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November 2020 • perenews.com



US Roundtable 2020

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Distress is coming

Since the pandemic began, vast amounts of capital have been raised by mega-managers to jump on distress investment opportunities. Their time to deploy that capital is near. By [Arshiya Khullar](#)

The unprecedented events of the past eight months have sent the US economy into a tailspin. The country's GDP plunged 31.4 percent in the second quarter.

Staggering numbers of job losses and shuttered businesses led to a 7.9 percent unemployment rate in September, believed to be the highest ever ahead of a presidential election. The US trade deficit stood at \$67.1 billion in August, the highest level in 14 years. Economists fear the US faces a double-dip recession if the coronavirus outbreak worsens in the winter months. At press time, the disease had already taken more than 220,000 lives and infected more than 8 million Americans – including president Donald Trump and several White House staff.

It is hard to find a silver lining in a grim reality, compounded by simmering racial tensions and protests since the death of George Floyd in May. For money managers in a financial world awash with liquidity, however, times of crisis are

times of opportune investing. More liquid investors have already capitalized on the stock market rallies over the past few months. Long-term investors in real estate and other private assets, meanwhile, are waiting for distress to show up in the system.

The discussion at this year's US roundtable, conducted virtually with three managers and an investor investing across the risk spectrum, centered on the market's expectations around the timing of this distress – the biggest talking point in US real estate today – and how it could be impacted by macro events, particularly the US presidential election.

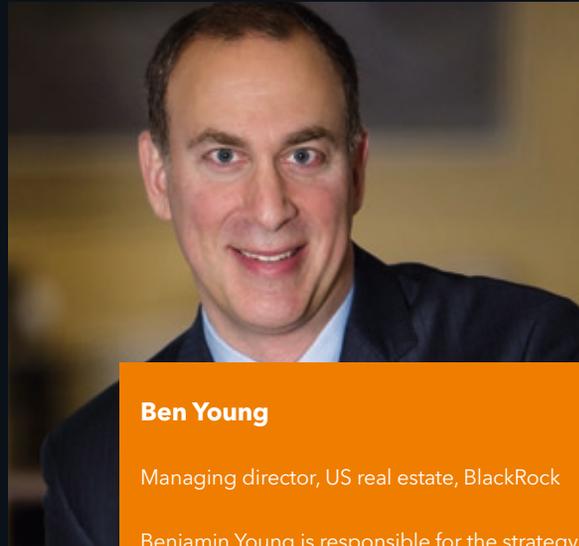
“Distress is coming, no matter what, and irrespective of what is going on with the elections,” says Ben Young, head of US real estate at global asset manager BlackRock. Young, who leads BlackRock's US business, which manages \$7.5 billion in real estate equity assets, says his firm is being patient on the value-add and opportunistic side. “We think there is a massive opportunity. But it is not coming



Boyd Fellows

Head of capital markets, ACORE Capital

Boyd Fellows is a founder and managing partner overseeing capital market activities, investor relations and marketing. He has over 35 years' experience in the commercial real estate finance industry and capital markets. Prior to ACORE, he was president and a member of the board of directors of Starwood Property Trust.



Ben Young

Managing director, US real estate, BlackRock

Benjamin Young is responsible for the strategy and portfolio management of the firm's real estate investments stateside. Prior to joining BlackRock in 2014, he oversaw the real estate distressed debt platform at Strategic Value Partners and has also worked in senior roles at RREEF, the former real estate asset management arm of Deutsche Bank.



Bert van den Hoek

Senior portfolio manager, Bouwinvest North America

Bert van den Hoek is responsible for portfolio construction and investment performance. In 2020, he opened Bouwinvest's New York office. He has previously held executive positions at Partners Group, Deutsche Asset Management and GIC Real Estate.



Matt Colter

Managing director, head of industrial group, Crow Holdings Capital

Matthew Colter has been a member of the real estate team since 2003. His primary role is investing in stabilized and development opportunities throughout the US. Colter is a member of the Crow Holdings Capital Investment Committee.

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until the end of the year, or early next year. We think time and liquidity will force sellers, not necessarily on value decisions, but on liquidity decisions.”

Post-March plan of attack

This imminent opportunity has been in the making since March, when the world came to a halt, putting an indefinite pause on everyone’s planned roadmap for 2020. How a firm reacted to the turn of events depended on where it operated in the capital stack as well as its sector focus. The one common theme was the heightened focus on asset management.

