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Fed support maintains liquidity in real estate capital markets

BY LORETTA CLODFELTER

The COVID-19 pandemic has brought widespread economic disruption and introduced uncertainty in the real estate capital markets over the past several months, similar to most other industries.

“The pandemic caused a sharp decline in the economy that did not leave the capital markets completely unscathed,” says Scott Lee, managing partner at Tauro Capital Advisors. “The CMBS market was hit the hardest. In April, almost all lending in the CMBS market stopped, followed by an influx in delinquencies in May and June.”

One of the factors affecting CMBS – a large percentage of hospitality loans were originated in the CMBS market, and hospitality was one of the industries that was most significantly impacted as travel, especially business travel, has evaporated amid the pandemic. STR reported U.S. hotel occupancy was 33.5 percent in the second quarter.

“That said, the CMBS market is already starting to rebound as new portfolios are being assembled and expected to be securitized within the next 60 days,” says Lee. “Beyond this, there are still a tremendous amount of capital sources available to meet investor demand, especially as the Fed has made several moves to support the capital markets and maintain liquidity.”

In March, the Federal Reserve cut the target federal funds rate to near zero. Other moves by the Fed include massive securities purchases, backstopping money-market funds, relaxing regulatory requirements, providing direct lending to banks and large corporations, and supporting lending to small and medium-sized businesses and nonprofit organizations.

The Fed’s actions have helped interest rates remain at historic lows, which has provided an opportunity for many investors to restructure their capital stack to fit their current needs, adds Lee.

In the current landscape, real estate financing remains available, but some terms have changed and some underwriting has become more conservative.

“One of the largest misconceptions that we see in the current market is this idea that there is a lack of capital available,” says Lee. “More than 50 percent of lenders have continued to lend as they normally would, despite the current environment. Naturally, a small number of lenders have left the market completely and others have become more conservative in their underwriting.”

Lenders are placing a significant emphasis on sponsorship, tenants and collections during the pandemic, notes Lee. Loans may be underwritten at slightly higher rates or lower leverage and loan-to-value levels over the next several months as the economy begins to rebound.

"However, there are lenders who see opportunity and are hungry for deals," adds Lee. "We are seeing lenders underwriting deals across almost all product types except for hospitality. For example, many currently view retail with uncertainty, as it is another sector that has been significantly impacted by COVID-19. That said, we have arranged financing on several retail deals that closed during the pandemic."

An ongoing question for investors at this time is: Where is the distress in capital markets? According to Lee, most of the potential distress right now is in the debt markets, and he predicted there could be opportunities in the debt sector in the future, but bid-ask spreads remain wide.

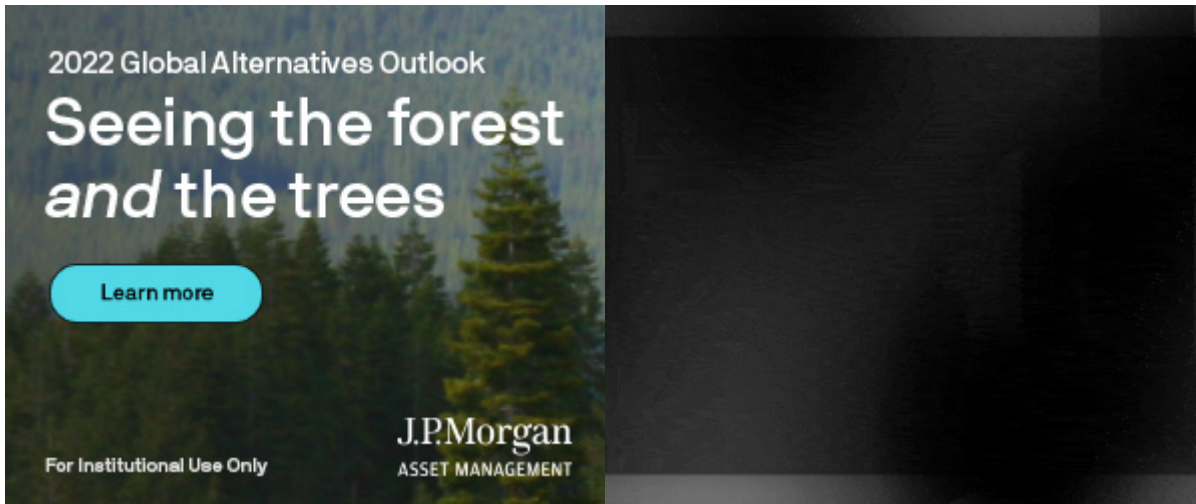
"Right now, potential sellers on one side are expecting par and potential buyers are looking for bargains and looking to buy at a discount," says Lee. "Currently, both sides are not willing to move one way or another. ... There is currently a gap between what investors are willing to sell at and what investors are willing to pay. Over the next six to nine months, we may see this shift and level off where individuals on both sides are more willing to come down or move up depending on the current market landscape."

Lee adds: "The challenge right now is that most investors are currently able to defer interest payments, so there is not much pressure to sell unless an investor's loan is coming due. It is likely there will be opportunities to acquire distressed debt at a discount toward the end of the year and into 2021; however, we have yet to see these opportunities truly emerge in the current environment."

Loretta Clodfelter is senior editor of *Institutional Real Estate Americas*.

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