
R O U N D T A B L E

Abundant liquidity is keeping distress at bay – for now

The US commercial real estate debt markets are awash with capital, which has helped to head off distress. But the long-term impact of this liquidity is still up in the air, [Samantha Rowan](#) writes

The abundance of liquidity seen in commercial real estate debt markets today is the key difference between what happened during the global financial crisis and what is going on as the US emerges from the covid-19 pandemic. But this liquidity, combined with significant changes in behavior around office space, could have a significant impact on the longer-term health of the US real estate market, according to panelists on *Real Estate Capital USA's* inaugural roundtable.

The event featured a panel comprising Richard Mack, CEO and co-founder of manager Mack Real Estate Group; Warren de Haan, co-CEO of real estate debt firm ACORE Capital; Will Silverman, managing director at real estate investment banking firm Eastdil Secured; Jonathan Roth, co-founder of balance sheet lender 3650 REIT; Russ Appel, founding principal at manager

The Praedium Group; and Jason Hernandez, managing director and head of originations, debt, real estate, Americas, at manager Nuveen.

While topics ranged from the stark divergence between high-end and commodity office properties, the willingness of institutional investors to be flexible as investment horizons extend due to the pandemic, potential changes to the US tax code, and how lenders and borrowers are leaning into green lending strategies, the mostly cerebral conversation also analyzed how this liquidity has so far kept the market from seeing widespread distress.

Roth says he has never seen as many notices of sale under the uniform credit code as he is seeing now. But while this means the capitalizations done over the past few years are failing in some form or fashion, it is surprisingly hard to find a high degree of rescue situations.

“The distress is coming out in dribs and drabs now and it is coming

relatively quietly. There has to be public notices for sale, but the resolutions we are observing are being done privately and quietly,” Roth says. “Folks don’t like to admit or expose problems in their portfolios. Because of the amount of capital in the system, things are being resolved a lot more quickly than I would have otherwise expected.”

Appel adds his own analysis. He believes the liquidity in the market today has affected the amount of visible distress. It is a very different situation compared with the period after the global financial crisis.

“The period of illiquidity was so short during the pandemic and, quite frankly, the recession itself was short,” Appel says. “Obviously, this is different in that what happened wasn’t a financial system stress that caused broader issues. It was a pandemic that caused stress for a period of time and liquidity came right back into the market.”

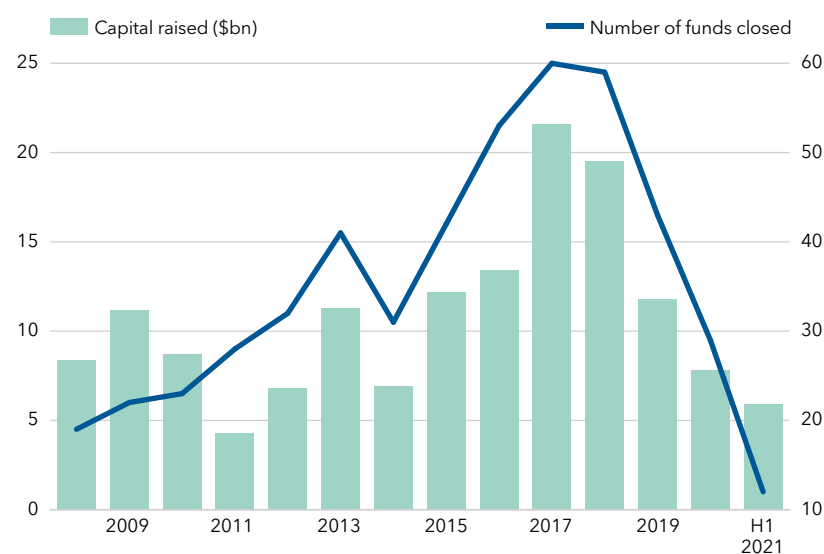
ACORE’s de Haan points out the pandemic-related liquidity crisis was able to be resolved quickly because, unlike during the global financial crisis, there were not the same kind of macro issues and over-leveraging affecting the markets.

“The forward-looking prognosis, though, is that we can see liquidity issues becoming credit issues within certain asset types, if the changes in behavior brought on by the pandemic persist in any material way,” de Haan says.

The biggest indicator of what might happen is how people behave with office, which de Haan says is the 800-pound gorilla looming over the market.

