovery

The consensus among the group is that commercial real estate will see a staggered recovery. The tourism and leisure market will rebound over the next 12 months – as we are already witnessing. On the other hand, recovery for business markets, ***"where a lot of the gravy is, will probably take two to three years."*** This is primarily due to tenants adjusting to new hybrid working models and wanting to reduce physical footprints and rental costs. ***"We have no idea about northern CBDs (central business districts)."***

The question remains how to bring back the dollars with a reduced physical presence or head count in a post-pandemic world. The drive-to leisure is popular with investors. ***"It's coming back tremendously. Napa Valley hotels are booked solid through harvest season."***

"That is why we are focusing on the Sun Belt and leisure destinations."

Wider horizons in 2021 – outside the traditional wheelhouse

While the objective is to continue focusing on their core businesses – multi-family and industrial – our clients discussed other options and what they currently see as attractive. These include selective office spaces, ***"small office satellite"*** leases outside the city, secondary markets, self-storage facilities, and student housing.

Secondary markets

Geography is a key factor. Dallas, Texas and Charlotte, North Carolina are doing comparably well in the large office sector as opposed to White Plains, New York, the *"platinum mile,"* and Stamford, Connecticut. ***"We have office exposure in Charlotte and leased up during the pandemic."*** Stamford is experiencing an uptick in the small office space in the under 7,000 sq. ft. range as ***"people can work closer to home and go into the city a couple of days a week."*** For some, the sponsor and size of deal remain factors in secondary markets. ***"We are not equipped to look at smaller deals – it becomes inefficient under a certain amount."***

Self-storage

Self-storage is a growing interest deal as an investment, with clients looking at several opportunities both in and outside of in New York City, with one being ***"in an atypical location, and it has a lot of inherent value."***

What keeps you up at night?

Our panelists concurred on their concerns as to what could possibly derail an industry recovery. The vaccination programs are beneficial, however the potential for herd immunity is reduced as *"40 percent are anti-vaxxers."* People are also skipping their second doses (8 percent for Pfizer and Moderna – *New York Time*, 04/25/21). Variants are also a potential risk when current vaccines are not as effective. *"A new COVID variant leading to another shutdown."*

"There is too much [vaccine] supply right now." As we progress through the next several months and the rules ease up, policies change, and regulations have an effect on behavior and compliance, *"we will see what happens over the summer."* The feeling is that COVID-19 is here to stay in some form and will be a revolving threat like the flu. *"Spikes are possible, and we will need booster shots."*

Student housing

Student housing is seen as an asset class that will ***"come back before anything else"*** as students look to go back to school in-person this fall. ***"Students want to be out and away from home."***

Shuttered hotels in New York are being considered for student housing. ***"They are actually looking at one asset for which they are considering alternative uses."*** There is concern that while it is a good opportunity at this moment, much can happen in the 12 to 18 months needed to complete the project. ***"It could be an entirely different world by that point."***

The suburbs

The suburbs pose a challenge. There are limitations when dealing with the suburban rental market, even for multi-unit properties. ***"It's too much of a headache."*** The ***"make-ready costs"*** are high for houses, and systems maintenance is expensive. ***"There is zero efficiency of volume."*** Structuring deals in the space is also a challenge. There is ***"limited efficiency in terms of operating expenses, and the margins are not great – we passed."*** A few lenders do work in the space, but with many houses involved, it is just too much work.

Office re-entry

Vaccinations are readily available throughout the region. ***"It was the most efficient government-run operation I've ever seen."*** Reducing restrictions varies by city and state as each is in a different stage of recovery. Our clients' experiences have varied according to where they live and work. ***"The Center City of Philadelphia is tumbleweeds."*** At this point, there is no regular regional rail service with five of 17 lines running on holiday schedules, and there is limited food availability outside of grocery stores. ***"I've been driving to the office since just after Labor Day 2020. Until they figure out the rail system, Philly will have trouble getting people in."***

The New York bound trains have increased in frequency and ridership. ***"I have been coming back to the office daily since September and am noticing the train is now two-thirds full – up from 30 percent back in the fall."***

Our panel agreed that the true back-in-office date would be the Tuesday after Labor Day 2021. Businesses have started the effort to have employees return beginning in June, however there will be push-back for the summer and vacations. ***"I'm working with my team to spend three days a week at the office so we can work together."***

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