

CRE

FINANCE WORLD

The Voice
of Commercial
Real Estate Finance

Winter **2018**

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Volume **20**

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No. **1**

HIGHLIGHTS

LIBOR: What Is It Good For?

**Hunger Games: Competing
HVCRE Proposals**

**Commercial Property Prices
Are Not a Roller Coaster**

**Retail Spotlight on Malls,
Grocery, and Off-Price
Department Stores**

PLUS

**CREFC Legislative &
Regulatory Update**

**Fintech Innovation Tests
U.S. Regulators**



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Volume 20, Number 1, Winter 2018

CRE Finance World® is published by the Commercial Real Estate Finance Council (CREFC®)

28 West 44th Street, Suite 815, New York, NY 10036

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WELCOME TO THE JANUARY 2018 EDITION OF *CRE FINANCE WORLD*



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reetings and Happy New Year,

I urge you to spend some time with the January 2018 edition of *CRE Finance World*. This year, the *CRE Finance World* Editorial Board adopted the motto of 'less is more' by opting to publish our magazine two times a year rather than three and streamlining the look and feel of the magazine so that our readers can concentrate on its real value: its important and timely content.

As has always been the case, this January edition provides its readers with valuable insights on the outside forces sweeping our industry in particular and the economy in general. Think:

- Regulatory reform — HVCRE, HMDA, 2-for-1 regulations;
- The first passage of meaningful tax legislation in over 30 years,
- The sunset of LIBOR,
- The ascendancy of fintech and the regulation that's racing to keep up, and
- Bank rules on High Volatility Commercial Real Estate

With our roots still firmly grounded in the multifamily and commercial property markets and the financing of these assets, this edition takes on the potential pitfalls and opportunities market participants will be presented with in 2018. You'll find good reads on the health of the retail sector (grocery, malls, and off-price department stores), and on the opportunities and pitfalls that present themselves in the late innings of the current real cycle.

In my view, the greatest insights come from those truly 'in the dirt,' those closest to the assets themselves and the financing and leverage necessary to feed the health of the sector...but not too much.

I would be remiss if I didn't thank all of those dedicated individuals who have been involved in the publishing of this magazine for many, many years, as well as those who take the time to write and submit articles for review and publication in these pages year in and year out. Special thanks go to our Publisher Joseph Forte (Sullivan & Worcester LLP) and Editor-in-Chief Paul Fiorilla (Yardi Matrix), as well as the entire *CRE Finance World* Editorial Board.

Enjoy the January 2018 edition of *CRE Finance World*. We welcome your feedback and encourage anyone who would like to submit an article for publication to do so.

A handwritten signature in black ink that reads "Lisa A. Pendergast".

Lisa Pendergast
CRE Finance Council Executive Director



A

s 2017 draws to a close, where do CRE markets and the overall economy stand? After two consecutive quarters of GDP growth in excess of 3%, steady employment figures, and three hikes in the Federal Funds Rate, market participants appear optimistic for the future. To many, this is a welcome change from 2016, which was marked by sluggish GDP and job creation figures. Further developments are yet to come, with both the GOP tax plan being finalized and a new Fed chair stepping into office in 2018. As my co-editor Krystyna Blakeslee mentioned in last summer's issue, disruption and change have been the theme of the past year.

CRE markets too have felt a change, with many citing 2017 as a flagship year for multifamily completions. Markets like New York City — once a beacon for low vacancy, high rent growth markets — is slated to welcome a record number of new rental developments this year and next, surpassing the city's previous record from 1986. Historic highs for new completion figures will also hit markets like Washington DC and Los Angeles. The industrial sector — the new age poster boy for rent growth — has remained strong in 2017, thanks in part to continuing robust growth in e-commerce and steady-as-she-goes global trade numbers. Consequently, the retail sector continues to wrestle with the shift to online sales and weaker shopper turnout. A few articles explore this issue, with one analyzing growth opportunities for grocery stores in e-commerce, while another studies the tremulous footing of the U.S. mall sector.

A couple of articles focus on environmentalism's impact on the CRE market, including how green-certification affects appraisal value as well as financing options for energy-efficient multifamily properties. With the economy at full employment, another article explores the relationship between cash flow margins across property types and unemployment in the U.S. Given the prospective end of LIBOR as a benchmark rate, one timely article explores its history, its potential replacements, and complications that may arise in this transition period. Finally, another article explains how to avoid potential pitfalls when buying distressed debt securitized by commercial real estate.

As we welcome 2018, we continue to anticipate further changes in both the economy and commercial real estate markets. Will there be negative black swan events that eclipse nascent optimism? There is always that chance, and by definition black swan events are extremely challenging to predict. Still, we hope that these articles will help you think through a few major trends as markets and the global economy continue to evolve. We hope that you learn from these articles as much as the editorial committee did, and we are proud to present this issue.

Regards,

Victor Calanog PhD
Chief Economist | Reis Inc

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A Guide to the Swamp: CREFC Government Relations Update



Believe it or not, the Trump administration is closing in on its one-year anniversary. While supporters and detractors of the president can debate successes and failures, there has been a lot of action. Despite Republicans controlling both the Congress and White House, it's clear that factions and division within the party (not to mention the pesky Senate filibuster) can still be major obstacles to implementing an agenda. Let's look at the legislative and regulatory action and then Trump's impact on the administrative state.

Legislative Snapshot

As we go to press, tax reform is very close to becoming law, and it will mark a signature legislative victory for the President and Congressional Republicans to tout — and defend in the midterms — in 2018. As last-minute negotiations have come down to the wire, we'll save the details and potential effects for our CREFC Government Relations Alerts and The Week in Washington Updates.

In part, the fevered drive to pass tax reform was fueled by the failure to repeal and replace Obamacare, which Republicans had campaigned on since the law's passage in 2009. While the individual mandate will be repealed as part of the tax overhaul, there is still plenty to address. It's unclear at this point if Republicans will address the health law before the 2018 midterms, but expect the topic to come up in the election, either from GOP primary challengers faulting the "swamp" for its failure or from Democrats looking to preserve and fix Obamacare.

While healthcare and tax reform have consumed much of the political horizon, there have been a few points to consider on financial services. Rep. Jeb Hensarling (R-TX), the retiring Chairman of the House Financial Services Committee (HFSC), was able to shepherd his Financial CHOICE Act through House passage, but the Senate had no appetite to take it up. After conceding that a piecemeal approach may be more effective, the HFSC passed a number of targeted bills aimed at reforming banking regulation. The Senate Banking Committee followed up recently with a regulatory relief package of financial reforms by passing S. 2155, which had the support of 10 Democrats, which is sufficient to overcome a filibuster in the upper chamber. CREFC staff expects the full Senate to consider the reforms in early 2018.

A bill of interest to CREFC passed by the HFSC, H.R. 2148, sought to fix the High Volatility Commercial Real Estate (HVCRE) capital regulation, which placed higher capital charges on certain construction loans. HVCRE has been a regulatory headache for banks — and even borrowers — since its rollout in 2013. The bill received wide bipartisan support and passed out of the House on a voice vote (meaning no one opposed it), a nearly unimaginable feat for a banking regulation in a partisan atmosphere. Senate action on H.R. 2148 is unclear since it was not included in the Banking Committee's reform package. Relatedly, the three banking agencies (Fed, FDIC, OCC) proposed an alternative capital framework for acquisition, development and construction loans in September 2017, which is widely thought to be more punitive than existing rules; CREFC commented and expects to see further regulatory action in 2018 on this front.

For a quick reference guide to major legislation, please see Table 1.

TABLE 1

Key Legislative Issues

Issue	Proposed Changes	Roadblocks	Status	Timeline
Tax Reform	Lowens the corporate rate and eliminates many deductions for personal and business filers. Business interest deductions and like-kind exchanges were preserved. Depreciation tweaked.	Democrats were uniform in their opposition. Some GOP opposed the bill on a variety of grounds.	Passed the House and Senate. Both houses expected to pass final, reconciled legislation. President expected to sign.	On track to become law in December 2017.
Healthcare	Repeal and Replace of the Affordable Care Act (Obamacare).	The repeal/replace passed the House but failed by 1 vote in the Senate. The GOP now can only lose 1 vote, so chances of a full repeal are very slim	As part of the tax deal, there may be reconsideration of a bipartisan Senate plan.	Timing unclear
Financial Reform Legislation	The Financial CHOICE Act contained a broad scope of reforms, but was too partisan for the Senate. The S. 2155 reforms pending in the Senate are the most likely vehicle.	House Republicans may balk. With 10 Democratic Senators on board, the reforms may not be strong enough to win some House GOP members. Still, political realities and compromise may win out.	S. 2155 passed the Senate Banking Committee on December 5.	Senate consideration likely in early 2018. House consideration unclear, but likely after Senate vote.
GSE Reform	No unified plan, but as of late 2017 stakeholders have stepped up talks on a bipartisan package	Bipartisan support is essential for movement in the Senate. The GOP House caucus may have divergent views, as well.	No proposed legislation.	2018

Regulatory & Deregulatory Snapshot

A key Trump promise — besides Making American Great Again — has been to cut regulation. In fact, the President issued an Executive Order that urged agencies to eliminate two regulations for every one new regulation issued. The President also directed Treasury Secretary Mnuchin to review all regulations and laws relating to financial services and identify areas for reform. To that end, Treasury has published four reports (Banks; Capital Markets; Asset Management and Insurance; and FSOC) that recommend statutory and regulatory changes in line with principles laid out by President Trump's Executive Order 13772. Key reform recommendations focused on the Volcker Rule, capital and liquidity rule reforms, risk retention, regulation AB II, and High Volatility Commercial Real Estate (HVCRE).

Although the process of administratively rolling back existing rules usually requires a rulemaking process with notice and comment, proposed rules and yet-to-be-proposed rules can be delayed or withdrawn without much red tape. Additionally, Congress and the President used the Congressional Review Act (CRA) to disapprove — effectively nullifying — 15 Obama-era regulations. The

CRA was the chosen method here since the action only requires a majority vote in the Senate instead of the usual 60 for most legislation. Thus, no Democrat votes were needed. None of the rules repealed using the CRA directly impact CRE finance, but the threat of rolling back unpopular rules could have a chilling effect on regulations from independent agencies (e.g., bank regulators) that run afoul of the Administration's deregulatory goals.

The regulators are beginning to address a few of the issues identified (HVCRE and Volcker) in the reports, though those discussions predate the Treasury Reports.

Regulatory Leadership

Besides hallmark legislation, a president can have a profound effect on the financial industry through the regulators he appoints. The independence of many financial agencies, along with their broad rulemaking and supervisor authority, mean agency leadership can have the largest influence on policy (absent new laws from Congress). And President Trump already has a significant number of appointees installed. Table 2 below highlights key regulators in place at the end of President Obama's time in office and where those positions stand now.

