Evaluating the Commercial Real Estate Debt Market: Observations and Opportunities

Morris Chen and Mark Cho | July 2021

As the pandemic continues to trouble the world's economies and challenge policymakers, the advent of effective vaccines in the U.S. has, for now, led to a significant decline in daily new cases and has helped push state and local economies to finally reopen. These developments have caused a change in mindset within the U.S. commercial real estate (CRE) market as investors have adapted to a more constructive outlook. It was only a year ago that CRE was one of the most impacted financial sectors, with almost every property type experiencing a profound disruption. Some of these disruptions will be temporary, while other pre-pandemic trends accelerated and will persist for the foreseeable future. Fortunately, there is more clarity today relative to the uncertainties we faced a year ago. In this report, the Commercial Mortgage-Backed Securities/ Commercial Real Estate team at DoubleLine evaluates where the sector stands today. We provide our observations and assessment of the current CRE landscape and outlook for opportunities within the CRE debt markets.

Observations

One of the most pronounced effects of the pandemic and succeeding lockdowns and reopenings has been bifurcated outcomes between the proverbial "haves" and "have-nots." These dichotomies are evident not only across but also within property types and further nuanced across geographic markets. Across property types, despite the ongoing improvement in CMBS delinquency performance over the past 12 months, lodging and retail remained the two hardest-hit sectors, while multifamily, industrial and office demonstrated stronger resiliency during this period. *(Figure 1)* A big driver for the lodging and retail underperformance has been the impact from the health scare and resulting lockdowns, as hotels are "leased" by the day, while retail properties have been hampered by rent collections and store closures, and such borrowers have exhibited diminished ability (or willingness) to make debt payments.

Conduit CMBS 30-Day+ Delinquency by Property Type

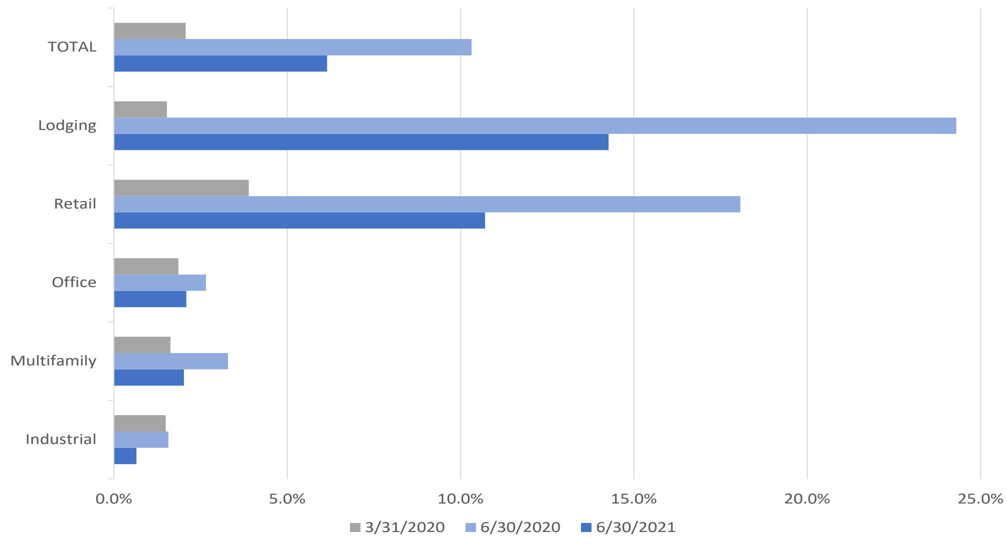

Figure 1
Source: Trepp

Observations (cont'd)

Within property types, bifurcation is evident as well. In lodging, the sector has experienced continuing improvement, with second quarter 2021 revenue per available room (RevPAR) at negative 22% versus negative 42% in the first quarter and June RevPAR at negative 14% versus the same period in 2019. However, we observe significant variance across markets and within lodging subtypes. Seasonal leisure demand drove second quarter RevPAR in resort locations to improve to negative 2% versus negative 42% in the first quarter relative to urban locations at negative 51% versus negative 63% in the first quarter. Furthermore, second quarter economy chain RevPAR improved to 5% while higher-end chains (luxury and upper-upscale) trailed at negative 40%.[1] Although hotels catering to business travelers have continued to underperform, we see promising green shoots as convention events start to get on the books and business transient demand slowly recovers as workers return to the office.