“We are concerned about the changes in behavior in the office sector. What’s going to happen to commodity, midblock class B office buildings in New York, or other major markets?” de Haan says. “People will occupy them, but at what price? If you’re paying \$75 a foot, pre-pandemic, for space and you had poor ventilation and small elevator banks and lobbies, as an employer that space becomes a ‘fairly unsafe’ place for

Capital raised by North America-focused private real estate debt funds



Source: PERE

Green lending

More US investors are interested in green investing and lending and making sure their managers are sensitive to green issues.

“I think European managers were at the forefront, followed by Canadian investors and now domestic US investors,” Praedium’s Russell Appel says.

The question is bigger than just green lending – it is more about ESG, ACORE’s Warren de Haan notes: “If your investors are institutional investors, you cannot ignore the topic, it is front and center for us.”

But green lending and ESG issues are very nuanced, panelists say. Richard Mack says: “Are investors prepared to take a lower return to follow their policies as it relates to real estate? I have not seen it yet. When that happens, it can start to influence the business. But no one is ready to do that yet.”

Appel concurs, noting this is true of both investors and consumers. “We haven’t seen many tenants willing to pay more in rent for additional sustainability features. It is a sensitive issue for investors. They want to see the same returns and they want green sensitivity as well,” Appel says.

Still, there needs to be a greater understanding about the environmental impact of building new properties. “In Europe, as it relates to office building, being green makes it less of a commodity, and I think we will see that in the US. I would argue the most green building you can have is an existing building,” Mack says. “When consumers of space say they want the newest building, and a green building, that is completely hypocritical. The cost and environmental impact of building new is huge and no one wants to confront that. To really be green, we need to retrofit existing buildings, with good bones, and make them environmentally state of the art.”



Jason Hernandez

Managing director, head of originations, debt and real estate, Americas, Nuveen

Hernandez is a managing director and head of originations, debt, real estate, Americas at Nuveen, where he is focused on expanding the firm's third-party debt business. He joined the firm in 2018 from ACORE Capital, where he helped to launch the business.



Jonathan Roth

Managing partner and co-founder, 3650 REIT

Prior to 3650 REIT, Roth was the president of Canyon Partners Real Estate. During his 18-year tenure at Canyon, Roth was instrumental in building out the firm's investment advisory business and in the formation and investment of several investment vehicles that invested more than \$5.6 billion.



Richard Mack

Chief executive and co-founder, Mack Real Estate Credit Strategies

Mack was formerly the chief executive of North America and managing partner of AREA Property Partners, where he was a member of the firm's US and European investment committees and oversaw strategy, investments and investment management.



Warren de Haan

Managing partner and co-chief executive, ACORE

De Haan is a founder, managing partner and co-CEO of ACORE. With more than 20 years' experience in the commercial real estate finance industry, he has also held senior positions at Starwood Property Trust and Countrywide Financial Corp. He was also a co-founder of Coastal Capital Partners and held a senior post in Nomura's commercial mortgage finance business.

Russell Appel

Founding principal, The Praedium Group

Appel has been building Praedium since 1991 and has overseen all aspects of its activities, including strategy and investment policy. He has also filled senior roles at the real estate groups of Credit Suisse First Boston - where he oversaw the execution of commercial and multifamily asset securitization and sale advisory assignments of more than \$13 billion - and Goldman Sachs.



Will Silverman

Managing director, Eastdil Secured

Will Silverman is a managing director at Eastdil Secured, where he handles functions that include investment sales, note sales and equity raising. Prior to Eastdil, he was a managing director at Hodges Ward Elliott and an executive managing director at Savills Studley.

your employees. Employers are more likely than not to upgrade, leaving that \$75 rent at maybe \$50 a foot [for the next tenant].”

Moreover, concerns about reduced demand for this type of office leads to the potential for over-building in adjacent sectors. This is a story that has been told in previous cycles with creative office and boutique hotels, which saw an influx of non-specialists which moved into these sectors without the right skills or relationships.

“We’re seeing a lot of inquiry for financing coming from developers chasing opportunity in sectors that are not core to their competency and relationships. For example, we are seeing traditional office developers who are saying, ‘Hey, I can build a life sciences building for \$1,200 per foot, compared to a normal office building that costs \$500 per foot,’” de Haan says. “While these sectors are performing beautifully right now, they’re not all made equal, and we could start to see some cracking over time.”