TABLE 2

Changes in Regulatory Agency Leadership

Agency	Obama Administration (As of 1.19.2017)	Trump Administration (As of 12.15.2017)
Treasury	Secretary Jack Lew	Secretary Steve Mnuchin
CFPB	Director Richard Cordray	Vacant (Acting Director Mick Mulvaney)
FDIC	Chair Martin Gruenberg Vice Chair Thomas Hoenig Vacancy	Chair: Martin Gruenberg* (Jelena McWilliams Nominee) Vice Chair: Thomas Hoenig Vacancy
Board of Governors Federal Reserve	Chair: Janet Yellen Vice Chair: Stanely Fisher Gov: Jerome Powell Gov: Lael Brainard Gov: Dan Tarullo Vacancy; VC of Supervision Vacancy	Chair: Janet Yellen** (Powell Chair Nominee) Vice Chair: Vacant Gov: Jerome Powell Gov: Lael Brainard Gov. Randy Quarles, VC of Supervision Vacancy (Marvin Goodfriend Nominee) Vacancy
OCC	Comptroller Thomas Curry	Comptroller Joseph Otting
SEC	Chair: Mary Jo White Comm: Michael Piwowar Comm: Kara Stein Vacancy Vacancy	Chair: Jay Clayton Comm: Michael Piwowar Comm: Kara Stein Vacancy (Hester Peirce Nominee) Vacancy (Robert L. Jackson Nominee)
CFTC	Chair: Timothy Massad Comm: J Christopher Giancarlo Comm: Sharon Bowen Vacancy Vacancy	Chair: J Christopher Giancarlo Comm: Brian Quinten Comm: Rostin Behnam Vacancy (Dawn Stump Nominee) Vacancy
FHFA	Director: Mel Watt	Director: Mel Watt (Term expires 2019)

* Gruenberg's term ended in November 2017, but he is able to stay on until a successor is confirmed.

**Janet Yellen's term as chair expires in February 2018; however she has indicated she will resign her position on Board upon her successor's confirmation. This will create another vacancy.

A combination of expired terms and resignations has allowed the President to alter the balance of power, to the extent new leaders harbor different views on regulation. For example, if Jelena McWilliams is confirmed, her confirmation would mark a major milestone for the administration's efforts in bank regulatory reform as Trump nominees will be installed at each of the three prudential banking regulators (FDIC, FRB, and OCC), which share joint authority over many important bank capital and liquidity rules.

As changeover continues at the agencies, we expect regulators to take up more of the reforms recommended in the Treasury Reports. However, even a more-friendly regulatory ear does not translate to quick action, especially when interagency coordinate is required, such as on risk retention or Basel rules.

Preparing for Midterms


The 2018 midterm elections will dictate the likelihood of any legislative action in the remaining two years of President Trump's first term. Some pundits are pointing to how recent Democratic victories in New Jersey, Virginia, and Alabama in 2017 are reminiscent of Republican victories in 2009 (Governors in NJ and VA; Senator Scott Brown in Massachusetts) leading up to the GOP retaking the House in 2010 (they didn't secure the Senate until 2014). But with nearly a year to go and a political environment that can swing wildly on a whim (or a tweet), it's not useful to predict the future here. You can search the archive of

any major news organization and find pages of post-election articles on how the Democrat Party "is toast" (2004); Republican Party "is obsolete" (2008); Democrats "are done for" (2010); Republicans "will never win another presidential election" (2012).

If Democrats do take a majority in either chamber, it's reasonable to expect the trickle of legislation to run dry amid numerous congressional-led investigations and hearings. And if Democrats win the Senate, all but the most bipartisan Trump appointees will face major, if not insurmountable, opposition.

CREFC Advocacy Agenda

For the first time, CREFC took a holistic view of our policy platform, starting with a broad-based survey in the summer to assess members' advocacy priorities, and then extensive debate on thornier issues in forum sessions and the Policy Committee. After meeting bi-monthly for the better part of 2017, the Policy Committee has successfully ploughed through the majority of the issues raised in our survey, establishing positions on over a dozen rules and pieces of legislation. For more information, please contact the CREFC Government Relations and Policy team.

2018 promises to be another very busy year in Washington.... 



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From the Aspirational to the Prosaic: Fintech Innovation Tests the U.S. Regulatory Framework



As Bitcoin prices soared when the Chicago Board Options Exchange (CBOE) launched futures contracts in the cryptocurrency, federal regulators began to address these new technologies in the financial sector. While virtual or cryptocurrencies are drawing headlines at the moment, it leaves us to consider the possibilities that “fintech” could extend to not only the macro plumbing of the financial sector, but also beyond those sectors easily observed in the market, like online banking and crowdsource platforms.

From better harnessing of data to complete and total disintermediated processes, the blockchain and related distributed ledger technology (DLT) that enables cryptocurrencies are the center of rapid innovation. Timothy Spangler, a partner at Dechert LLP who specializes in fintech and securities law, believes that the transition to a DLT-enabled world will be as significant as the transformations from phone-based to Internet-based information transfer.

Their pace and far-ranging applications, however, call into question the appropriateness of the current regulatory framework for everything from securities, to consumer protection to banking regulation. Regulators recognize fintech as markets themselves, as tools to enhance the user experience and to optimize execution, and possibly as a new infrastructural building block for payment systems and other aspects of the financial system. We discuss below how regulators are reacting to the growth of fintech and where the CRE sector is in its adoption cycle.

Tech Imitates Life

On the surface, cryptocurrencies (Bitcoin, Ethereum, Litecoin, etc.) represent an alternative to fiat currency, but the technologies that sit behind the headlines may be as newsworthy, as blockchain and DLT innovation have spawned an explosion of tech enterprises funded by the currencies. It's as if you could actually live in your Second Life world, as long as you looked the same and were a programmer.

The latest progeny of the virtual currency revolution is the initial coin offering (ICO), in which virtual currency tokens are sold. To many, ICOs are a way to take cryptocurrency profits and reinvest them in a new venture. Chance Barnett reported in *Forbes* on September 23, 2017, that the value of ICOs has “quickly

grown to account for more startup funding in blockchain-based companies than all of Venture Capital. Nearly \$2.3 billion has been raised to date in ICOs, with the large majority of that taking place in the first half of 2017.”

U.S. Regulators Move to Limit Access to Soaring Cryptocurrency Market

As many tech companies have sought to do in the second half of 2017, Munchee Inc. floated its own ICO to raise capital for development of its app. On December 11, 2017, the SEC stepped in and deemed Munchee's ICO to be a sale of “securities”, meaning that the company and individuals involved would have violated securities law with its capital-raising action. In its enforcement action against Munchee and in other recent statements, the SEC has called into question the legality of a large swath of the tokens, or coins, distributed through these ICOs to date, raising the question of the cryptocurrency juggernaut and related fintech advancement.

Spangler sees the SEC's enforcement action against Munchee as more of a bump in the road than a roadblock in the adoption of new technologies. To him, Bitcoin was the “imperfect beginning” of the blockchain and DLT. ICOs are an iteration of virtual currency, and while they serve the purpose of furthering innovation through funding, they are not the end goal.

CRE and Fintech

The commercial real estate industry is often accused of lagging behind in the adoption of technology, but Jonathan Schultz, founder of Onyx Equities, believes there is “real momentum” behind adoption now, especially around data integration. There is also enthusiasm for a different tier of technology-enabled improvements that fall into a broader category of “how we operate, finance, and lease real estate.”

For Onyx, Schulz finds that with the help of data onboarding and artificial-intelligence-assisted analysis, he can detect trends faster than in the past. Schulz says that these kind of real-time observations are only feasible now that the data is increasingly available. Everyone is mining data better, whether it be lenders, investors, or building managers and this allows, as Schulz says, you to be much more organized than in the past.

For his part, Spangler sees the adoption of smart contracts (a special protocol intended to contribute, verify or implement the negotiation or performance of the contract) as a key disruptive force in the financial system and the corporate environment altogether. For now, their legality is not clear and other challenges make them less useful than they may become in the future.

Regulatory Frameworks: Will They Become a Bulwark or a Blockade?

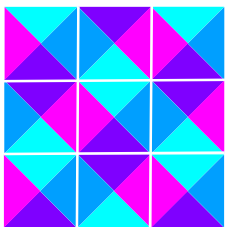
In September 2017, the Chinese government banned the trading of Bitcoins on exchanges (though they are allowing over-the-counter trading). The SEC and the CFTC are allowing the CBOE and possibly other clearing houses to clear and settle cryptocurrency contracts without additional registrations and/or requirements, which is an example of how the U.S. framework may in some ways already be well-equipped to adjust to some aspects of the fintech revolution. In the consumer-facing end of the financial system, the Consumer Finance Protection Bureau (CFPB) and the Office of the Comptroller of the Currency (OCC) have taken accommodative stances. In September 2017, the CFPB issued a "no-action" letter to Upstart Network, an online lending platform using alternative data for credit decisions. The OCC took a more formal proactive step and plans to extend bank charters to fintech entities.

What is more difficult to assess, however, is the ways in which the regulators may be working with middle- and back-end technologies. Several U.S. agencies, including the CFTC, OCC, and SEC have launched "sandboxes", in which the regulator allows the technology to be tested with customers in a controlled environment. While the Federal Reserve Bank of San Francisco has set up a department to provide outreach to fintech companies, Gerald Tsai who is the Director of Applications, Enforcement and Fintech at the Fed recently rejected the idea of the more open, sandbox approach.

In the meantime, regulators are aware that technology does not wait for updated rulemaking. As such, we expect to continue to see dual efforts to update the regulation and apply existing law to new tech. 🏢

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LIBOR: What Is It Good For?

In 2021, LIBOR will be good for almost nothing. LIBOR (London Interbank Offered Rate), originally used as the interest rate for interbank loans, is currently the benchmark for approximately \$350 trillion of financial instruments and products. Over the past several years, LIBOR's reliability has been impacted by its own fundamental shortcomings and scandal. The United Kingdom Financial Conduct Authority (FCA) will stop regulating LIBOR in 2021, which, in essence, will end LIBOR's service as a near-universal benchmark.

What Went Wrong?

Any mention of LIBOR triggers thoughts in some minds of fast bankers manipulating LIBOR rates for illicit gain. Indeed, several banks have paid billions of dollars in fines to settle accusations of wrongdoing related to LIBOR rate-rigging. LIBOR's poor public relations campaign (or lack thereof) certainly has not helped its popularity. However, its systemic shortcomings are ultimately the source of its demise.

The LIBOR rate is computed by calculating the average interbank short-term unsecured loan rates that a panel of contributing banks submits to the LIBOR administrator (ICE Benchmark Administration). Many banks, however, no longer make these types of loans to one another and do not know the rate for these types of loans. Instead, banks use their "expert judgment" to provide a rate for the LIBOR computation. This leads to an imprecise set of rate samples from which the ultimate LIBOR rate is derived. The LIBOR rate, therefore, is not pegged to an active market.

