Commercial Real Estate Credit in Post-COVID-19 World

Morris Chen, Portfolio Manager | September 2020

Despite late-cycle concerns after a decade of continuous growth, U.S. commercial real estate (CRE) appeared on track to extend positive performance through 2020. CRE benefited from a strong macroeconomic backdrop with low odds of recession and stable fundamentals while heading into a presidential election year. Then came the COVID-19 pandemic, resulting in government-imposed shutdowns that disrupted the asset class's fundamentals and technical outlook. Within months following the onset of the pandemic in the U.S., the economy entered a recession characterized by the largest levels of unemployment since the Great Depression. The federal government and the Federal Reserve have tried to fight back with fiscal and monetary stimulus to the tune of roughly 16% of U.S. annual GDP … and counting. Notwithstanding the unprecedented scale of this intervention, significant uncertainty surrounding the timing of a recovery for CRE and the broader economy remains. Looking beyond the eventual cyclical recovery, the economy and society in general will likely undergo structural changes, the full nature of which remains to be seen. With those caveats, I would observe that in previous recessions, commercial real estate property prices have tended to lag the broader economy by about six months. At a minimum, those precedents and the present economic environment argue for a cautionary outlook on certain areas of commercial real estate credit over the near and medium term. Ultimately, my view is this is a public health crisis that has impacted the U.S. economy and has led to unprecedented policy responses by the U.S. government. I believe such a backdrop and actions could differ the behavior of CRE borrowers and underlying CRE performance versus previous down cycles.

Fundamentals

The U.S. commercial real estate market has been impacted by the government-imposed closure of nonessential businesses and stay-at-home mandates. As a result, transaction activity plunged 68% in the second quarter of the year compared to the prior year.[1] *(Figure 1)* In prior economic recessions, slowing transaction volume, which typically reflects a growing disconnect between buyer and seller expectations as well as tighter lending conditions, has generally been a precursor to downward pressure on property prices.[2] *(Figure 2)*

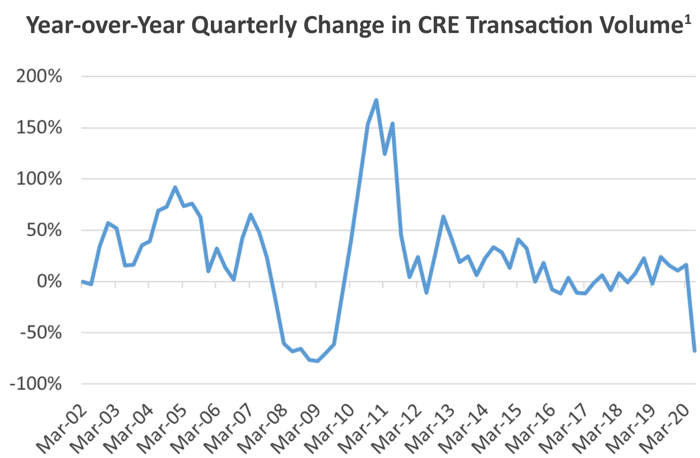


Figure 1

CRE Transaction Volume versus Price Change[2]

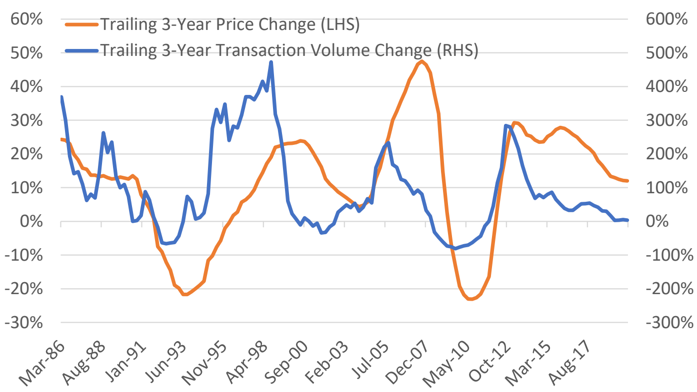


Figure 2

This trend might become more apparent over the coming quarters as price growth has already started to slow across all sectors of commercial real estate, with hotel and retail, not surprisingly, underperforming the other property types.[3] *(Figure 3)*

RCA CPPI™ Year-over-Year Growth[3]