Still, de Haan points to the key difference between the global financial crisis and the pandemic and how that is affecting what is going on today. “Leverage levels weren’t at 85 percent or 90 percent this time,” de Haan says. “More importantly, the industry as a whole has maintained discipline. Loan structure is stronger and loan sizing is based off actual net operating income versus pro forma.”

In Hernandez’s view, this discipline means the entire system is in a better position. “Even if we do see that liquidity crisis flowing into a credit crisis, we’re better positioned going in and the capital structures are cleaner. If you want to inject capital into a deal, you can do it much more easily today than after the GFC,” he says.

Hernandez, however, brings up another potential specter for the market – the amount of control that best-in-class sponsors have over the terms of their loans. And once again,

this is a trend that is being affected in part by liquidity.

“The best-in-class sponsors always want to dictate their terms. It is a trend we are seeing a lot more of. We’re also getting a lot more pushback as liquidity has returned on the traditional mortgage-mezz structure,” Hernandez says. “What we are seeing now is that people are pushing back, partly for a cost issue, but partly because they don’t want to give you the mezz foreclosure rights. That’s caused us to be a lot more creative with how we finance our positions outside the traditional mortgage-mezz structure.”

The panel also raised concerns about the number of new debt funds launching. “Every day, we all wake to see someone else is launching a new debt fund. We all understand how to

operate real estate. But a lot of the new entrants in our industry are three guys and a Bloomberg, and we’ve all seen how that story plays out – it usually doesn’t end well for them,” Roth says.

This phenomenon translates into higher competition, which drives down pricing and loosens structures. “The world of class A borrowers gets to dictate a lot of terms now, whether interest-only for a 10-year loan, or no lock box, or even down to the way non-recourse carve outs are structured. I’m seeing a lot of very aggressive terms agreed to for those 1 percent borrowers. Everyone else has generally maintained discipline,” Roth says. “As lenders, our very best outcome is that we make a loan, and it gets repaid with interest. In light of such, you better have a structure that empowers you to get

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JONATHAN ROTH
3650 REIT

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The denominator effect

The denominator effect has meant more institutional investors are gravitating toward real estate, needing to deploy capital to keep their portfolios in balance. De Haan notes that perhaps today’s distress could more accurately be described as an opportunity for higher-yielding investors.

“A lot of investors are in finite-fund lives and the notion of getting pushed out 18-24 months on your business plan may not work for a number of equity sources that are stuck in existing deals,” de Haan says. “Capital structures are in motion and will continue to be in motion, even more as a result of deferrals and delays. So, maybe it is not distress, but it is really an opportunity for high-yield investors to rotate.”

Appel notes it seems investors are being more flexible and have greater sensitivity around changes in asset business plan time frames. “Most of the institutional investors that we deal with have to be invested so they have to take market risk,” he says. “They’ve been relatively flexible and that hasn’t been as much of an issue in the current environment challenge.”

Communication, as always, has been key as this process has unfolded, Roth says. “What we are finding is if you keep your investors informed about what is going on in real time, they can extend when you need to extend and shorten when you have to. We have been in a cycle of continual growth with a few interruptions,” Roth says.

The market is also being more flexible, panelists note, because no one could have predicted the pandemic. “As folks who spend our lives identifying, quantifying and mitigating risk, I did not anticipate a pandemic, nor did our investors. As a result of this uncertainty, folks are leaning in and being flexible because they still need to put capital to work, and realize good risk-adjusted returns,” Roth says.

Niche narratives

The question of allocating capital to niche sectors is a major topic. There is substantial demand from investors to get exposure to investment narratives where there might not be enough appropriate product to meet demand, Silverman notes.

“We have got that phenomenon in which the system is awash in capital and people have to choose among the best available deals at this moment in time. That forces them to run to the narratives most compelling at the moment.

“Of late, those narratives have mostly been national industrial and Sunbelt multifamily, and to a similar extent the niche sectors – life sciences, self-storage, cold storage or studio,” Silverman

says. “In the advisory world, we are fond of saying the only thing better than buying from a forced seller is selling to a forced buyer.”

The challenge around these niches is that there are more investors that want to plant the flag in life sciences, studio or cold storage than there are actual, good opportunities, Silverman

says. That has caused some to attempt to shoehorn other forms of real estate into these sectors.