As Andrew Bailey, the current chief of the FCA said, interbank lending is no longer "sufficiently active" to provide a meaningful LIBOR rate. More pointedly, he asked: "If an active market does not exist, how can even the best run benchmark measure it?" To illustrate the dearth of interbank market activity, only 15 transactions for a single currency were executed among banks in 2016. The ideal benchmark should instead be an index based on active market transactions yielding an accurate rate.

The Next Step

Global banking officials are now considering alternative benchmarks in anticipation of LIBOR's replacement. In the United States, the Federal Reserve's Alternative Reference Rates Committee (ARRC), comprised of private sector

participants, has recommended a rate that most comprehensively reflects the rates used in the Treasury repurchase market (collateralized Treasuries used for short-term loans). The newly published index will be called the Secured Overnight Financing Rate (SOFR).

SOFR is considered a vastly superior benchmark, in that it is based on an active trading market. In fact, 15 banks this past June voted in favor of replacing LIBOR with SOFR. Federal Reserve Board Governor Jerome Powell, who has been nominated by President Donald J. Trump to chair the Federal Reserve, said, "SOFR will be derived from the deepest, most resilient funding market in the United States. As such, it represents a robust rate that will support U.S. financial stability." The New York Fed and Office of Financial Research (an independent body of the U.S. Treasury) will publish the rate, which should help maintain rate integrity.

Challenges — LIBOR Legacy Contracts

Whichever index the regulators choose, the overarching issue is transitioning to the new benchmark. The transition poses challenges in that many financial products with variable rates that are tied to LIBOR extend beyond 2021 — so-called legacy contracts. These products' interest rates reset periodically and therefore require a benchmark index rate from which they can base their adjustments.

In some legacy contracts tied to LIBOR, an alternative benchmark may not have been considered. Other legacy contracts do however provide a replacement index in the event LIBOR is no longer published. The replacement index, however, is typically not the same across all legacy contracts (some adopt UST + X, others adopt PRIME + X, etc.). This is likely to pose a challenge as contracted parties move off LIBOR to a garden-variety of benchmarks, which could create widespread divergence in spreads beyond the differing LIBOR + X spreads previously negotiated.

If LIBOR continues to exist after 2021, a party to a legacy contract may insist on continuing to use LIBOR if it believes it is in its best interest (LIBOR's inaccuracy notwithstanding), making the argument that LIBOR was the agreed-upon contract benchmark, irrespective of its soundness or administrator. So long as LIBOR's rates are published, the parties should continue to refer to them.

However, public policy interests could afford parties the option of discontinuing the use of LIBOR, which is universally acknowledged as flawed. Parties originally selected LIBOR because of its wide acceptance and presumed accuracy. The contract's negotiated spread over LIBOR represented the lender's borrowing costs and, to an extent, the borrower's risk tolerance. This all rested on the assumption of an accurate baseline. Continuing to use LIBOR, which no longer serves its original purpose, could upend the original deal metrics. Accordingly,

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using an index that tracks the deal originally contemplated by the parties at loan origination would seem the most equitable resolution. A judge, jury or, most likely, an arbitrator may ultimately have to decide this issue.

Regardless of which position one takes, the arguments to use an alternative benchmark over using a stale LIBOR benchmark may be moot, because it is likely that LIBOR will not exist after 2021. As it is, banks are uncomfortable submitting their rates to ICE, because ICE asks the banks to provide rate information that the banks do not have. Instead, banks must rely on their “expert judgment” to determine a rate and submit it to ICE. The admitted conjecture involved opens the banks to possible liability — not a new headache in the LIBOR sphere — and banks understandably do not want to participate. They nevertheless do so to cooperate with regulators in order to prop up LIBOR, and because the FCA technically has the authority to compel banks to submit their rates to ICE. (This power is not “indefinite,” but the banks have agreed to continue sending in their rates until LIBOR sunsets.) However, now that financial regulators have (i) agreed to quit LIBOR; (ii) agreed to establish a new benchmark to replace LIBOR; (iii) acknowledged that LIBOR is inaccurate; (iv) acknowledged the banks’ already uneasiness in submitting rates; (v) all but acknowledged LIBOR is an anachronism; and (vi) waning power and therefore a lessened desire to nudge banks into submitting to LIBOR, it is possible to envision a scenario whereby ICE will no longer have a contributing panel of banks, thus definitively marking the end of LIBOR.

If true, how do we transition to a new benchmark?

Transition

The ARRC is currently drafting a transition report that is expected to be published at the end of 2017 (after the writing of this article). Specifically, the report will recommend solutions to incorporate a new benchmark into legacy contracts. Apart from this committee’s impending report, there is no consensus or roadmap guiding the markets forward (in how best to integrate a replacement benchmark into legacy contracts).

Recent and current events in the Swiss financial markets are instructive and possibly prescient. In 2013, the CHF TOIS (Switzerland’s LIBOR equivalent) encountered problems similar to those LIBOR is currently experiencing — an insufficient trading marketplace to inform CHF TOIS. Much national and regulatory effort was expended to stabilize CHF TOIS, but to no avail. In 2016, Swiss bank officials announced that the CHF TOIS benchmark would end on December 29, 2017. The Swiss National Working Group (the AARC equivalent) favored SARON, the rate on the overnight Swiss Franc repo market (the SOFR Swiss equivalent) as a replacement benchmark. The National Working Group issued the following recommendation with respect to transitioning to the new benchmark:

For all TOIS with a maturity date beyond the discontinuation date of the TOIS fixing, there are two obvious choices for addressing the situation that adherence to the original agreed-upon floating rate becomes impossible after the discontinuation date. TOIS either need to be terminated early prior to the discontinuation date at the prevailing market value, or they need to be restricted to be linked to an alternative floating rate instead of TOIS. In case of a restrike, the NWG proposes that TOIS be restricted to reference SARON.

While the value and number of financial products relying on LIBOR are much greater than those underpinned by the CHF TOIS, the recommendation’s principle applies.


For LIBOR-based products, terminating or negotiating individual contracts on a massive scale would be impractical, cumbersome and likely impossible given the number of securitizations using a LIBOR benchmark that occurred following loan origination. Additionally, an automatic “re-peg” to a replacement benchmark, while relatively more seamless and practical, may be subject to legal challenges in as much as the replacement index was not contemplated as part of the parties’ original bargain. But if LIBOR ceases to exist, which seems likely, parties to a contract involving LIBOR may have no other choice but to face a wholesale “re-peg” or some customization thereof, by parties who seek now to change their contracted benchmark.

One alternative but imperfect way to alleviate a possible automatic “re-peg” of LIBOR to the replacement index is to make a one-time adjustment that would equal out LIBOR and the replacement index’s value and spreads on a particular date. For example, if on January 1, 2019, the rate was L + 300 basis points with LIBOR at 2.00 percent equaling an all-in rate of 5.00 percent, then after selecting a replacement benchmark, the parties could back into the LIBOR all-in rate, using the new index such that if the replacement index is at 1.75 percent, the spread adjusts to 325 basis points.

Of course, this method exposes flaws and is subject to infinite variables, such as the overall intrinsic volatility of LIBOR compared to its prospective replacement index (to be sure, LIBOR’s volatility in the run up to the financial market meltdown greatly surpassed other relatively comparable indexes — allegations of LIBOR fraud aside), and thus the replacement index’s movements may not accurately match. To address this, perhaps the ARRC or another committee can add control factors to solve for any marked distortion in the replacement benchmark’s movements versus LIBOR by studying these indices’ previous performance relative to LIBOR.

Another alternative but imperfect “re-peg” option is for the ARRC or other body to recommend three benchmark rates that parties to a legacy contract can choose from. The ARRC or another body would explain and provide the historical performance of these three benchmarks compared to LIBOR. This will assist the less sophisticated party in understanding and appreciating its replacement benchmark options, and both parties would agree on one of the three options. This solution may be more palatable than an automatic “re-peg” to a predetermined replacement index, as it avoids a situation of an unwanted single replacement benchmark being foisted upon unwitting parties. This solution also eliminates the daunting prospect of choosing from numerous possible exchanges, about which one of the parties may have very little information. One issue with this option is that one party, such as a large financial institution, may inherently have the upper hand over an individual borrower in determining which benchmark is best, inasmuch as financial institutions may have better resources to evaluate the benchmark options, and will select one that benefits itself. Another issue with this option would be implementation may be difficult because of the sheer number of contracts.

Conclusion

Bank officials have given financial markets four years’ notice that LIBOR will end. Financial markets would benefit from a framework from banking officials that would guide the transition to LIBOR’s replacement. The volume of financial products tied to LIBOR requires a clear path forward to ease the shift away from LIBOR. Ultimately, the new benchmark will have the same function as LIBOR but will have a healthier set of transactional market underpinnings. Matt Levine of Bloomberg adroitly surmises, “[I]t would be easier if they’d just rebrand the new benchmark ‘Libor,’ and report it in the same places as the old Libor: Then contracts that refer to ‘Libor’ could keep referring to ‘Libor.’ It would just be a different Libor.” 



Hunger Games: How Competing HVCRE Policy Proposals May Affect Competition Between Banks and Non-Bank Lenders

The federal banking agencies (the “Agencies”) and the House Financial Services Committee (the “HFS Committee”) have proposed competing revisions of the regulatory capital framework for high-volatility commercial real estate (“HVCRE”) lending. These approaches will affect the cost of HVCRE exposures in different ways for small banks, large banks, non-bank lenders, and ultimately borrowers. This article explores how these alternative policy ideas may affect the lending market for acquisition, development and construction (“ADC”) of commercial real estate (“CRE”).

I. The Existing HVCRE Exposure Framework

Since 2015, U.S. standardized approach banks have been required to risk-weight HVCRE exposures at 150%.¹ An “HVCRE exposure” is generally a loan secured by raw land or ADC projects that, prior to its take-out by a permanent facility, finances the ADC of certain categories of real property unless the project qualifies for an exemption. Single-family housing, agriculture loans, and some community development loans are exempt. Another exemption, known as the “contributed capital exemption,” requires a regulatory loan-to-value (“LTV”) test and the borrower contributed cash or readily marketable securities equal to at least 15% of the real estate’s “as-completed” market value, and a commitment to retain any internally generated capital in the project for its life.

Standardized approach banks have long complained that ambiguities in the “contributed capital exemption,” what constitutes permanent financing make the existing framework unworkable and effectively force them to over-classify as HVCRE certain CRE exposures that should properly be exempt.

II. The Agencies’ Proposed HVADC Exposure Framework

In September, the Agencies issued a joint notice of proposed rulemaking (the “NPR”) to simplify and enhance consistency in the treatment of ADC loans by standardized approach banks.² Capital for HVCRE exposures of advanced approach banks would still be determined by the banks’ own methodologies.