Transaction activity has also increased, with second quarter 2021 transaction volume up approximately 79% and sales price per room up 16% versus the same period in 2019.[2] Sales for leisure hotels set records, including the highest per-room sale price in North America for Ventana Big Sur, which sold in June for $148 million ($2.5 million per room), and the highest per-room sale price for a select-service hotel for Residence Inn by Marriott Maui Wailea, which also sold in June for $148 million ($740,000 per room).[3] In contrast, urban full-service hotels have continued to trade at a discount to their pre-pandemic values. With more clarity on valuations amid rising transaction activity, financing availability has also continued to improve: More issuers of CMBS and nonbank lenders have become more receptive to lend on lodging properties. Examples of this recovery in CRE financing include the $4.65 billion single asset, single borrower (SASB) transaction supporting the June acquisition of Extended Stay America by funds managed by Blackstone Real Estate Partners and Starwood Capital Group, the largest CMBS deal of 2021 to date.[4]

Within multifamily, the bifurcation in performance between properties in gateway markets, which include New York and San Francisco, relative to nonprimary markets was observed early on in 2020 and continued throughout the year. *(Figure 2)*

Multifamily Trends in 2020 by Market [5]

Market	Net Absorption 2020	Net Absorption % Stock 2020	Occupancy Rate Dec. 2020	Avg. Rent Dec 2020
National	**252,013**	**1.7%**	**94.7%**	**$1,389**
Secondary	154,112	2.3%	94.5%	$1,337
Tertiary	96,160	2.0%	95.4%	$1,183
Gateway	-7,599	-0.3%	93.9%	$2,201

Figure 2
Source: CRE Finance Council, June 2021

Signs of improvement have appeared within primary urban markets, as absorption, occupancy and rents have improved with concessions moderating. We expect this trend to further improve with the continued return to the office. Within nonprimary markets, occupancy and performance remained resilient even during the depths of the pandemic. In recent months, these markets have shown strong rent growth, which we expect to continue over the near term. *(Figure 3)*

Multifamily Rent Growth vs. Net Absorption as % of Stock[6]

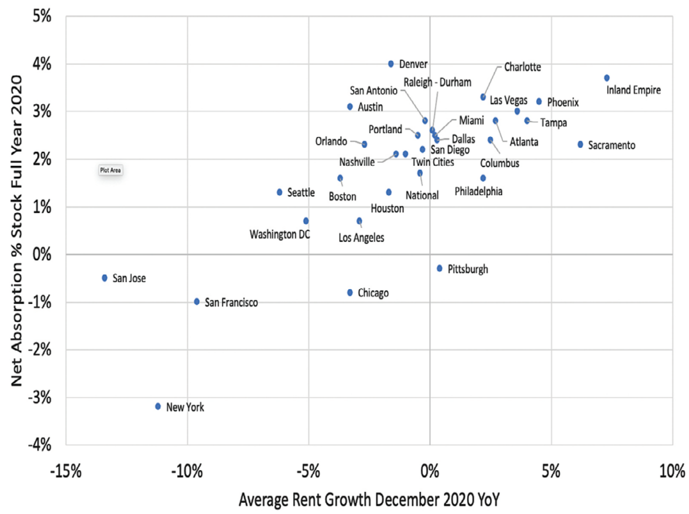

Figure 3

Observations (cont'd)

The outlook for office has been a prominent topic of discussion given the uncertainties with future demand, as there is broad variance in how tenants are approaching work-from-home (WFH), full-time-in-the-office and hybrid work trends. While the early stages of the pandemic were characterized by delayed leasing activity, short-term renewals and a significant increase in sublease space, those headwinds appear to have subsided over the past three to six months amid renewed activity. Within office, we observe bifurcation between the better-located, higher-quality properties and more-commoditized properties that are not as well located or maintained. Tenants have used this opportunity to trade up in quality to properties that are newer, better located and better amenitized, where any increase in rents relative to their prior space might be offset by reduced space needs. While the hybrid model currently is the predominant plan for a majority of office users, this does not mean the end of office use but rather a shift in how offices will be used – namely to be more collaborative and flexible. While this hybrid shift might lead to some downsizing of space, it is important to note that tenants still need to be thoughtful to optimize space for current employees as well as manage for future growth. There will continue to be uncertainty on how these trends will impact office needs; over time, companies will experiment and adjust to what works best.

It is worth noting prior examples where several companies, including IBM, Yahoo and Aetna, have reversed their WFH policies to return employees full time to the office, citing the need for in-person interaction and to foster more collaboration and innovation. We are mindful that although circumstances and the technological landscape have changed, the collaboration, mentorship and camaraderie that only results from in-person interaction remain critical today. Another interesting observation is that many tech companies, which have been at the forefront of the WFH dynamic, have actually expanded their office footprints across markets and were one of the biggest drivers of leasing demand in 2020. We will remain cautious as these trends play out and also constructive that office demand will prove to be more resilient and relevant over the long term.