“The overriding theme is that more capital has to find a home than the opportunity allows, which means that either prices have to rise, or the definition of the opportunity has to expand.”

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RUSSELL APPEL
Praedium Group

The question of the future of so-called commodity office was a critical one for the panel, with Silverman noting the future is not clear for properties that fall into this category.

The future of office

“We have developed a running joke internally – there is an easy definition of commodity office. It is office that someone else owns. Amazingly, no one seems to have one,” Silverman says.

But the idea of what is next for the broader office sector could be defined by elevated pricing for industrial and multifamily properties, Silverman says.

“We are getting that call now. We closed on a portfolio of workforce housing in New Jersey at a cap rate of 4 percent and are seeing sub-3 percent cap rates in the Sunbelt. That sort of activity has people saying, “Tell me more about New York office.”

The challenge in the office sector centers mostly around commodity office, given the structural issuances that trip tenants up. “You cannot do anything about columns or ceiling height. But there is still a strong bid for the upper leg of the K,” Silverman says, citing the following example. “We are raising equity for a boutique office building at a prime location in Midtown South that will be 300,000 square feet and does not deliver for five years. We have multiple term sheets on a deal that was underwritten at \$130 per square foot.”

Mack quickly notes, however, non-commodity office situations are a different world than commodity properties and the concerns being raised now are not new.

“Office was probably a bad business before the pandemic. We can call it whatever we want. But it is basically a J-curve business. It is no-cashflow, and it all goes back in [the building] every time a tenant leaves and you have to rebuild the space,” Mack says. “Technology companies and co-working space started to make everyone who owned office space look smart, even though

the underlying demand was not that strong, especially for commodity space. And now the pandemic is starting to make us acknowledge that one tenant is gone, and the other tenant only wants the best space.”

Additionally, work from home will continue to be a major factor. “All of those things were there pre-pandemic and people just didn’t want to look at them, especially the fact of owning office space from a cashflow perspective. We will see people who will cycle back to office if it gets cheap enough on a relative basis. But my view is that you are better off building industrial and multifamily than buying office on a relative basis,” Mack says.

While there is risk in the office sector, it is possible to take a single risk around an office loan, citing the example of a recent position the firm took in Chicago, Hernandez says.

“There was a disconnect on where the market was pricing the whole loan and where we could finance our position – we felt we could ring-fence the syndication risk. The underlying asset was a class A office asset with considerable WALT for a top-notch sponsor. Therefore, we felt the primary risk in the position was refinance three to five years out. At our leverage level and basis, we could get comfortable with that market risk.”

Again, the idea of a bifurcation in the sector emerged. “If we see a great office in a great location, with a basis that we can get our heads around, we will do that. As a credit investor, there is an incremental spread you can earn there. We are not making a macro bet on the office sector one way or the other. Our duration is much shorter versus a core equity investor so we can be opportunistic in pursuing select high-quality office positions,” Hernandez says.

The situation may be different for lenders than equity investors, Silverman says.

“I think there’s something that is going to happen. But it is hard to

pinpoint how far up the chain the contagion goes. If you look at all the hot asset classes, the one thing they all have in common is inelastic demand. Everyone agrees there is some sort of challenge towards the bottom of office, but no one can agree how far up it goes. We just do not know where the contagion will stop. It feels safe as a lender. You know it will be below a certain point. But as an equity investor, putting

a finer point on it is a much more subtle art.”

Migration markets

One of the biggest questions that needs to be answered is how will lenders – and institutional investors – put together their portfolios on an asset class and market basis.

There is one further question, de Haan notes. Lenders need to ask

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JASON HERNANDEZ
Nuveen

themselves whether the building they're looking at has a real reason to exist and can it compete in the new post-covid paradigm?

"We are not ready to make a bet on a commodity office building in many markets, particularly New York. It is too early to figure out if the rental rate is \$60 per square foot or \$45 per square foot and I would rather deploy money aggressively into migration markets where we're looking at the most attractive buildings," de Haan says. "Migration patterns are strong and persistent. Now, new supply could kick you in the butt in three or four years. But I am always more comfortable in the higher-quality real estate that is well located than the lower-quality real estate for the office sector."

Mack concurred, noting while it is clear there is a place for lower-end multifamily, this may not be the case for lower-end office. Retail is even trickier. "Other than the Shops at Columbus Circle, we do not have any other retail in our equity portfolio and in our debt portfolio, we have zero retail."