A. New Purpose-Based HVADC Exposure Definition

The Agencies propose replacing the HVCRE exposure category as applied in the standardized approach with a new exposure category, termed “HVADC exposure.” This is defined as a credit facility that “primarily” finances or refinances: (i) acquisition of vacant or developed land; (ii) development of land to prepare to erect new structures, including, but not limited to, laying of sewers or water pipes and demolishing existing structures; or (iii) construction of buildings or dwellings, or other improvements, including additions or alterations to existing structures. A CRE loan meets the “primarily finances” requirement if more than 50% of the loan proceeds are intended for ADC activities.

Significantly, the “primarily finances” test would supersede the current requirement that HVCRE loans be secured by real estate. Eliminating the “secured-by” requirement and adopting the “primarily finances” requirement will likely broaden the scope of coverage under the proposed HVADC framework and will require consideration of whether corporate financing transactions and warehouse lending facilities to non-bank lenders may constitute HVADC exposures.

B. Elimination of the Contributed Capital Exemption from the HVADC Exposure Definition Eliminates a Headache

The proposed HVADC exposure definition would remove the contributed capital exemption, thereby also removing the need to monitor compliance with supervisory LTV limits and with restrictions on the distribution of internally-generated capital. This is an attempt to address banks’ concerns about the complexity and potential inconsistent application of the exemption, due to the multiple requirements to qualify for the exemption and the potential conflict between the borrower’s organizational documents and the contractual limitations on distributions from the project that result from complying with the requirements.

C. A New Definition of “Permanent Financing” Would Provide Greater Certainty When HVADC Status Falls Away

As under the existing HVCRE framework, an ADC exposure would cease to be an HVADC exposure under the NPR when it is converted to “permanent financing.” Under the existing HVCRE framework, the classification of a loan as permanent financing is based on each bank’s subjective determination as to whether the loan meets the underwriting criteria for long-term mortgage loans. The HVADC framework would provide an objective standard by explicitly defining a “permanent loan” as “a prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments aside from the sale of the property.” A loan need not be fully amortizing to satisfy the definition of “permanent loan.”

D. New Risk-Weight; Grandfathering

The NPR would reduce the risk-weight for HVADC exposures from 150% to 130%. This proposed reduction is intended to counterbalance the anticipated greater inclusion under the proposed HVADC framework owing to the elimination of the contributed capital exemption and replacement of the “secured-by” requirement with the “primarily finances” test. Loans originated by standardized banks before the effective date of a final rule would continue under the existing HVCRE framework, including scope and risk-weighting.

III. The HFS Committee’s Proposed HVCRE ADC Loan Framework

In October, the HFS Committee reported out a bill, H.R. 2148, (the “Bill”) that would amend the Federal Deposit Insurance Act to redefine the scope of HVCRE. The Bill is closer to the existing HVCRE framework than to the proposed HVADC framework in the NPR but has important differences from both.

A. Narrowed HVCRE ADC Loan Definition

The Bill would replace the current HVCRE exposure definition with a new term, “HVCRE ADC loan.” This is a credit facility “secured by land or improved real property” that (i) “primarily” finances, has financed, or refinances the acquisition, development, or construction of real property; (ii) has the “purpose” of providing financing to acquire, develop, or improve such real property into income-producing real property; and (iii) is “dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility.

Retaining the “secured-by” requirement may eliminate some concerns about whether the “primarily” finances test and the “purpose” test may expand the scope of coverage. However, including refinancing loans may blur the line between ADC loans and permanent take-out financing and may create particular ambiguity with respect to bridge loans.

B. Preservation of the Contributed Capital Exemption with Changes

Unlike the NPR, the Bill seeks to preserve the current 15% contributed capital exemption. However, it would apply that exemption differently from existing law. Notably, instead of measuring land contributed as capital based on cost basis, the Bill would base that measurement on the “appraised value” of the property in accordance with the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.³

C. Simpler Definition of “Permanent Loans”; Same Risk-Weight; Grandfathering

Under the Bill, a loan that was originated as an HVCRE ADC loan would be converted to non-HVCRE ADC status upon (i) completion of development or construction of real property being financed by the credit facility; and (ii) cash flow being generated by the real property being sufficient to support the debt service and expense of real property, in either case to the satisfaction of the lender in accordance with the institution’s applicable loan underwriting criteria for “permanent financing.” The Bill does not prescribe a risk-weight for HVCRE ADC loans, leaving it to the Agencies to apply a risk-weighting framework to the revised definition. The Bill would not apply to loans originated before January 1, 2015.

D. All Banks Covered

The Bill would apply equally to standardized approach banks and advanced approach banks. This is different from the NPR, which covers only banks that use the standardized approach.

IV. Implications for Players in the ADC Financing Market

Like dueling gladiators in the arena, each of whom brandishes a different type of weapon, the Bill and the NPR apply different tools whose very differences may

impact the outcome of the battle. The NPR requires a weighing of the competing forces of greater inclusion on one hand and lower capital cost on the other. The Bill is more straightforward and, in some ways, has a more evident impact on the market, but it too contains ambiguities that may lead to unintended results and is silent on capital cost. This section analyzes the implications of the NPR and the Bill for bank lenders, their borrowers, and non-bank lenders.

A. Implications for Bank Lenders and Their Borrowers

A key trade-off in the Bill and the NPR is the balance between the breadth of the relevant exposure definition and the regulatory capital for covered loans. The proposed HVADC exposure definition in the NPR would likely capture more ADC exposures than are currently captured by the HVCRE exposure definition as a cost of a mechanism that purports to be simpler to administer. This may be offset (at least for standardized approach banks) by reducing the risk-weights for HVCRE exposures to 130%, and may indeed result in a net equivalent retention of capital among that cohort. Whether that would be true for any particular bank would largely depend on that particular bank’s lending activities going forward. On the other hand, the Bill would likely capture fewer loans than under existing law or under the NPR, but because it does not purport to affect the corresponding risk-weights, the regulatory capital position of banks with HVCRE ADC loans would depend on whether and how the Agencies modify the 150% risk-weight to accommodate the new definition.

The purpose requirements of the NPR and the Bill are key issues that will affect the scope of coverage of each. To take the NPR first, the “primarily finances” test represents a significant expansion of the scope because it replaces the current requirement that an HVCRE loan be “secured by” real property. Eliminating an objective standard that intuitively applies only to CRE loans may effectively expand the definition of HVADC loans to include corporate credit facilities for general corporate purposes that may incidentally include refurbishment of office facilities and the like. This may impose new due diligence and compliance burdens on both bank lenders and borrowers, similar in general terms to the compliance burdens imposed by margin lending regulations. As a result, bank lenders may seek to cover HVADC compliance in covenants regarding the use of proceeds or perhaps request corresponding legal opinions even in loans that do not appear to involve CRE. As to the Bill, including the “primarily finances” purpose test and the “source of repayment” requirement will reduce loan coverage for both individual banks and the market as a whole, particularly since the Bill preserves the “secured-by” requirement in its HVCRE ADC loan definition.

The fate of the contributed capital exemption under the NPR and the Bill will affect the respective competitive positions of standardized approach and advanced approach banks in ADC lending. Eliminating the contributed capital exemption may increase classifications of loans as HVADC loans by bank lenders using the standardized approach since lenders would not be able to control classification of ADC loans by requiring borrowers to contribute a certain amount of capital and prohibiting distributions during construction. This may be problematic from a risk perspective as it shifts the capital risk of projects from the borrower to the bank lender.

Risk-weight modification further complicates the assessment with respect to banks’ regulatory capital requirements under both the NPR and the Bill, but in different ways. Although the NPR proposes a 20% risk-weight reduction to counterbalance the expected increased loan coverage, the effect on particular institutions may be hard to assess to the extent new loans that would not be considered HVCRE (as it currently exists) exposures under the existing definition might receive a risk-weight of 130% instead of the 100% they would otherwise have received. The net effect will vary between standardized approach banks and advanced approach banks and among individual banks within each group.

The Bill's effect on regulatory capital requirements is more difficult to analyze because the Bill changes the definition but leaves it to the Agencies to prescribe the regulatory capital for banks with HVCRE ADC loans. Therefore, the actual cost would depend on whether and how the Agencies modify the 150% risk-weight to accommodate the new definition.

The considerations described above may also have implications for financial system stability. If risk-weighted regulatory capital levels for banks are too high, ADC lending may flee to unregulated financial institutions in a manner analogous to what has been seen in corporate lending following introduction of the Federal Reserve's leveraged lending guidance in 2013. If capital levels are set too low, the risk of bank insolvency may be increased, with concomitant pressure on the Federal Deposit Insurance Corporation's insurance fund and the resolution mechanisms put in place since 2010. To the extent that advanced approach and standardized approach banks are required to use the same regulatory approach to risk-weight ADC exposures, the large banks may be disincentivized to invest in robust risk management protocols in this area.

B. Implications for Non-Bank Lenders

If it becomes more costly to finance ADC activities through bank lenders that must retain capital in accordance with the NPR or the Bill, borrowers may turn to non-bank lenders for alternative financing options. This may affect not just classic CRE finance but also non-real estate secured facilities in certain cases. To the extent warehouse loans by banks to those non-bank lenders may themselves be considered as HVADC exposures under the NPR or HVCRE ADC loans under the Bill, there may be an effect on liquidity to the non-bank lender sector. For the

reasons discussed above, under the NPR, the competitive position will depend in part on whether the lowering of the risk-weight is offset by the broadening of the scope of coverage. Under the Bill, the competitive position will largely depend on how the Agencies assign a risk-weight to the revised definition.

V. Conclusion

The Bill and the NPR each promises to change the face of CRE finance in different ways. Their potential impact is a multi-dimensional puzzle that requires an assessment of how each may affect big banks and small banks differently and may change the cost of general corporate lending. The effect of certain proposed changes may be difficult to model, particularly in relation to the tradeoff in the NPR between an expanded definition and a lowered risk-weight and in relation to the Bill how the Agencies might adjust capital charges to the Bill's narrower definition of HVCRE exposures and whether the Agencies will be able to withstand political pressure not to take away the proverbial punch bowl by raising capital costs.

1 The U.S. regulatory capital rules detail two approaches for determining risk-weighted regulatory capital requirements under Basel III. Under the "standardized approach," banks apply standard risk weightings to different categories of exposures without distinguishing among different levels of risk within a single asset category based on the relative creditworthiness of the obligor and the tenor of the obligation. A small number of large, internationally active U.S. banks must, and other institutions may elect – with the consent of their primary regulators – to use one of two advanced approaches for measuring operational risk and credit risk based on their own experience and internal credit scoring methodologies. See 78 Fed. Reg. 62018 (Oct. 11, 2013).

2 The deadline for comments is December 26, 2017. The NPR does not propose material changes to the exclusion for one-to-four family residential, agricultural or community development projects.

3 12 U.S.C. 3339.