“There were bond investors that took very tactical moves, whether in CMBS or Freddie Mac bonds. They did very well in the short term. That is not who we are. We are the long-term, private investor,” says Young. “What we did once the pandemic hit was emphasize our asset management. We did not jump into a ton of assets. We did not sell a ton of assets either, although we were in the process of selling multifamily assets pre-pandemic and that still held up without price changes.”

Others, like Dutch pension fund manager Bouwinvest, entered 2020 with ambitious expansion plans for its North America business, including the opening of a satellite office in New York. Bert van den Hoek, who relocated to the US to assume the position of senior portfolio manager for North America, says that plans to open this office were made quite some time ago, so Bouwinvest “pursued it, notwithstanding the short-term disruption in the environment.”

Moreover, since Bouwinvest typically plans its investments on a three-year rolling basis, the coronavirus setback in March did not materially alter its commitment goals for the year. “In 2019, we made significant commitments in the residential and industrial sectors. So, coming into 2020, we did not have a drive to make a lot of new commitments during the year,” he adds. “From March onwards, we focused on making

“We think there is a massive opportunity. But it is not coming until the end of the year or early next year”

BEN YOUNG,
BlackRocke

sure we knew where the risks were in terms of the fundamentals, valuations and leverage for our \$1.65 billion equity investments.”

The lockdown brought most real estate activity to a standstill. But industrial and logistics were one property type witnessing an acceleration in momentum, driven by the surge in e-commerce demand. Matt Colter, head of industrial at Texas-based manager Crow Holdings Capital, says e-commerce was 15 percent of all US retail sales before covid-19. But there are now estimates that penetration could increase to nearly 40 percent by 2030. “An already healthy environment for industrial development is likely to be supercharged by this pandemic,” he says.

Crow Holdings is understood to have a pipeline of deals totaling \$500 million. The firm is also in the market with Crow Holdings Realty Partners XI, a 2019-vintage value-add fund that has already attracted over \$750 million in capital from investors including the Teachers’ Retirement System of Louisiana and the South Carolina Retirement System, according to *PERE* data.

Colter agrees the uptick in demand for industrial products has also prompted the firm to revise its performance target. “Given the strong industrial demand, we have been able to adjust up our underwritten returns from the mid- to high teens,” he says. “This is reflective of the returns we expect to generate largely in the speculative development world, because existing product is priced to, or beyond, perfection. As a point of reference to the continued demand, across our portfolio since covid-19, we have executed leases on 2.8 million square feet and at an average of 12 percent above underwritten market rates.”

On the debt side, things looked a lot different. Jim Costello, senior vice-president at deal data firm Real Capital Analytics, noted in a March blog post that a floor was already being reached for mortgage rates despite

Election watch

At the time of our roundtable, US elections loomed large. *PERE* asked the participants for their views on how the commercial real estate industry would fare under a Joe Biden versus Donald Trump presidency.

Matt Colter: “It will likely be a rocky road in the near term either way; however, if Biden wins and the Democrats take the Senate, there is belief it may increase the tax burden for commercial real estate going forward.”

Bert van den Hoek: “International capital markets are increasingly focused on sustainability. In the US, however, the focus has been mostly on the social and diversity elements of ESG. There is a long way to go on the ‘E’ part. Emissions that the real estate industry is putting into the environment need addressing, and it is our current understanding that investment in infrastructure and focus on the environment may be higher if Biden gets elected.”

Ben Young: “The change in SALT tax deduction under the [Trump] administration has negatively impacted the blue states, contributing to a movement of people to red states. There will also be massive deficits in big cities on the East and West Coast, implying higher taxes, whether individual or property-level, and increased insurance. This will drive short-term value decisions.”

Boyd Fellows: “If the Democrats take the Senate and White House, there is a much higher probability that stimulus will be created to help the states and cities that are in very deep trouble with their deficits. That will be a silver lining. As a result, the return to urbanization is likely to happen sooner if the left wins. If the right wins, you will see protracted pain in the cities, making them less attractive to live in for a longer period.”