"The reason why we have no retail in our portfolio is not because we were brilliant or able to see the future. It is just that bad retail we could not get paid enough to do and good retail, we could not get paid enough to do it. It never made sense to us on a risk-adjusted return as a lender."

Mack posits that office might be the next sector that becomes harder for alternative lenders to do: "It may be that the European lenders compress that spread to lend on the better office and no one wants to lend on the bad office. Right now, office is a pretty interesting place to be an alternative lender and there is some spread, and it is worthwhile doing. But I don't think it is going to hold."

Roth notes, however, the asset class is idiosyncratic, and each asset needs to be analyzed individually. "Given the pace at which the use of real estate is changing, we have to be smarter about

"To really be green, we need to retrofit existing buildings, with good bones, and make them environmentally state of the art"

RICHARD MACK
Mack Real Estate Credit

Tax code changes

The consensus among panelists was the possible changes to the tax code have not affected sales as expected, even though there is a general acceptance state and federal taxes will rise.

"I do not think we are seeing as much tax-related selling as we thought we would see," Praedium's Russell Appel says. "Given the threat of the elimination of 1031 exchanges and capital gains possibly being taxed at the ordinary income rates, one would think you would see enormous volume and we really have really not."

Eastdil's Will Silverman concurs. "Everyone remembers the 2012 spike in activity [after tax code changes] and everyone thought that today would be 2012 on steroids. We are working on some assignments that are related to that and we're seeing some of that – it is a fraction of what we thought it would be. Part of it is that refinancings are so attractive right now that a lot of people say, 'I'll just do a more aggressive refi' and that is probably more attractive than paying any form of taxes. If rates were in a different place, or debt was not as plentiful, this might be playing out differently. In terms of the safe things that people would be 1031-ing into, those have been so aggressively bid right now that a lot of that looks unappealing to folks."

what the demand drivers will be. I have been pooh-poohing the naysayers about office because we are humans and social creatures and firms are doing better that are working together in the same four walls.

“We will get past the pandemic and there will be a mad rush back to life as we once knew it, subject to the technological changes that folks have become accustomed to. There is no substitution to showing up and sitting in front of a borrower or investor.”

Performance

Early in the pandemic, there was a widely quoted statistic that about

40 percent of borrowers asked for some form of relief from their lender. “We were no different,” Roth says. “But when you started having the real conversations a very small percentage of the borrowers actually needed relief. When we provided relief, it was mostly in the hospitality sector, where we fielded questions like, ‘Can I transfer my capex reserves to interest reserves?’ The answer was always ‘yes.’”

This flexibility had a direct impact on performance, Roth adds: “We have been more than delighted in the performance of our portfolio. When we built 3650, we did so on the belief that creating direct relationships with borrowers was of

paramount importance. As a relatively young firm, covid allowed us to test our plumbing, having direct real-time conversations and communications about potential problems afforded us the opportunity to avoid problems.”

De Haan notes there’s been a tiering in the market: “If you were one of the big mortgage REITs or debt funds with big balance sheets and access to capital and relationships, you had some leverage. There were a bunch of smaller lenders who got washed out. They couldn’t make margin calls. Maybe the lesson learned is that whether you’re on the equity or debt side, scale will help you.”

Innovation

Looking ahead, the panel identified one key area of growth – managers able to raise capital from retail investors. “I think that [Blackstone’s] BREIT and [Starwood’s] SREIT are the tip of the iceberg,” Silverman says. “It is insane that the heyday of real estate syndication was Wien & Malkin in the 1940s with thousands of doctors and dentists owning the Empire State building.”

There are many ways this could go, with Silverman citing the potential use of crowdfunding platforms, cryptocurrency or other strategies. “I keep waiting for a private equity fund that figures out a way to put good deals in front of retail investors and lets the public into the same deals as the pension funds,” Silverman says. “I promise you that there will be more democratization of the ownership of real estate.”

Despite the prolonged pandemic and the challenges facing significant parts of the US commercial real estate debt markets, the mood was hopeful that the most solid sectors and markets will continue to see strong performance. Meanwhile, some enterprising managers will figure out the next steps for commodity offices, retail properties and other sectors that have been hit hard by covid – and the discipline seen so far among lenders will stay in place. ■

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WARREN DE HAAN
ACORE