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Expanding the 'Triple Bottom Line' of Multifamily Green Financing



Many multifamily buildings were built over 30, 40, or even 50 years ago — long before modern energy-savings guidelines. This means their air-conditioning systems, lighting, shower heads, and household appliances are pretty old too, and probably not energy efficient.

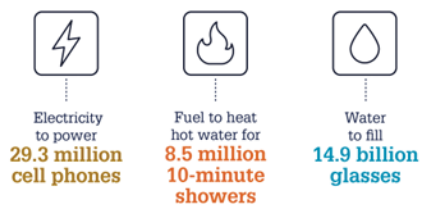
This disparity not only leads to social and environmental costs, it also means building owners and apartment renters are overpaying. More efficient energy and water consumption is widely considered beneficial for the health of communities and our planet. Because of this, competitive and viable ways to pay for practical, environmentally friendly upgrades to existing multifamily dwellings has taken on a new urgency.

Encouragingly, many multifamily lenders and borrowers have embraced innovative green financing techniques that are not only financially beneficial for apartment owners, but make life better for renters and improve the health of local communities. Green financing makes this triple bottom line (TBL) — financial, social, and environmental returns — possible.

What is a Green Mortgage Loan?

Green Mortgage Loans support upgrades that are projected to save 25% or more on annual energy or water consumption, as well as properties with a third-party green building certification, such as LEED or ENERGY STAR®.

The Green Rewards portfolio is projected to save annually:

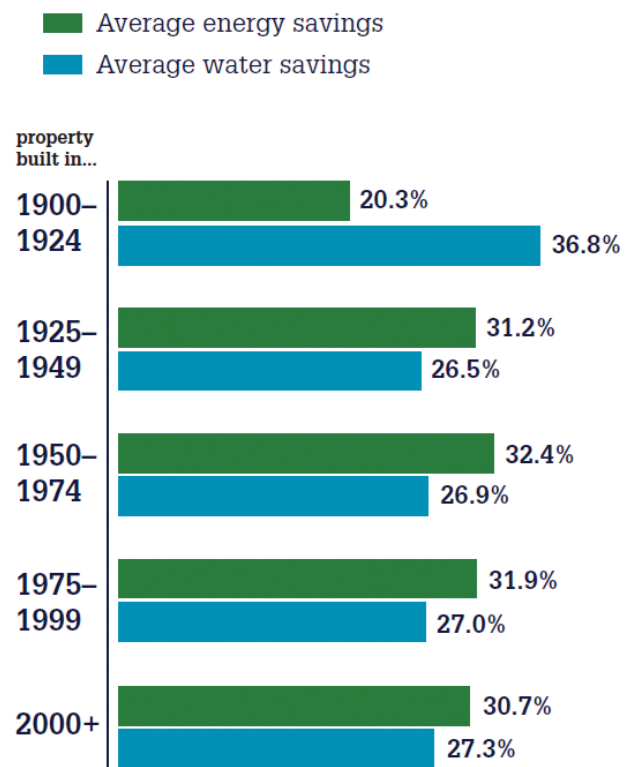


Source: Fannie Mae, as of Q2 2017

Green Mortgage Loans can fund improvements to common areas or individual units. Large projects might include replacing single-pane windows with double-paned, replacing energy inefficient appliances with efficient ENERGY STAR models, or installing solar panels. Smaller projects might include installing low-flow water faucets, shower heads, and toilets, or replacing incandescent lighting with high-efficiency LED lighting.

And any property can benefit. Whether they were built 10 or 100 years ago, most properties have the potential to save 20% to 40% in water or energy spending annually.

Regardless of Property Age, Potential Savings Are Possible



Source: Fannie Mae, as of Q2 2017

Many Reasons to Go Green

The TBL is an accounting framework that's been around since the 1990s. Also called the three Ps (people, planet, and profits), TBL recognizes that we're all in business to make money. But we can go beyond the traditional profit measures of ROI and shareholder value to include environmental and social dimensions.

In other words, you can do good when you're doing well. You can make money while positively and measurably impacting the social bottom line (people) and the environment (planet).

Helping People

Energy accounts for a substantial share of the cost of living in rental housing, especially among low-income tenants. Over 80% of our units financed are affordable for working families, and helping those buildings become more water and energy efficient can mean lowering utility bills for the building owners as well as tenants. These cost savings mean that tenants can spend more of their hard-earned money on other daily expenses, like education, transportation, healthcare, and child care.

Positive social impacts:

More than
190,000 tenants
are living in
upgraded properties

At properties where tenant-saving improvements were selected, **tenant utility bills were reduced by nearly 10% on average**

— that's savings that can go to other needed expenses: child care, groceries, healthcare, etc.



Plus, tenants will be living in housing that's more resilient to natural disasters or breaks in utility services. For example, these homes may still draw power from solar panels during wide-spread power outages. And the people living there could see increased health benefits. They can enjoy living in a healthy home environment.

Helping Our Planet

Buildings take up a tremendous amount of Earth's resources. According to the U.S. Environmental Protection Agency (EPA), buildings account for:

- 39% of total use of energy from fuel oil, coal, and other energy types
- 68% of the total electricity consumption
- 12% of the total water consumption
- 38% of the carbon dioxide emissions

More energy and water efficient properties are helping to conserve these resources through better siting, design, construction, operation, maintenance, and removal — the complete building life cycle.

Bright Future

Incorporating green building principles into property improvements enhances the overall quality of the existing multifamily housing stock and delivers TBL benefits to property owners, tenants, lenders, and investors.

While the market is still young by most standards, we're seeing more interest, commitment, and growth now in our green products than ever before, highlighting the need and desire to do good by doing well.

For more information, visit fanniemaegreenfinancing.com

Jeff Hayward is Fannie Mae's Executive Vice President and head of its Multifamily business — the largest provider of financing for multifamily apartments in the U.S. Fannie Mae introduced its first green energy product in 2012 and has grown the green financing book of business each year, culminating in the issuance of over \$10 billion in the first half of 2017. 🏡

Source: Fannie Mae Environmental, Social and Financial Impact Database through Q2 2017

How the Appraisal Process for High-Performance Buildings Affects Commercial Real Estate Professionals



As high-performance features become more common in commercial buildings, it's increasingly important for commercial real estate professionals to understand how to effectively highlight those features on behalf of clients. Understanding and properly documenting green features can assist CRE professionals in making a strong case for the value of energy-efficient building features when dealing with lenders.

To help appraisers become more familiar with the valuation of green properties, some excellent tools exist which educate those professionals on the intricacies of valuing high-performance commercial buildings. It's also important for CRE professionals and lenders to work with appraisers who have specific education and experience related to valuing commercial properties with energy-efficient features.

One example of a free tool is the Appraisal Institute's Commercial Green and Energy-Efficient Addendum (http://www.appraisalinstitute.org/assets/1/29/AI_821_Green_Commercial_Interactive.pdf), a form intended to help analyze values of commercial buildings' energy-efficient features. The addendum also assists investors in communicating the construction features of the property that impact income, particularly for buildings that are not certified green by a formal certifying organization but do possess green features.

Often, buildings are constructed with green features, but blueprints and specifications can be misplaced or overlooked and special features are not reflected in the building's future valuations. The addendum can assist in understanding actual green features in a subject property and properly applying them in the valuation process.

Green Features Impact Property Sales

When valuing green buildings, real estate appraisers' analysis must be supported by market data on the subject property that helps explain why it stands out from its conventional peers according to guidance included in "High-Performance Buildings and Property Value: A Primer For Lenders," (http://www.imt.org/uploads/resources/files/LenderGuide_FINAL.pdf) issued by the Appraisal Institute, the Institute for Market Transformation and the District of Columbia's Department of Energy and Environment.

According to these organizations' guidance, because buildings with energy-efficient features are different from traditional ones, owners have had to change not only how they design, build and market but also how they approach the financing and construction processes. Otherwise, owners may pay for green — with certifications, capital improvements and marketing — and not yet fully realize the expected market benefits.

Moving beyond the value that accrues to owners from rents, operational savings and market recognition at sale the guide helps building owners and developers understand the appraisal process and how green, high-performance characteristics and data can be used by appraisers to help fully maximize a property's valuation.

The guide further highlights the four components of value — revenue, occupancy, operating expenses and risk. These categories make the case for green appraisal value and should be considered by lenders both during appraisal and underwriting.

Green Influences on the Market

It's important for CRE professionals to work with lenders from a risk management perspective and encourage the lender to assess green and energy-efficient building features, as collateral risks may be reduced if green premiums on such properties are being paid in the marketplace. In addition, green building features also guard against obsolescence and its associated risks.

Further, CRE professionals can work with lenders to insist on well-informed opinions of value as they commission appraisals during project due-diligence. This process can be enhanced by finding competent appraisers and developing comprehensive scope of services requests.

A number of elements in the guidance from the Appraisal Institute, Institute for Market Transformation and District of Columbia Department of Energy may have an impact on building value, and the more information that is provided to assist the appraiser the smoother the process will be for all involved. A range of documentation, including capital improvements, engineering reports, tenant retention rates and comparable sales can be used by appraisers to analyze market trends.

Attention should be paid to how green and energy-efficient features might influence absorption trends, rental rates, cap rates, credit quality of tenants, collection losses, tenant satisfaction, months vacant (or downtime between leases) and renewal probabilities of tenants.



Appraisers will reconcile the primary approaches to valuation (income, cost and sales comparison), assigning relative weights to each based on quality and quantity of available data. For instance, if a recent sale of a high-performance building occurred, the sales comparison approach may take on great significance. Viewed in the context of an operating statement, green building performance and value can show up across the board in quantifiable property metrics and favorable adjustments made during appraisal and underwriting.

Navigating the Appraisal Process

Although it's the appraiser's responsibility to create the scope of work document, CRE professionals can help to ensure that the scope of services adequately reflects the complexity of valuing a high-performance building. For example, CRE professionals can ensure that green elements are built into the scope of services provided to appraisers bidding on the assignment.


One aspect of that could include a requirement that the appraiser completes the Appraisal Institute's Commercial Green and Energy Efficient Addendum in the appraisal assignment request. The addendum can help commercial appraisers research and analyze market behavior on green and energy efficiency issues.

It's also important to work with appraisers who have experience with high-performing assets and have the local market knowledge necessary to generate a credible opinion of value. Working with a Designated Member of the Appraisal Institute should give clients confidence that the appraiser meets those standards.

CRE professionals should ask whether the appraiser has received any specialized education on the valuation of sustainable buildings. Later during the review process, as the underwriter is analyzing the appraisal a more detailed review and additional consultations with the owner's technical consultants may be necessary.

Additionally, CRE professionals should provide as much data as possible for the appraiser's use which could include a market study with comparable properties, energy audits, construction or retrofit costs and other due diligence. Information on tenant demand for green features — preferably with a list of tenant representative contact information — can help as well.