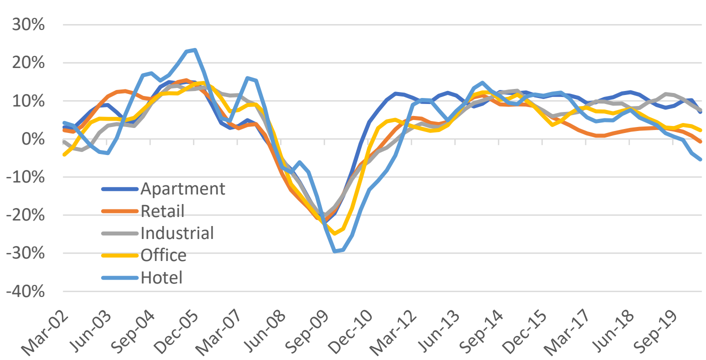


Figure 3

Despite nascent signs of recovery as local economies have reopened, the hotel sector has been hit particularly hard. On a national basis as of August 1, occupancy fell 37% year-over-year (YoY), average daily rate (ADR) 27% and revenue per available room (RevPAR) 54%.[4] This deterioration in fundamentals resulted in an increase in 30-day-plus delinquency rates for commercial mortgage-backed securities (CMBS) hotel loans to 23.8% in July from 1.5% in January of this year.[5] *(Figure 4)* I view this more as a near-to-medium-term risk and believe the hotel sector will ultimately rebound as the economy normalizes.

Percentage of CMBS Marked as 30+ Days Delinquent[5]

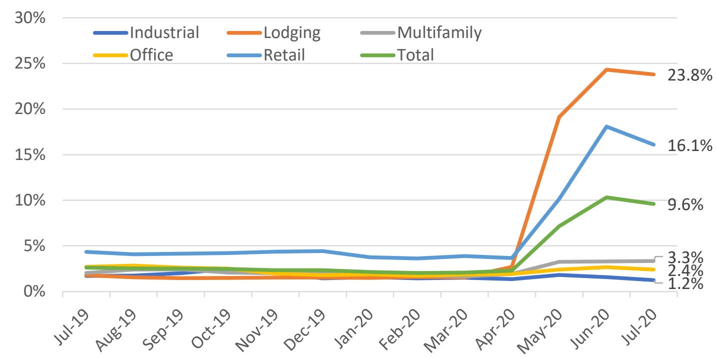


Figure 4

CMBS loan delinquencies in the retail sector have also increased due to the pandemic-induced shutdown of non-essential businesses and the resulting acceleration of the shift in consumer shopping from brick-and-mortar shops to online. While this secular shift in consumer behavior was occurring before the pandemic, the pace of retailer bankruptcies, tenant downsizing and store closures has accelerated in the wake of COVID-19.

In the office sector, the majority of office workers nationwide have been working from home for several months now. The widespread prevalence and apparent effectiveness of remote working have caused many companies to reevaluate their office space needs. Couple this new thinking with the implications of a rise in corporate bankruptcies, cost-cutting initiatives and the number of small businesses struggling to survive in this environment. As a result, there will likely be rising vacancies and falling effective rents, ultimately leading to lower cash flow and resulting valuations in the near to medium term. However, in my view, the office environment remains woven into the corporate culture and productivity of nearly all organizations. Thus, over the long term, I still view office space as critical for businesses. Combined with the availability of space and urban centers with housing and infrastructure built around them, this natural demand should cause a gradual return to normalcy for the office sector.

Commercial Real Estate Credit in Post-COVID-19 World

Morris Chen, Portfolio Manager | September 2020

While certain CRE property types have suffered, other sectors such as industrial and suburban multifamily are doing relatively well. Within the industrial sector, as e-commerce continues to take market share away from traditional brick-and-mortar businesses, there comes an increasing need for logistics, including warehouse and distribution space. This has resulted in an insatiable demand for well-located last-mile industrial properties that will likely continue for the foreseeable future. In the multifamily residential sector, rent collections have remained strong to date, partly attributed to the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Combine this with the availability of low-rate debt financing and forbearance activity from the government-sponsored enterprises (GSEs) to temper any deterioration in performance to date. One area to monitor is the migration of renters leaving high-density urban areas. This trend is particularly pronounced among large metropolitan areas, such as New York, Chicago and San Francisco, where rents are high, many of the benefits of living in the city have disappeared in the current environment, and the interim need to live close to the office is less relevant due to employees working from home. It remains to be seen whether this trend will reverse itself once working from home becomes less prevalent amid an eventual return to the office.