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BOYD FELLOWS
ACORE Capital

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BEN YOUNG
BlackRock

accommodative monetary policies, including the target federal fund rates being reduced to zero. In its US Capital Trends report published in August, RCA notes the CMBS originators comprised only 1 percent of the originations in the commercial mortgage market in Q2 2020, while their share was always in the range of 14 percent to 20 percent between 2015 and 2019. So-called ‘investor-driven lenders’ consisting of debt funds also started retreating and took up only 5 percent of the total market share. Only bank lenders remained the most active in the second quarter, accounting for 54 percent of originations.

California-based ACORE Capital is a debt shop that originates, acquires

and manages mortgages, B-notes, mezzanine debt, bridge loans and preferred equity throughout the US. The firm has a portfolio of more than \$15 billion in roughly 200 loans, with most over \$100 million. Once the pandemic hit, managing partner Boyd Fellows says the firm immediately reverted from an origination focus to the asset management of the portfolio, re-underwriting every asset and quickly triaging the book to focus on its more challenging loans. “At this point we were cautiously optimistic,” he says.

Then the market gradually started taking a turn for the worse, he says. “Things slowed down suddenly in April. In May, several deals that were already deep in process were

restructured and closed. While we had a few new inquiries in June as well. In July, it was crickets. Activity went to near zero. I have been doing this for 25 years and I have never seen a time as quiet as July.”

Signs of distress

On one hand, new acquisitions were scarcely being pursued, despite a zero-interest rate environment and abundant dry powder in the market waiting on the sidelines to be deployed. But there was no material uptick in distress sales, either. As a consequence, there was no price correction or reset in asset valuations to appropriately reflect the ongoing turmoil.

In August, for example, there were only \$13.9 billion-worth of US commercial real estate transactions, a 68 percent year-on-year drop, according to RCA’s report. All property types recorded a decline in transaction volumes, with hotels, retail and offices leading the chart.

When asked why the recession did not trigger distress asset sales in the past few months, even amid widespread economic distress, Young draws comparison to the global financial crisis. “If you look back to the GFC, public markets hit bottom around Q1 2009, and private equity markets hit bottom a year later. Private debt markets were even slower. The height of distress only happened at the end of 2010-11,” he says. “So, I am not surprised that private markets are tailing the public markets even today. There will be situations – like during the GFC – where liquidity is going to drive decisions. That could be in hospitality, office or multifamily.”

There are growing signs today that such situations are around the corner, prompted mainly by the changing behavior of the lending community. Indeed, as Fellows remarks, lenders play a big role in the “timing of the acceleration of the pain.”

“When the pandemic began unfolding in March, almost all lenders

were being generally accommodating, in part out of a desire to be part of the solution. Lenders were quick to defer interest for three months without receiving much in return,” he says. “That is over. There is no more obligation to help felt by lenders across the board. It is time to pay your interest.”

He adds: “This will start to precipitate illiquid borrowers being forced to sell. Most sellers in the market so far were desperate due to a lack of liquidity. As lenders draw a line in the sand, you will see more borrowers forced to liquidate assets to pay off their loans.”

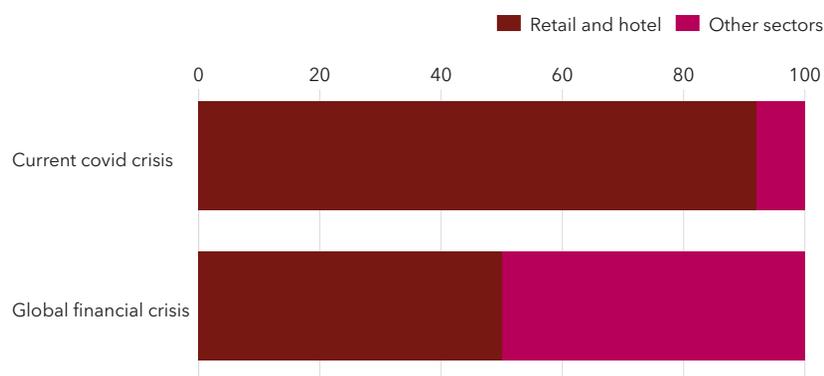
“Over the summer, people literally and figuratively had their heads in the sand. Now the rubber has met the road and gloves are off. Foreclosures and asset sales will take some months to materialize,” agrees Young.