The best way to ensure a credible opinion of value on a high-performance building is by working with a qualified appraiser and providing that individual with the necessary information to properly assess the value of the building's green features. By working with lenders and appraisers, CRE professionals can work to help fully recognize the value of green features in today's high-efficiency buildings.

James L. Murrett, MAI, SRA, is the 2018 president of the Appraisal Institute, the nation's largest professional association of real estate appraisers. Based in Chicago, the Appraisal Institute has nearly 19,000 professionals in almost 60 countries. More information about the organization's green programs and educational offerings is available on the Appraisal Institute's website: <http://www.appraisalinstitute.org/education/education-resources/green-building-resources/> 

Commercial Property Prices Are Not a Roller Coaster



Commercial property deal volume has been pulling back in the US for almost two years. Memories of the downturn from 2008 to 2010 are still felt sharply by many industry participants even though that calamity began a decade ago. There are fears that, as with the last cycle, a plunge in prices is just around the bend.

There is a line of thinking that commercial property prices are like a roller coaster, and since prices are high today, the market is due for a correction of the scale seen in the last downcycle. Sure, looking at the headline figures for the Real Capital Analytics CPPI there have been periods of loopy runups and declines that certainly look like the Cyclone at Coney Island.

The error in this line of thinking is the assumption that every market cycle is the same. There are behavioral reasons that force many industry participants to this line of thinking, but the way market forces interact to drive prices and volume has varied across multiple market cycles. The current disconnect between deal volume and prices is a function of a pullback by potential sellers of assets.

Why do Industry Participants Look Backward?

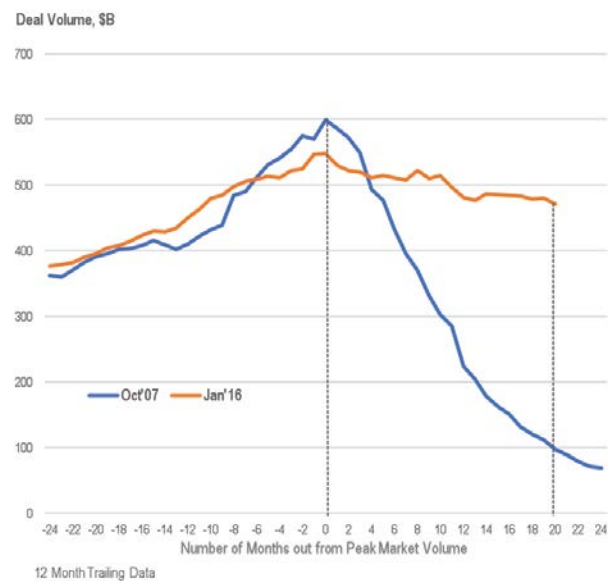
On every panel at every industry conference in the last few years, there will be inevitable doomsayer noting that when someone says, "This time it is different" that you should run for the hills. As funny as such commentary on irrational optimism might seem to be at a conference, regarding the current cycle, such comments may well be a case of irrational pessimism. Using the word "irrational," I am only arguing that people are looking at the wrong signals to make sense of the market. There is a simple behavioral reason explaining why this backward-looking viewpoint is so prevalent.

Observations on That Downturn a Decade Ago

The end of the third quarter of 2017 was 20 months out from the peak level of deal volume seen in this market cycle. As shown in Figure 1, deal volume is now 14% lower than the peak for this cycle. Price declines have not happened yet despite the market coming down from peak volume. As far as market corrections go, this one is modest compared to the calamity following the market peak in October 2007.

FIGURE 1

All Down Cycles Are Not the Same



Looking 20 months out from the peak level of deal activity in the last cycle, by June of 2009 volume was 84% lower than the peak. Do you recall what you were doing in June 2009? It is likely that you were facing sleepless nights worried about whether the doors to your business would stay open and how you would pay your mortgage.

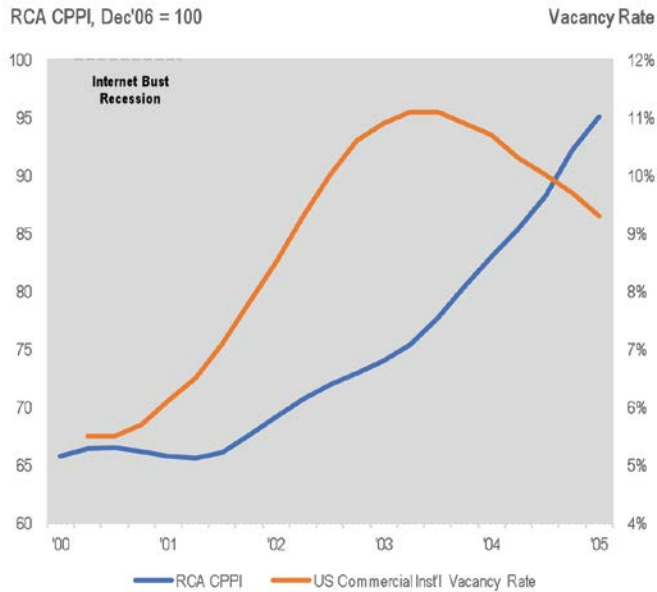
As I talk with my younger colleagues and interact with clients around the world, it is clear that a good number of the people I deal with daily only have 2008 to 2010 as a reference point for a market downturn. Other downturns have not been as severe as that seen in 2008 to 2010 and were driven by other factors.

Observations on the Downturn Following the Internet Bust

The year 2001 started with a collapse in valuations for Internet startups, leading to rapid growth in sublet space in the office market and growing stress in the leasing markets. Overall though, that downturn would have likely stayed at relatively modest levels were it not for the tragic events of 9/11 that followed. The market did not react as many expected at the time as they were looking back to the downturn of the late 1980s as a guide. Experience with that 1980s downturn is something that I do not have, but it did set my expectations for what future market downturns would look like ... at least for a while.

FIGURE 2

A Minor Downturn in Prices Following the 2001 Recession



Sources: Real Capital Analytics, NCREIF (Institutional Vacancy Rate)

That late 1980s downturn came with a tremendous liquidity crunch as savings and loan lenders collapsed. Even well leased and cash flowing assets defaulted as refinancing was often not an option. With the Internet Bust well underway and households feeling a sting as the imaginary wealth tied up in formerly hot technology stocks disappeared, there was a fear that a similar liquidity crunch would follow.

We all knew that something bad was coming to the commercial real estate market early in 2001, but it turned out to be a problem of the real economy and not the financial economy. In the end, prices barely moved in response to the economic challenges.

From a peak in the third quarter of 2001, the RCA CPPI fell only a cumulative 1.4% by the second quarter of 2002 after which prices grew at double-digit rates for five years. Prices were climbing from 2002 to 2003 even though the leasing market was in shambles.

Vacancy data for the institutional quality properties tracked by NCREIF posted a sharp increase between 2001 and 2003. For commercial properties of all types excluding apartments, vacancy rates jumped from 5.5% to just over 11%. These vacancy rates are only for the institutional quality portion of the market, the total market faced greater weakness on the leasing side.

Every Market Cycle is Different

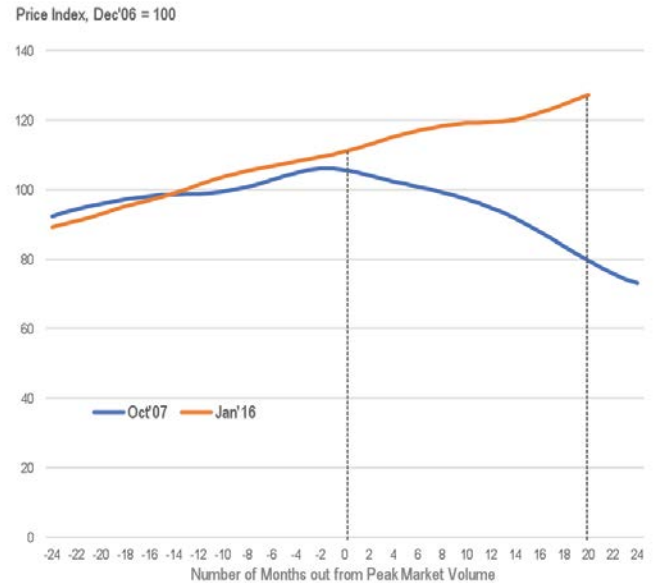
One simple lesson that comes from my experience across three downturns is that one cannot look to the most recent downturn, chart out that track and think that any current weakness in the market will follow the previous track exactly. Yes, there are some structural relationships that will matter, but there are forces that will be different across cycles.

Across every cycle, the pattern I have seen is that the initial reaction people have is to assume that what they went through before in the previous downturn will

be what happens as the high prices of the current cycle unwind. This behavior makes sense from an intuitive perspective, people after all act on what they know and in the case of the current market cycle, what most know is that this far along from the peak in deal volume last time, prices were well below the peak.

FIGURE 3

The RCA CPPI Following a Different Track Today



However, if we look at the RCA CPPI in the same framework presented in Figure 1, one can see that prices have been following quite a different track in this cycle than in the last. Twenty months out from the peak in deal volume in October of 2007, the RCA CPPI had already fallen 25% with more declines still ahead of it. Twenty months out from January 2016, the RCA CPPI stood 15% higher than the previous level.

What market forces are at play today that are keeping prices at an elevated level and why were they not seen in the last downturn? To answer these kinds of question, one needs a framework to interpret the moves in prices and volume. The key is to look at different movements in the supply and demand for capital and assets across different cycles.

A Framework for Understanding Price and Volume

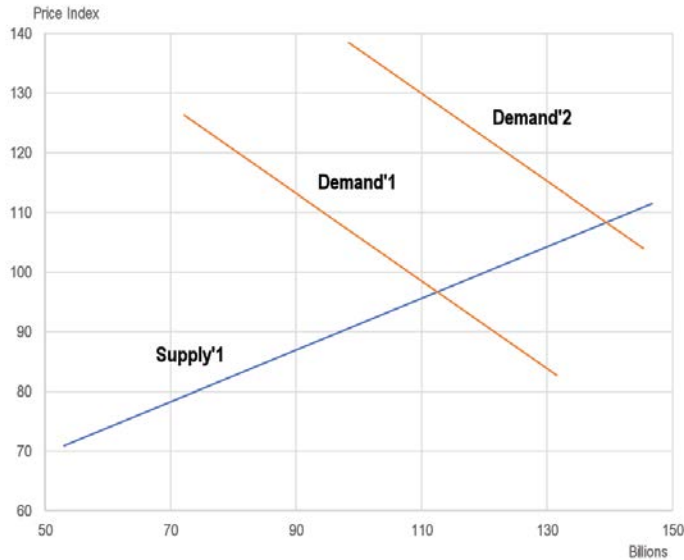
Prices move over time ... up, down, sideways. Unless you develop a framework to understand and interpret what is driving those movements, you will only be left with rule of thumb descriptions of the market and the track followed by previous market cycles as a guide. The key feature of the price disconnect in this cycle, a feature that was not part of the track followed in the last, is that relative to the demand for assets, there is a dearth of supply.

