WALKER & DUNLOP
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WHAT WE'RE WATCHING

CRE trends & insights with WDIP

CRE MARKET RECAP

The U.S. commercial real estate ("CRE") market is undoubtedly at a precarious moment. The Fed's late but decisive actions to curb inflation have had a dramatic impact on the market, causing significant cash flow disruption and value degradation at a rate not seen since the Great Financial Crisis. In this market recap, we will discuss the current situation and various possible outcomes. We will also provide our view on where the best opportunities in this market will be found and how WDIP is uniquely positioned to take advantage of this current market dislocation.

THE STANDOFF *(PROPERTY PRICING)*

Foremost, transaction volumes have seized, down 70% YoY in the first quarter of 2023, according to Green Street. The market is in this standoff due to the sizeable bid-ask spread on real estate values. On the bid, buyers' borrowing costs have increased dramatically and as a result, most opportunities at yesterday's pricing do not support today's increased cost of capital. Further, many buyers are reluctant to acquire a property with negative leverage* unless they can underwrite a business plan with a clear path to positive leverage with cash flow and value upside.

On the ask, sellers are either stuck on pre-rate-hike pricing, or if they bought at the peak, reluctant to sell and realize a loss. Many would-be sellers are taking the "hold and hope" approach; they see the forward SOFR curve dropping materially (expecting Fed rate cuts starting in 2024 and hope that such a drop in rates would partially close the gap on the bid ask spread. It is mostly forced sellers – undercapitalized, over-leveraged owners – who are reaching down across the bid-ask spread and reluctantly transacting. Given this dynamic, we anticipate transaction volumes to remain low until we either have i) a valuation reset, with more sellers capitulating and/or ii) a material reduction in interest rates.

**Negative leverage: buying a property with an unleveraged cash yield lower than the interest rate on the senior debt, resulting in a leveraged cash yield lower than the unleveraged cash yield*

THE FED

No one can predict with certainty what the Fed will do. However, there are only two directions the Fed can take from here, each with its own impact on the CRE market.

In one direction, the Fed could cut interest rates in the near-term. While the current forward interest rate curve is predicated upon an impending economic slowdown, by itself a rate cut would help narrow the bid-ask spread by reducing buyers' cost of capital. Forward growth expectations have cooled yet exit cap rates are under less pressure than is typically the case in a more "normal" rising yield curve environment. In this scenario we would anticipate an increase in transaction volumes (both sales and refinancings), albeit still below levels reached in 2021 and the first half of 2022. We expect the market environment to look more like "normal" pre-Covid 2019 volumes in this scenario.

In the other direction, if inflation and job reports continue to remain high and strong respectively, the Fed could hold or further increase rates. Depending on the duration that rates are held high, we would anticipate this to materially stress CRE owners (especially smaller, middle market owners whose resources are often limited) and eventually culminate in higher levels of distress (defaults, material valuation declines, and a significant premium for liquidity).

OFFICE

WDIP has minimal exposure to investments in office properties (a handful of flex properties and conversions from office to industrial). This sector faces strong secular headwinds caused by the structural work-from-home and hybrid work changes resulting in significantly reduced corporate demand for office space and increasingly higher-vacancy as tenant leases expire. Additionally, with the uncertainty of future demand for office space and values plummeting, debt and equity capital is scarce. These challenges are further exacerbated by all-time-high cost of tenant improvements, required to attract new leases. Many owners are challenged with investing tenant improvement dollars into an already devalued asset and may be "throwing good money after bad."

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There are however some bright spots in office. Tenant demand is strong, and occupancy remains high for the most attractive and amenitized Class A buildings located in prime locations within quality markets. The highest quality assets and locations will continue to thrive as companies use "A+" quality office space to attract and retain talent and boost brand. Additionally, boutique office product with access to scarce resources, such as specialized talent or executive housing, may continue to prove to be as well. Overall, however, we expect the office investment landscape to remain complex among significant headwinds.

BRIDGE LOAN MATURITIES

While it is all but certain that maturing office loans will create distressed needs for capital as this sector contends with a secular shift in demand for office space and higher interest rates, the volume of floating rate bridge loan maturities in multifamily is flying somewhat under the radar yet has the potential to create distressed supply. This distress could lead to elevated forced selling and great buying opportunities within the middle market for well-capitalized buyers.