Inflation is also a topical discussion in today's environment. Headline consumer prices in June rose 5.4% from a year earlier, the largest year-over-year increase since August 2008, when headline inflation reached 5.3% just prior to the Global Financial Crisis (GFC). For now, we expect continued inflationary pressures from rising demand, driven by the government stimulus and continued reopening of the economy, coupled with supply constraints due to supply-chain bottlenecks, imbalances within the labor market and impacts from climate change. While some of these impacts will be transitory, others are likely to persist and remain sticky. We are mindful that inflation by itself shouldn't be evaluated in a vacuum, one should weigh the broader economic factors, including U.S. debt, GDP growth, employment and the interest rate environment, in conjunction with inflation. However, let us examine inflation solely in the context of CRE. Real estate is generally considered a good hedge for inflation due to 1) cash flow appreciation – real estate generates income where rents reset periodically and leases have built-in fixed or Consumer Price Index-linked increases – and 2) valuation appreciation – values for hard assets tend to increase during periods of inflation, further supported by rising replacement costs and construction costs that limit supply.

Given the broad impact, it is important to evaluate the influence of inflation on the revenue line, namely the ability to increase rents and the pricing power of these increases, in conjunction with operating expenses and capital expenditures required for each property type. Properties such as hotels, self-storage and multifamily, with the ability to reset rents daily, monthly and annually, respectively, are able to maintain inflationary pressure more frequently than properties on long-term leases. Furthermore, certain property types, such as multifamily, industrial and self-storage, can have stronger pricing power given the current supply-demand imbalances and underlying market fundamentals that allow owners to increase rents. Similarly, it is important to factor in each property's operating expense and capital expenditure requirements as well. Properties such as office, multifamily and lodging have either higher operating expenses and/or capital expenditure requirements that are the owner's responsibility and will impact profitability.

Observations (cont'd)

As one example, hotels, which have typical operating expense margins averaging 70% (with labor comprising one of the largest components of expenses) and high recurring capital expenditure needs, will need to manage these costs as occupancy increases to maintain profitability; or in the alternative, utilize technology or other cost-saving initiatives to offset increased expenses. We evaluate property types based on the revenue line, which includes the ability to reset rents and pricing power, and the operating expense margin/capital expenditure requirements in the context of an inflationary environment. *(Figure 4)*

CRE Property Type Framework

	Opex Margin/Capex Requirements	
Rent Reset / Pricing Power	High	Low
High	Lodging Multifamily	Industrial Self-Storage
Low	Office	Retail

Figure 4
Source: DoubleLine

We generally expect certain segments within CRE, such as industrial, self-storage, and multifamily, to outperform in an inflationary environment on a relative basis over other property types, such as office and retail. However, in tandem with the bifurcation impact across property types, we highlight the importance of not overgeneralizing and painting the market with a broad brush, as each property requires granular analysis as impacts within each property-type segment and market can vary greatly. As an example, limited/select-service and extended-stay hotels tend to have lower operating expenses versus full-service hotels and resorts. Geography also plays an important role in divergent outcomes, markets such as New York and San Francisco have higher operating costs versus markets in the Sunbelt states. Furthermore, the tenant lease structure will also impact this framework, as triple-net-leased properties, where tenants cover all operating expenses and capital expenditures, will help offset rising operating expense and capital needs for the property.

Opportunities in CRE Debt Markets

Taking into account the composition of the U.S. CRE market and uncertainty surrounding inflation in combination with rising interest rate risks, we find several attractive areas of opportunity within the CRE debt markets. Within the CMBS space, the interesting opportunities are in the SASB market, particularly in floating-rate transactions where investors can express investment views on specific property types backed by strong institutional sponsors. In the CRE collateralized loan obligation (CLO) market, there are also opportunities given its floating-rate nature. We are constructive on this segment given its short duration. We would note the CRE CLO market has continued to be a subsector with meaningful issuance growth coupled with strong performance throughout the pandemic. This is a dynamic that will likely persist in the near to medium term as the private bridge lending market continues to take market share from traditional bank lenders due to the pullback in traditional lending.