It Is All about Supply and Demand

The tools to understand this supply and demand relationship are easy to grasp. Everything presented on supply and demand curves in that microeconomics 101 course you took back in college is all you need for a framework to interpret recent price movements.

FIGURE 4

A Way to Think About Real Estate Capital Supply and Demand



If you own real estate assets, you are permanently engaged in a review of the current market. Whether through a formal appraisal process or from a thumb in the air, you will always be trying to develop a sense of market pricing. If prices are higher than expectations, you might be inclined to sell a few assets, take some of unexpected gains off the table and sell even more assets as prices rise.

Figure 4 shows this sort of behavior with the upward-sloping supply line labeled as Supply'1. The x-axis is a quantity measure and the y-axis is a price measure. As prices increase, you the holder of assets, are more inclined to push more assets out to the market to reap some of those unexpected gains. Potential buyers have a different view of the world: they all want a bargain. If prices are at record highs, buyers will hold back if they don't see any upside.

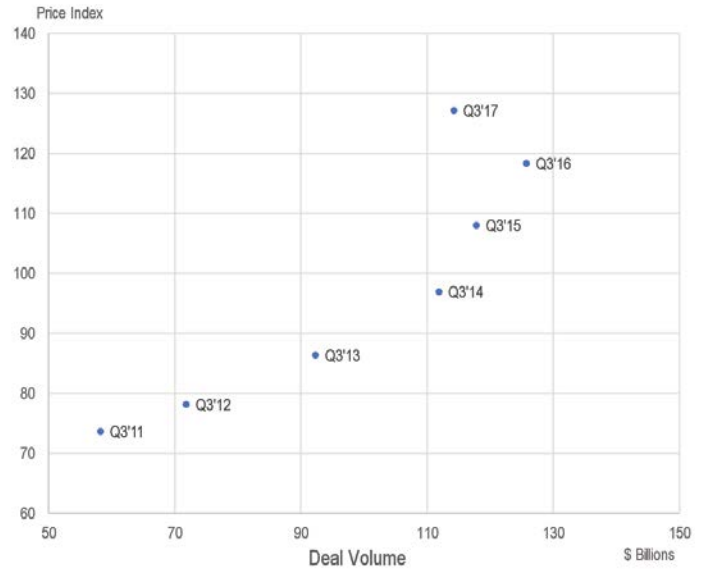
Looking at Real World Data on Supply and Demand

The truth of the matter is that these abstract lines shown in Figure 4 are not something we can really observe at any minute. Those figures on the x-axis and y-axis ... I tied the RCA data on commercial property sales volume and the levels of the RCA CPPI for all commercial property types nationally the scale of each axis on that chart. Figure 5 highlights what can be observed in the real world.

Looking at trends from the third quarter of 2011 to that of 2017, a clear pattern emerges. The relationship between supply and prices has a well-defined linear relationship from 2011 to 2014. After that there is a bit of a jump to 2017 though there is simple linear shift in the demand price relationship between 2016 to 2017. All of these figures are shown on a Q3 basis every year to control for seasonal effects between quarters.

FIGURE 5

What we Observe on Supply and Demand

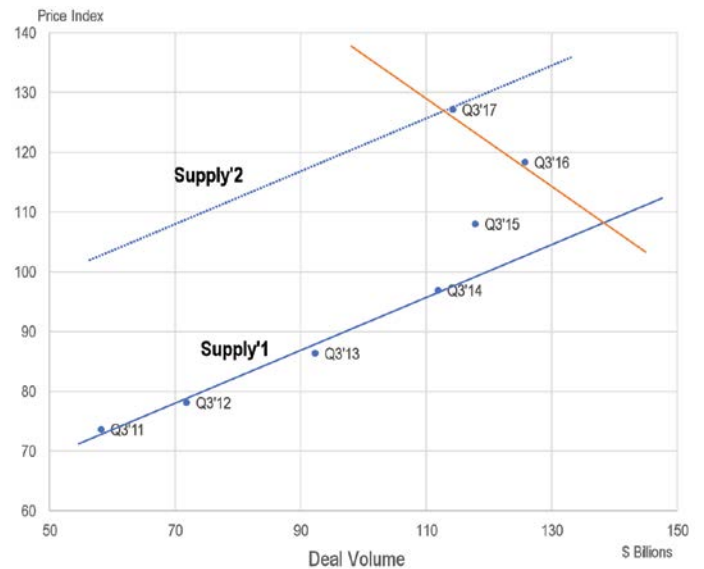


I highlighted all these moves in Figure 6, not by simply free-hand drawing a line as in Figure 4, but by mathematically fitting a line to the observed data points for 2011 to 2014. Throughout this period, seller preferences remained somewhat constant. For every 1% increase in prices, there was a greater than 1% increase in the supply of assets. The thing that really moved up until 2016 was buyer preferences.

Over a five-year period, buyers became more aggressive wanting more assets at the prices seen in the previous year. For each of those data points labeled Q3'11 to Q3'6, imagine a unique demand line for each point along the way. Those lines kept shifting up along the supply curve as buyer aggressiveness and appetite for lower and lower yields continued.

FIGURE 6

Following the Track of Supply and Demand



There is only one way the market could have gone from the high volume/high price position in Q316 to a lower volume/higher price position in Q317. At current prices, sellers are just not as motivated to unload their remaining assets. Many high-quality properties have already transacted in this cycle and if one sold a high-quality asset today, replacing that income with the purchase of another high-quality asset becomes more problematic.

Deal volume could be back at the Q316 levels, but to motivate owners to unload their current holdings, buyers would need to pay prices above what they are willing to stomach today. These supply and demand relationships suggest that prices somewhere 10% to 20% higher than current levels would be needed to see sellers motivated to unload assets at the same pace seen in 2016. Buyers are still hungry for the yield in the sector today as a year ago, but their aggressiveness has peaked. In 2017, buyers became less willing than they had been in 2016 to push up to higher prices to achieve deals.

Where Do We Go from Here?

Just because we have not seen the Drop of Doom 20 months out from the last peak though, can we be sure that such a drop is not just around the corner? No, of course not, but a global liquidity crunch like that seen in the last downturn is not as likely. Buyer aggressiveness seems to have peaked but buyer demand for the returns of commercial properties has not waned. For that reason, this demand curve has not shifted downward.

The PREA consensus survey of NCREIF returns shows that most industry participants expect commercial property returns to slowly fade to the high single-digit range from the double digit returns that induced many investors to allocate capital to the sector. Such a move could inspire buyers to pull back on the aggressiveness of their bidding and slowly shift that demand curve backward.

The speed of that adjustment on return expectations is what matters to how quickly, and how far, that buyer demand curve shifts. Heaven forbid we face another global financial crisis where debt was unavailable even for good projects, then buyer demand would fall back very far and very fast leading to a collapse in deal volume and pricing.

FIGURE 7

The Stock of Commercial Property Debt is Growing Today, Not Shrinking



Sources: Real Capital Analytics, Federal Reserve Bank Flow of Funds Database

As shown in Figure 7, the stock of both commercial property and multi-family debt fell sharply during the Global Financial Crisis. This stock of debt measures existing loans, less maturations and defaults plus new loans issued. Even though the recession ended in June of 2009, the stock of commercial property debt shrank every year from 2009 to 2013, liquidity of the debt markets and the ability of new operators to enter the sector was hampered. Today though, the stock of debt continues to grow.

As debt capital is still plentiful owners may opt not to sell but can continue to refinance as needed. A slow steady uptick in interest rates would lead to a slow steady downward trend in deal volume and pricing. To get to a shocking collapse in pricing and deal volume though, lending would likely need to collapse as in the last downcycle.

Every Cycle Is Different

Is it different this time? Of course it is; every cycle is different. There are common features one must worry about in any cycle. If a borrower wants a 95% LTV on an investment with flaky tenants and no clear management plan, no market cycle is going to save the uninformed lender doing that deal. To assume that every market cycle ends with the same sort of decline as the previous one is equally uninformed.

Without a sense of the historical forces which drove various cycles over the years as well as a framework to interpret these forces, one can be misled into thinking that each bump in the market is the precursor to the next Drop of Doom.

Prices never exist in a vacuum. There is a certain amount of demand for investment product and a certain amount of supply. When demand for investment products is steady while the supply of assets on offer pulls back, prices should tend to rise.

The current fall in deal volume need not lead to a decline in pricing like that seen in the aftermath of the Global Financial Crisis. The preferences, opportunities and financial positions of investors vary across every business cycle. The current downshift in deal volume is happening at a time of still-high buyer demand for the returns on offer by commercial real estate assets. 📈



Go With The (Net Cash) Flow: Correlation Between Margins and Unemployment in U.S. CMBS and Its Impact on Property Subtype Performance

It can be constructive to do a deeper dive into the relationship between commercial real estate profit margins, unemployment rates, and historical U.S. CMBS loan performance, in order to help market participants in evaluating a commercial real estate portfolio's risks and provide historical context around which property subtypes are the most volatile and susceptible to default when market conditions deteriorate.

Our findings showed that lodging loans generally had the highest default rates and loss severities among the five major property types, but regional malls exhibited the highest default rates and loss severities for any of the property subtypes when they fell below 1.0x debt service coverage (DSC). Industrial properties, especially newer ones, were among the best performers over the study period. Multifamily also performed well.

Lodging Exhibits Lowest Historical "Profit Margins" by Property Type and Subtype

Of the major property types, retail and industrial properties have showed the highest net cash flow (NCF) margins (NCF/revenue) over time, averaging 66% and 68%, respectively, from 2000-2016, followed by office (56%) and multifamily (49%) (see Table 1). Lodging properties consistently exhibit the lowest NCF margins of the major property types, averaging 27%.

TABLE 1

Historical Net Cash Flow Margins and Correlation to Unemployment Rate by Property Type

	2001 (%)	2006 (%)	2011 (%)	2016 (%)	15- year average	Correlation with the unemployment rate
Lodging	29	25	25	29	27	-0.69
LO – full service	26	19	20	28	23	-0.64
LO – extended stay	39	37	35	36	35	-0.6
LO – limited service	31	31	28	31	29	-0.65
Retail	67	66	65	67	66	-0.71
RT – mall	60	61	61	63	61	0.01
RT – anchored	69	67	65	68	67	-0.74
RT – unanchored	67	63	60	62	63	-0.68
RT – pharmacy	94	93	93	94	93	0.28
Office	60	56	55	54	56	-0.36
OF – CBD	60	54	54	54	55	-0.27
OF – suburban	61	58	56	53	57	-0.43
OF – portfolio	55	53	51	N/A	53	0.06
Industrial	71	68	67	66	68	-0.29
IN – <1970	67	63	63	69	64	-0.11
IN – 1970-1980	71	62	65	63	66	-0.34
IN – 1980-1990	68	65	64	63	66	-0.54
IN – 1990 to 2000	77	73	70	78	73	-0.55
IN – 2000 to 2010	80	77	74	79	77	-0.51
IN – >2010	N/A	N/A	N/A	87	89	N/A
IN – portfolio	68	68	62	61	63	-0.31
Multifamily	51	49	50	53	49	-0.2
MF – primary	52	49	51	55	51	0.04
MF – secondary	51	48	49	52	49	-0.22
MF – tertiary	51	49	50	52	50	-0.16
MF – portfolio	48	47	47	55	48	-0.39

LO—Lodging. RT—Retail. MF—Multifamily. IN—Industrial. OF—Office. CBD—Central business district. N/A—Not applicable.