As if on cue, private managers across the capital stack have been preparing their war chests to jump on this buying opportunity. The past two months have been banner fundraising periods, especially for real estate debt funds. According to PERE data, \$4.6 billion was raised by US closed-end private real

The US saw just \$627m in distress sales transactions during Q2 2020, indicating sellers are not feeling pressured to sell just yet

Sector	Distress sales count	Distress sales (\$m)	Share of sector sales volume
Office	13	365.5	3.1%
Industrial	6	44.5	0.4%
Retail	16	120.7	2.4%
Apartment	5	38.2	0.3%
Hotel	6	57.6	7.8%

Retail and hotel assets - real estate's two most troubled sectors - comprised the bulk of all second quarter distress activity, significantly more than during the global financial crisis (%)



Source: Real Capital Analytics data

“From March onwards, we focused on making sure we knew where the risks were in terms of the fundamentals, valuations and leverage for our \$1.65 billion equity investments”

BERT VAN DEN HOEK, BOUWINVEST

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estate debt funds in August versus \$950 million in July. September has been the best fundraising month in 2020 so far, with \$8 billion in total US real estate debt fundraising. Driving this activity was Blackstone's \$8 billion final close for Blackstone Real Estate Debt Strategies IV, the largest real estate credit fund ever raised in history.

Sectors in distress

Once distress does show and kickstarts a price correction exercise, certain property sectors will face bigger headwinds than others.

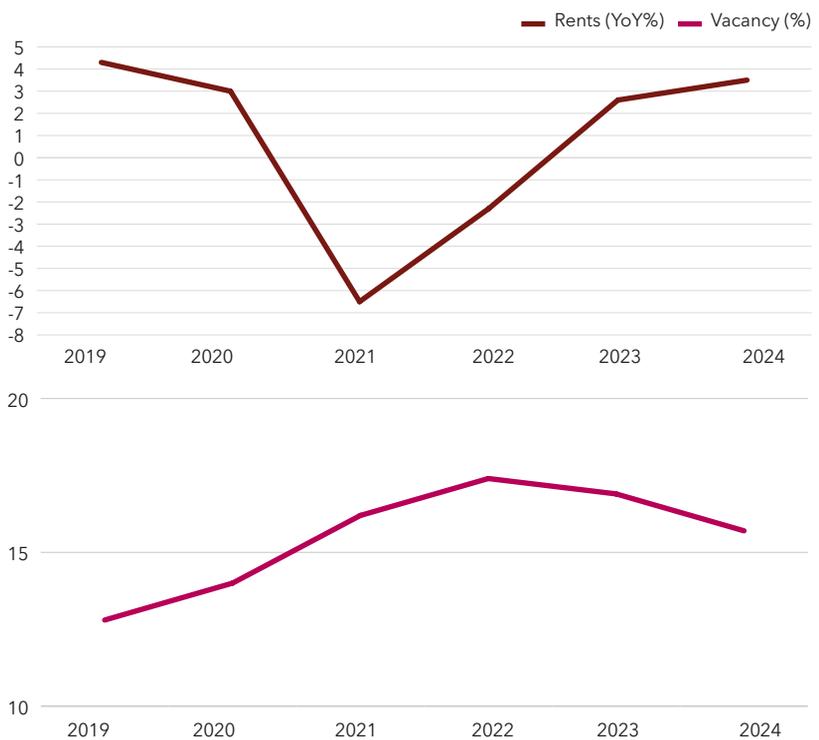
With global travel ground to a near-halt since March, and second waves of covid-19 infections dampening the gradual pick-up in tourist and business travelling in many parts of the world, concerns over the future cash-flows of hotel assets are mounting. Inflated loan delinquency rates of many hotel borrowers could trigger waves of foreclosures in the hotel and hospitality industry, such as the reported closure of the Luxe Rodeo Drive, a luxury hotel in Beverly Hills. Indeed, hotels comprised 50 percent of what RCA describes as "newly troubled assets" in Q2 2020.

Depending on a manager's investment strategy, however, the challenges in the hotel sector could give rise to buying opportunities as well.

"We believe demand measured in room nights seen in 2019 will likely not return until 2023 and it could be another full year before price compression drives RevPar back to near 2019 levels," Fellows says. "Along the way, there will be plenty of opportunities to provide rescue capital in the hotel sector."