Floating rate CLO issuances totaled $55B from 2014-2020, just under $8B per year on average. In 2021, there was $45B issued and in 2022 another $30B, totaling $75B of CLO issuances at a time of peak property valuations, aggressive underwriting, and abundant leverage. This ramp up in CLO issuances was driven by the accretive trade between the near 0% floating benchmark interest rate and almost any credit spread product. According to the Commercial Real Estate Finance Council, about 65% of the outstanding property CLO's are on multifamily assets. A primary driver of this is the borrower profile which predominantly utilizes these aggressive value-add bridge loans to reduce the amount of equity needed for transactions while also boosting underwritten leveraged returns. Many of these owners who utilized this type of debt (often equity syndicators) ramped up their acquisitions in 2021 and 2022 utilizing this high leverage bridge debt with underwriting predicated on shorter hold periods and low interest expense. This ownership profile is least likely to have significant cash reserves and/or the ability to resolve refinance shortfalls at loan maturity due to significantly higher interest rates than originally underwritten. With the current tight credit environment many of these owners will be forced to sell these properties if interest rates remain high, which will create distressed buying opportunities.

CAPITAL STACK GAPS IN PROPERTY OWNERSHIP

Given the Fed's actions and the resulting steep increase in the cost of debt and asset value diminution, many owners of properties acquired with floating rate debt over the past three years are faced with near-term loan maturities and a significant shortfall in refinance proceeds (or will be unable to fully pay off the existing loan with a new loan). This "gap" in their capital structure will need to be filled through additional capital infusions by way of new common equity, preferred equity, or mezzanine debt. Absent this infusion of capital, an owner will need to sell the property or face foreclosure.

The property owners most exposed in the current environment tend to have one or more of the following characteristics in their investments:

- High leverage, floating rate bridge debt
- Business plans reliant on cap rate compression
- Reliance on market rent growth to enhance value

INVESTMENT OPPORTUNITIES

One seller's distress is another buyer's opportunity. Opportunities are emerging from undercapitalized owners who don't have the wherewithal to contend with the distress caused by higher interest rates, maturing high-leveraged bridge loan debt, and reduced liquidity. As a result, these owners are being forced to sell, which provides the opportunity to buy good real estate at very attractive bases.

Despite any capital distress we are seeing today or will see over the next 12 to 18 months, we believe the long-term outlook for multifamily and industrial property sectors is positive. Multifamily benefits from the ongoing demand for housing and a diversified rent roll with lease expirations throughout the year, ensuring a relatively stable rental income even during a recession. As for industrial real estate, secular tailwinds such as the rise of e-commerce and evolving consumer preferences bolster demand for warehouse and distribution facilities, particularly close to population centers where supply is constrained, making them a reliable investment option in the current environment as well.

Our investment philosophy when we acquire a property is to buy at an attractive basis relative to replacement in locations with durable barriers to new supply, and execute a business plan that creates intrinsic value by increasing net operating income. When we develop a property, we aim to build to an attractive, stabilized yield-on-cost well above stabilized market cap rates in macro and micro locations that have strong fundamentals and compelling demand drivers relative to supply. This philosophy serves to protect investor downside while positioning the investments for upside realization. We are focused on generating returns by increasing hard asset values through operations and capital improvements, not by betting on capital market movements or manufacturing returns through unduly high leverage.

As the market continues to evolve, it is essential for investors to remain agile and adapt to the changing landscape of opportunities. WDIP, as an investment manager, benefits from being part of a well-established organization like Walker & Dunlop, which provides a significant advantage. The scale of deal flow and access to proprietary transaction volume from Walker & Dunlop's banking and brokerage teams allow us to respond more quickly to emerging opportunities. This affiliation also enables access to off-market deals that are not accessible to other market participants, providing a competitive edge in identifying and capitalizing on unique investment opportunities.

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Cameron Croy
615.210.4121
CCroy@walkerdunlop.com

Our team has a strong track record with consistent performance and more than 25 years of experience in the industry. Interested in partnering with us or learning more? Contact a member of our team https://www.wdinvestmentpartners.com/

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