Commercial real estate: The mounting disconnect between buyers and sellers in a COVID economy - by Joshua Olshin

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Distressed commercial real estate loans on the rise, while pricing of real assets remains sticky and transaction volume shrivels up. Severe buyer-seller disconnect, particularly in New York, will soon correct and present opportunities for investors.

Since the Coronavirus hit the United States nine months ago, our world has been turned upside down. For owners of commercial real estate, this has been most literal, as people have been forced to vacate offices, hotels, restaurants, school and malls and started working from their homes and learning, buying and socializing online.

Like every other aspect of this crisis, signals from the CRE market have been inconsistent, if not completely elusive. For example, last spring Facebook announced that all its employees can

permanently work at home. Then two months later, we received a very different signal when it was announced that they had entered into a lease for almost 730,000 s/f of new office space in Midtown Manhattan.

However inconsistent the anecdotal evidence is, I believe that by reviewing currently available data and information, a distinct picture is forming as to where we may be headed over the next 18 months. Investors should be patient, as historic buying opportunities will no doubt arise.

Distressed Loans on the Rise

According to banks and special servicers the inflows of nonperforming loans is starting to overwhelm them. Real Capital Analytics estimates that approximately $40 billion in loans became classified as “distressed” in the second quarter of this year alone. For perspective, that is a 20-fold increase from the same quarter in 2019, and well above the $35 billion record previously set during the worst quarter of the financial crisis. Many players have entered this market buying up this distressed debt at a discount and for the first time since the great financial crisis, we are seeing distressed strategies such as “loan to own” being broadly considered. This played out recently as Pacific Retail Partners and Golden East Investors were able to gain control of the underlying mall portfolio of Starwood after Starwood defaulted on its debt.

Not surprisingly, this first round of distressed debt is coming mostly from hospitality and retail properties. But office loan default rates are mounting at a very quick pace, as the pandemic continues and stimulus packages are delayed.

Price Growth is Positive for the Year

While certain types of CRE loans are in trouble and trading at a discount, pricing of real property in the aggregate has held up. CRE price growth for September 2020 actually rose by 1.4% year over year according to the Real Capital Analytics Commercial Property Price Index. Though the underlying breakdown is a little more nuanced, with gains in the multifamily (up 6.7%) and industrial sectors (up 7.4%) balancing declines in retail (down 5.3%) and office (down 1.5%).

This strong price support for CRE in the face of depressed CRE loan pricing is in part the result of widespread forbearances being granted by lenders. This laxness, while encouraged by the regulators, has also made sense in many ways because the world changed so quickly. But this spirit of forbearance is rapidly coming to an end. I was recently on a panel with one of the largest special servicers in the country, who stated in no uncertain terms that hard decisions were imminent. Everyone got a pass last spring, but at this point, only the stronger borrowers with a good business and strategic plan to survive and credibility will be given further leniency. The day of reckoning is coming, which means forced sales down the road.

The more significant reason for CRE price indices holding up as well as they have, has been the lack of transaction volume. Although CMBS trading volume is up 26%, CRE transaction volumes were down 57% in September. Transactions are just not occurring and market illiquidity seems to be

masking the true decline in underlying valuations. The extent of this freeze has been somewhat surprising because there is pent up demand in the market. I speak to buyers on a daily basis and it seems like would-be buyers have been coming out of the woodwork to search for properties, and private equity and other promoters are raising funds at unprecedented levels. – all clamoring to buy. We also getting seller calls, inquiring as to the timing and conditions involved to auction a property. So the low transaction volume is not the result of people being in lock-down and out of the marketplace. Rather, the low transaction volume is the result of a wide disconnect between the pricing expectation of buyers and sellers.

This disconnect is widely felt. According to a recent CBRE survey, 61% of CRE buyers are looking for discounts from pre-pandemic prices, while only 9% of CRE sellers are actually willing to offer them. Among buyers looking for discounts, nearly 75% were for office or retail properties and 95% were for suburban office. At Auction Advisors, we are constantly having to ascertain the immediately realizable value of a property, and bridge the gap between seller and buyer expectations. This is a challenge even under the best of times. But the extent of this disconnect in the market today is staggering, and an ominous harbinger of things to come.

Analysts at the MIT Center for Real Estate Price Dynamics Platform have tried to quantify this disconnect, by examining the price adjustments that would be needed to keep deal volume at a historical average. They have determined that right now CRE buyers have an expectation that is 12% lower than owners on a nationwide basis, and for those in the New York metro area, buyer price expectations are a whopping 27% below what owners want to sell for. These sorts of models must be taken in perspective; however, I do think at least directionally they match up with what real estate professionals have been experiencing these past few months. History has shown that as lenders start to force sales and other catalysts take effect, Seller expectation will eventually fall and the markets will find an equilibrium at lower pricing levels. But this will still take some time.

Keep in mind, that during the great financial crisis it took almost two years (from August of 2008 to July 2010) for peak to trough pricing of CRE to decrease a total of 34%. Many then saw incredible returns as pricing proceeded to rise by 250% in the following decade. So for investors I reiterate the need for patience. Let this cycle play itself out—great long term opportunities are on the horizon. And for sellers, while valuations may not be what they once were, know there is still a robust marketplace of well financed buyers ready, willing & able to step in and acquire CRE at reasonable prices.

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