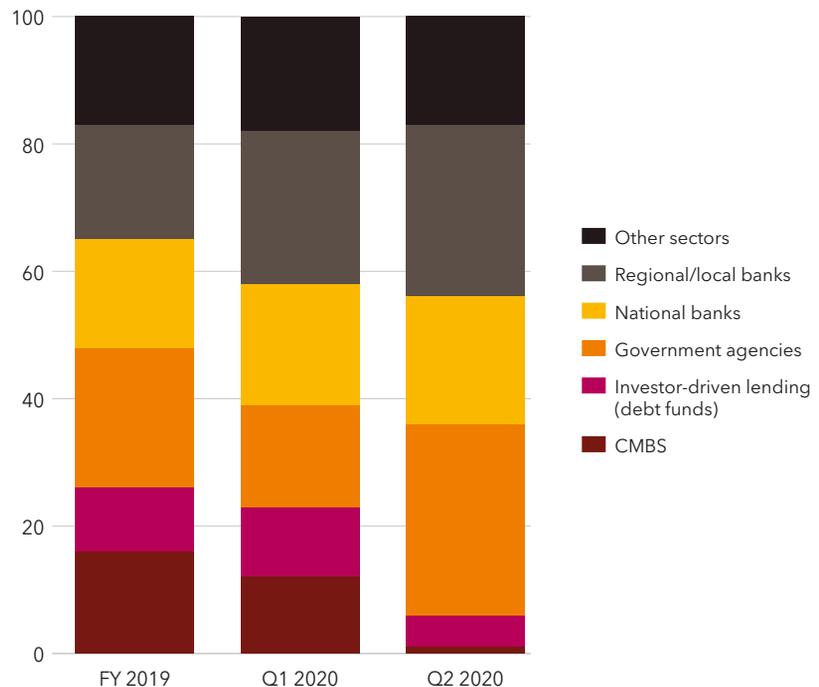
The other question marks are around retail and office assets. For the office sector, especially, uncertainty around the timing of a full-fledged return to offices, coupled with increasing deurbanization, threatens to reduce investor interest. Property services firm Cushman & Wakefield noted in a September report that US office vacancy could peak at as much as 17.4 percent

2022 and 2023 will be the toughest years for US offices, with negative rent growth and peak vacancy



Source: Cushman & Wakefield's Office Impact Study & Recovery Timing report, September 2020

Loan originations by CMBS and debt funds dropped in Q2 2020, while bank lenders and government agencies became major sources of debt capital (%)



Source: Real Capital Analytics

“Uncertainty in demand coupled with the risk of locking in long-term low-rate leases that require significant capital outlays makes offices a sector we will continue to underweight in the near term”

MATT COLTER
Crow Holdings Capital

in 2022, while rents are estimated to have a year-on-year drop of negative 6.5 percent in 2021 before ultimately bottoming out by Q1 2022.

Crow Holdings’ Colter wants to avoid the sector: “We were already under-allocated to office pre-covid. It is unclear how soon the workforce will return to the office and how many jobs will remain,” he says. “Uncertainty in demand, coupled with the risk of locking in long-term low-rate leases that require significant capital outlays, makes this a sector we will continue to underweight in the near term.”

Investors across the risk-return spectrum will end up readjusting their strategy to focus on recession and pandemic-resilient sectors that continue to benefit from secular trends. After spending time focusing on reviewing the portfolio, Bouwinvest’s van den Hoek says the firm finally got a green

light from its shareholder – the pension fund for the construction industry in the Netherlands – over the summer to start thinking about its next three-year investment plan. Bouwinvest has now set a target to expand its US portfolio from \$1.65 billion to \$2 billion by 2022, with a buffer until 2023 if more time is needed. The firm will give preference to investing in industrial and alternative sectors like life science offices and data centers over retail, he says.

Certain types of residential investments are also drawing investor interest. Colter says he is seeing greater value-add opportunities in manufactured housing and believes there will be potential for aggregation premiums. As Fannie and Freddie continue to lend within the sector due to their focus on providing affordable housing in the US, he says there will continue to be opportunities due to the fragmented

ownership market and limited new supply within the sector.

“Within the residential space, we feel covid-19, at least in the short term, will drive the suburbanization trend. We believe single-family rental is one sub-sector that shows a lot of potential, because it represents an affordable alternative over the long term,” adds van den Hoek. “As a firm we focus on affordable housing, because fundamentally that is where we see opportunities for long-term, sustainable returns.”

At the onset of the pandemic, the real estate industry, like almost all other industries, was singularly focused on preparing its business and workforce to survive and adapt amid unprecedented changes. The future is all about finding one’s feet and investing momentum in this new normal. ■