Looking Ahead

Unprecedented times call for unprecedented actions. In conjunction with Congress, the Fed has established an array of programs to support capital markets and spur lending by providing trillions of dollars in fiscal stimulus to directly support the economy during these challenging times. CRE has benefitted to some degree from measures such as the Term Asset-Backed Securities Loan Facility (TALF) 2.0 and the CARES Act. However, the support that these initiatives have provided to the sector is inadequate relative to the severity of the deterioration in sector fundamentals. In recognition of this mismatch, some members of Congress are supporting a program to directly support CRE borrowers in the form of the Helping Open Properties Endeavor Act of 2020 (HOPE Act). My team and I would caution that, in its present form, the HOPE Act likely faces an uphill battle on Capitol Hill. Legislators, who might be sympathetic to the plight of CRE borrowers, creditors and employees, run the risk of being perceived as directly "bailing out" CRE borrowers who, however unfairly, might be categorized as mostly private equity firms and high-net-worth individuals. With that said, we view the public discussion and support from Congress as constructive efforts to ensure CRE is on their radar.

As discussed earlier, past recessions point to varying degrees of impact on commercial real estate. The Global Financial Crisis (GFC) resulted in a 37% peak-to-trough decline in the RCA Commercial Property Price Index (RCA CPPI™). This time, the asset class faces something new and different – a pandemic-fueled, government-imposed shutdown of the U.S. economy. Fiscal and monetary stimulus that dwarfs the size of Fed assistance programs during the GFC, combined with a low-rate environment, has translated to an increase in the spread between cap rates and Treasuries above the historical average.[6] *(Figure 5)* Also playing a part is the dry-powder capital that investment firms have waiting on the sidelines: $344 billion, according to financial data firm Preqin.

U.S. All Property Cap Rates versus 10-Year U.S. Treasury[6]

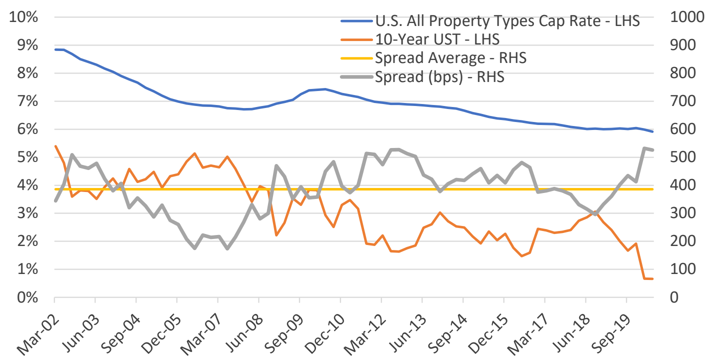
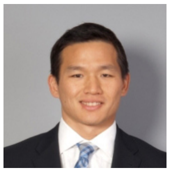


Figure 5

I believe this backdrop will mitigate some of the potential downside risks and temper CRE price declines versus what was observed during the GFC. Furthermore, leverage in the current CRE lending markets is not as high as what prevailed at the start of the GFC, a factor that could help moderate loss expectations. Those constructive factors notwithstanding, the outlook remains clouded for recovery of property fundamentals and performance trends. Thus, my team and I have a cautionary outlook for CRE, especially if lack of direct government support persists. We expect CRE to remain in the eye of the storm as the pandemic continues to play out. ■



Morris Chen
Portfolio Manager
Commercial Mortgage-Backed Securities/
Commercial Real Estate

Mr. Chen joined DoubleLine at its inception in 2009. He is a Portfolio Manager leading the CMBS/CRE Debt Investment team and CRE New Investment Review Group, and is responsible for the oversight and management of all CRE Debt related investments at DoubleLine. Mr. Chen is a permanent member of the Fixed Income Asset Allocation and Structured Products Committees providing valued insight into the CMBS sector. He is also an active participant and speaker at CREFC events. Prior to DoubleLine, Mr. Chen was a Vice President at TCW where he was responsible for CMBS credit analysis and trading from 2004-2009. He holds a BS in Business Administration with concentrations in Business Development and Finance from the University of California, Riverside.

Citations

[1] Real Capital Analytics, Investment & Pricing Trends data, as of June 30, 2020.

[2] Morgan Stanley Research, "*CRE Tracker: What Happens in a Recession?*" as of March 31, 2020.