Within the private debt market, we are constructive on CRE loan opportunities. The outstanding commercial mortgage market currently stands at $3.9 trillion. Nonbank lenders make up 10% of this market, and we expect this share to grow. With credit spreads across fixed income bond markets at or near post-GFC tights, attractive opportunities remain on a relative value basis within the private debt market as it is less efficient. In terms of opportunity-set backdrop, a large wall of loan maturities is coming due with approximately $2.4 trillion of commercial mortgages scheduled to mature over the next five years, between $400 to $500 billion annually. This volume of maturing debt, coupled with some tightening of lending standards from traditional lenders (e.g., banks and insurance companies), should provide opportunities for private-capital lenders to gain market share while being selective. *(Figure 5)*

Commercial Mortgage Maturities

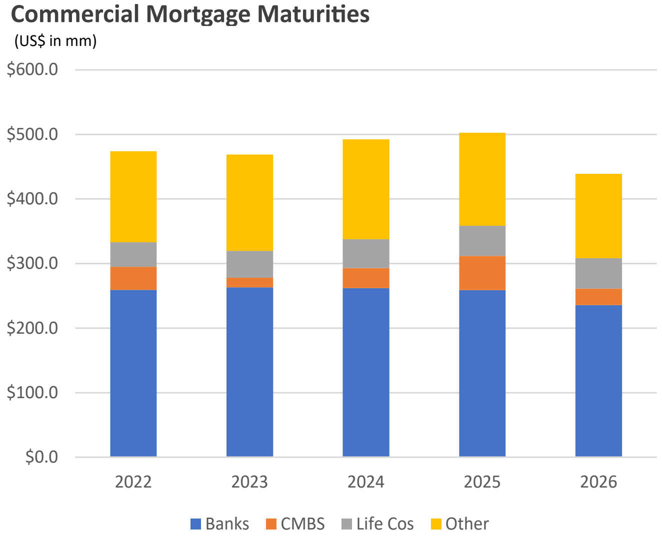

Figure 5
Source: Trepp

Opportunities in CRE Debt Markets (cont'd)

The CRE market is experiencing a bifurcated recovery, and we provide our general observations within certain segments within the CRE landscape. We highlight the importance of not overgeneralizing across property types as CRE risk is inherently idiosyncratic and requires an in-depth, granular analysis of each investment and dedicated ongoing focus on surveillance and asset management. Having the deep expertise of our experienced, credit-oriented team is critical in the ever-changing CRE landscape where being selective about investments is paramount.

DoubleLine's CMBS/CRE team manages $12.6 billion of CMBS and has been involved in the direct origination and purchase of over $1.7 billion CRE whole loans since 2014. Through its CRE debt investment platform, we believe the firm is well positioned to capitalize on opportunities within the CRE debt universe. ■

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Author Biographies

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Portfolio Manager, CMBS/CRE

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.

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Mr. Cho joined DoubleLine in 2013. He is a Portfolio Manager responsible for the CMBS credit platform at DoubleLine and participates in the CRE New Investment Review Group. Prior to DoubleLine, he was an Investment Associate at H/2 Capital Partners covering a broad range of real estate credit opportunities. Previous to that, Mr. Cho worked in real estate acquisitions as a Director at Jamison Properties and began his career as an Investment Banking Analyst at Lehman Brothers. He holds a BA in Economics from Stanford and an MBA from the Wharton School at the University of Pennsylvania. Mr. Cho is a member of the Founder's Circle of SPIRE (Stanford Professionals in Real Estate).

Citations

[1] Bank of America Global Research, STR Inc.

[2] Q2 2021 Select Major U.S. Hotel Sales Survey, LW Hospitality Advisors

[3] DoubleLine did not participate in these transactions.

[4] DoubleLine's participation in this transaction included exposure to Class A ($10.4 million), D ($15 million) and F ($10 million).

[5] "CRE and Multifamily Finance in the Spotlight: Multifamily Absorption Surprises on the Upside in 2020," CRE Finance Council, June 2021

[6] "CRE and Multifamily Finance in the Spotlight: Multifamily Absorption Surprises on the Upside in 2020," CRE Finance Council, June 2021

Definitions of Select Terms

Collateralized Loan Obligation (CLO) – Single security backed by a pool of debt.

Commercial Mortgage-Backed Securities (CMBS) – Securitized loans made on commercial rather than residential properties.

Consumer Price Index (CPI) – This index examines the weighted average of the prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by averaging price changes for each item in the basket. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

Revenue Per Available Room (RevPAR) – Metric used in the hospitality industry to measure hotel performance. The measurement is calculated by multiplying a hotel's average daily room rate by its occupancy rate. RevPAR is also calculated by dividing a hotel's total room revenue by the total number of available rooms in the period being measured.

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