[3] Real Capital Analytics. RCA CPPI™ Data for US National Indices, as of June 2020.

[4] BofA Global Research. "*CMBS Commentary: Hotel performance update*" as of August 5, 2020. Hotel metric performance is based on year-over-year performance on a running 28 day basis as of August 1, 2020.

[5] Trepp CMBS Research. "*CMBS Delinquency Rate Sees Biggest Drop in More Than Four Years,*" August 2020.

[6] Real Capital Analytics, Bloomberg. Data for US All Property Types, as of June 2020.

Commercial Real Estate Credit in Post-COVID-19 World

Morris Chen, Portfolio Manager | September 2020

Important Information Regarding This Material

Issue selection processes and tools illustrated throughout this presentation are samples and may be modified periodically. These are not the only tools used by the investment teams, are extremely sophisticated, may not always produce the intended results and are not intended for use by non-professionals.

DoubleLine has no obligation to provide revised assessments in the event of changed circumstances. While we have gathered this information from sources believed to be reliable, DoubleLine cannot guarantee the accuracy of the information provided. Securities discussed are not recommendations and are presented as examples of issue selection or portfolio management processes. They have been picked for comparison or illustration purposes only. No security presented within is either offered for sale or purchase. DoubleLine reserves the right to change its investment perspective and outlook without notice as market conditions dictate or as additional information becomes available. This material may include statements that constitute "forward-looking statements" under the U.S. securities laws. Forward-looking statements include, among other things, projections, estimates, and information about possible or future results related to a client's account, or market or regulatory developments.

Important Information Regarding Risk Factors

Investment strategies may not achieve the desired results due to implementation lag, other timing factors, portfolio management decision-making, economic or market conditions or other unanticipated factors. The views and forecasts expressed in this material are as of the date indicated, are subject to change without notice, may not come to pass and do not represent a recommendation or offer of any particular security, strategy, or investment. All investments involve risks. Please request a copy of DoubleLine's Form ADV Part 2A to review the material risks involved in DoubleLine's strategies. Past performance is no guarantee of future results.

Important Information Regarding DoubleLine

In preparing the client reports (and in managing the portfolios), DoubleLine and its vendors price separate account portfolio securities using various sources, including independent pricing services and fair value processes such as benchmarking.

To receive a copy of DoubleLine's current Form ADV (which contains important additional disclosure information, including risk disclosures), a copy of DoubleLine's proxy voting policies and procedures, or to obtain additional information on DoubleLine's proxy voting decisions, please contact DoubleLine's Client Services.

Important Information Regarding DoubleLine's Investment Style

DoubleLine seeks to maximize investment results consistent with our interpretation of client guidelines and investment mandate. While DoubleLine seeks to maximize returns for our clients consistent with guidelines, DoubleLine cannot guarantee that DoubleLine will outperform a client's specified benchmark or the market or that DoubleLine's risk management techniques will successfully mitigate losses. Additionally, the nature of portfolio diversification implies that certain holdings and sectors in a client's portfolio may be rising in price while others are falling or that some issues and sectors are outperforming while others are underperforming. Such out or underperformance can be the result of many factors, such as, but not limited to, duration/interest rate exposure, yield curve exposure, bond sector exposure, or news or rumors specific to a single name.

DoubleLine is an active manager and will adjust the composition of clients' portfolios consistent with our investment team's judgment concerning market conditions and any particular sector or security. The construction of DoubleLine portfolios may differ substantially from the construction of any of a variety of market indices. As such, a DoubleLine portfolio has the potential to underperform or outperform a bond market index. Since markets can remain inefficiently priced for long periods, DoubleLine's performance is properly assessed over a full multi-year market cycle.

Important Information Regarding Client Responsibilities

Clients are requested to carefully review all portfolio holdings and strategies, including by comparison of the custodial statement to any statements received from DoubleLine. Clients should promptly inform DoubleLine of any potential or perceived policy or guideline inconsistencies. In particular, DoubleLine understands that guideline enabling language is subject to interpretation and DoubleLine strongly encourages clients to express any contrasting interpretation as soon as practical. Clients are also requested to notify DoubleLine of any updates to client's information, such as, but not limited to, adding affiliates (including broker dealer affiliates), issuing additional securities, name changes, mergers or other alterations to Client's legal structure.

DoubleLine Group is not an investment adviser registered with the Securities and Exchange Commission (SEC).