Our subtype property analysis revealed a few interesting trends:

- For lodging, extended-stay and limited-service properties tend to operate with higher margins than full-service hotels, which typically feature more amenities and are more operationally and capital intensive. Industrial margins seem to improve for newer properties.
- We split multifamily properties by market size (i.e., primary, secondary, and tertiary), and found that, on average, profit margins were similar.
- For retail, the “anchored” subset had the best margins over time, a few percentage points higher than “unanchored” and regional malls.
- Suburban and central business district (CBD) office margins were within a few percentage points of each other.

NCF Margins Tend to Decline as Unemployment Rate Increases; Hotels and Retail Have the Highest Negative Correlation

As expected, the correlations between cash flow margins and unemployment across all of the major property type averages were negative; that is, as the unemployment rate rises, NCF margins tend to decline.

Hotels and retail have the highest negative correlation with unemployment, at -0.69 and -0.71 correlation, respectively, which makes them relatively more sensitive to an economic downturn. Other property types exhibited lower correlations with the unemployment rate — office (-0.36), industrial (-0.29), and multifamily (-0.20) — indicating that they are slightly less susceptible to adverse effects in light of rising unemployment.

By property subtype, we see a few interesting results, as well:

TABLE 2

Summary of Distressed Loan Data by Property Type (2000-2016)

	Loans in data set (no.)	Loans that fell below 1.0x DSC (no.)	Loans that fell below 1.0 DSC and defaulted (no.)	Loans that fell below 1.0x DSC (%)	Default rate for loans that fell below 1.0x DSC (%)	Average loss severity of defaulted loans (%)	Loss given default (%)
Retail (RT)							
Unanchored	17977	5534	1978	31	36	43	15
Anchored	12430	2848	980	23	34	40	14
Mall	1472	284	139	19	49	60	29
Pharmacy	2797	208	18	7	9	37	3
Total RT	34676	8874	3115	26	35	43	15
Lodging (LO)							
Extended stay	463	173	72	37	42	49	21
Full service	1179	587	256	50	44	51	22
Limited service	2498	1383	564	55	41	45	18
Total LO	1642	760	328	39	39	46	18
Office (OF)							
CBD	6271	1874	552	30	29	35	10
Portfolio	160	33	14	21	42	22	9
Suburban	10122	4123	1637	41	40	45	18
Other	80	14	5	18	36	7	3
Total OF	16633	6044	2208	36	37	43	16
Industrial (IN)							
Built before 1970	1224	391	104	32	27	49	13
1970-2000	4085	1273	331	31	26	22	6
After 2000	1048	349	101	33	29	29	8
Portfolio	336	85	34	25	40	45	18
Other	288	84	20	29	24	53	13
Total IN	6981	2182	590	31	27	38	10
Multifamily (MF)							
Portfolio	451	135	47	30	35	40	14
Primary	8348	2751	826	33	30	35	11
Secondary	7503	2952	933	39	32	38	12
Tertiary	6643	2429	748	37	31	34	11
Other	456	143	40	31	28	32	9
Total MF	23401	8410	2594	36	31	36	11

DSC—Debt service coverage. CBD—Central business district. Source: S&P Global Ratings.

- Suburban office margins have more sensitivity to the unemployment rate than their CBD counterparts.
- Anchored retail properties exhibit the highest negative correlation with unemployment (-0.74), while the regional mall data suggest almost zero correlation. The low mall correlation is likely due to the significance of other variables, such as location, e-commerce, competition, potential sample bias, or long-term leases for key tenants that create a time lag between changes in economic conditions and margins.
- Lodging subsectors show little variation between them, as full-service, limited-service, and extended-stay hotels displayed similar correlations between NCF and unemployment.
- Industrial properties built after 1980 also all have about the same sensitivity.
- Multifamily portfolios that are diversified by location show higher correlations with unemployment than single properties, regardless of their market size. Multifamily properties in primary markets appear less sensitive overall to unemployment versus those in secondary/tertiary markets.

Lower Margins, Correlation to Unemployment, and Other Market Factors All Contribute to Historical Performance of CMBS Loans

Finally, we examined loans in rated CMBS deals that fell below 1.0x DSC (i.e., distressed loans), calculated the share of loans that defaulted (more than 60 days delinquent), and, if those loans took a loss, what the severity of that loss was. The results are displayed below in Table 2, as well as an average “loss given default (LGD)” measure, which is simply the defaulted percentage multiplied by the loss severity. This helps us rank the various property types and subtypes. We also graphed the 15-year average NCF margins along with each property subtype’s LGD measure in chart 1.

CHART 1

15-Year (2001-2016) NCF Margin Vs. Average Loss Given Default Rate by Property Type

	(%) NCF	(%) NCF LGD
RT – unanchored	63.06	15.48
RT – anchored	67.03	13.6
RT – mall	61.32	29.4
RT – pharmacy	93.15	3.33
Total RT	65.93	15.05
MF – portfolio	47.7	14
MF – primary	50.68	10.5
MF – secondary	48.84	12.16
MF – tertiary	49.61	10.54
MF – other	44.91	8.96
Total MF	49.45	11.16
OF – CBD	55.33	10.15
OF – portfolio	50.96	9.24
OF – suburban	57.14	18
OF – other	57.83	2.52
Total OF	55.92	15.91
IN – built before 1970	63.73	13.23
IN – 1970-2000	68.22	5.72
IN – after 2000	75.23	8.41
IN – portfolio	62.75	18
Total IN	64.08	12.72
LO – extended stay	34.51	20.58
LO – full service	23.19	22.44
LO – limited service	29.06	18.45
LO – other	27.83	14.08
Total LO	26.79	17.94

NCF—Net cash flow. LGD—Loss given default. LO—Lodging. RT—Retail. MF—Multifamily. IN—Industrial. OF—Office. CBD—Central business district.

Overall, we observe a general trend that lower margins are a contributing factor to a higher loss given default (from the top left to the bottom right in chart 1). The only real outlier is regional malls, which, in many cases, have been experiencing declining sales and increasing vacancy rates due to internet shopping disrupting their performance. Another sector that somewhat bucks the trend is suburban office versus CBD office, which may be showing that correlation to unemployment and other market factors also play a role in the overall historical performance figures.

Historical Performance of Distressed Loans and Their Relationship to Unemployment and Margins

Lodging: hotel loans have highest propensity to be distressed and default

The lack of long-term leases, high fixed expenses and capital investment needs, exposure to event risk, and high correlation with economic performance and unemployment levels all contribute to a much higher level of NCF volatility for hotels relative to the other major property types. Lodging properties of all types have historically exhibited the lowest NCF margins of any major property type, averaging between 22%-29% during the 2000-2016 period we reviewed. Within the sector, full-service hotels had the lowest average NCF margin of 23%, followed by 29% for limited-service hotels and 35% for extended-stay hotels.

Because of their low margins, changes in hotel revenue can, and often do, result in NCF changes twice that change, eroding DSC at a faster pace than the other major property types. On average, loans secured by hotels had the highest propensity (39%) to fall below 1.0x DSC when compared to other property types, despite

typically being originated at a higher going-in DSC. More importantly, of the loans whose DSC fell below 1.0x at some time during their loan term, 39% ultimately defaulted, and these loans had the highest loss severity of any major property type at 46%.

Of the lodging property subtypes, extended-stay hotels stood out as having the lowest tendency to fall below a 1.0x DSC relative to full-service and limited-service hotels; but once hotels default, each of the three sub types generally demonstrate default rates (41%-44%) and loss rates (45%-51%) within a relatively small band. However, full-service hotels, probably due to their lower NCF margins, did have the highest default and loss rate relative to limited-service and extended-stay properties, resulting in a slightly higher loss given default of 22%, versus 18% for limited service and 21% for extended stay.

Lodging exposure in conduit deals year-to-date (YTD) through November 2017 has remained steady at around 16%. Similarly, over \$13 billion within 20 stand-alone deals has been secured by single hotel properties or lodging portfolios, tops among the property types. As lodging levels remain elevated within CMBS deals, we continue to assess more conservative RevPAR assumptions relative to the trends within the past several years as supply growth is on an upward trajectory and RevPAR gains have slowed or even turned negative in several major markets.

Retail: high negative correlation with unemployment depends on level of consumer income

The U.S. retail sector has been facing numerous, well covered headwinds over the past five-to-seven years.

Still, retail properties across the board have historically exhibited one of the best performing NCF margins, hovering between 65%-67% throughout 2000-2016; only 26% of retail loans fell below a 1.0x DSC during their term, the lowest of any property type. However, the average loss severity rate of 43% for the retail loans that did drop below the 1.0x DSC threshold and subsequently defaulted was one of the highest of all the property types, except for lodging.

Within the retail sector, regional malls had a very low tendency (only 19%) to fall below a 1.0x DSC. But when they do drop below 1.0x DSC, they have the highest default rate (49%) and loss severity of any property subtype, at a staggering 60%. In fact, we evaluated the loss severity for all regional mall properties with losses over 2% with a disposition date during the past 10 years (see chart 2). The severity rate was particularly high in 2009 and 2010 (over 80%) during the economic downturn and has remained elevated during the past five years or so.

CHART 2

Weighted Average Loss Severity of Mall Loans 2007-2017

	(%) Weighted average loss severity (left scale)	(\$) Securitized balance (right scale)
2007	44.77	23991013
2008	39.22	4144792
2009	88.18	102500000
2010	83	237777312
2011	49.24	715322483
2012	69.26	730180994
2013	82.31	919396667
2014	65.07	478746631
2015	73.37	493099999
2016	63.74	1230105133
2017	72.51	157830213

Anchored and unanchored retail properties both had a higher tendency to fall below 1.0x DSC than malls, but when they did, their default rates were lower at 34% and 36%, respectively, and their loss severity rates were much lower at 40% and 43%. Notably, the NCF margins for loans secured by pharmacies was the highest of all the property subtypes, creating a low unemployment correlation and the lowest default rate and loss severity of all the property subtypes we examined. These properties are typically leased to investment-grade tenants on long-term triple-net leases, which foster favorable loan performance. We should note that recent headlines suggest forthcoming disruptions to the prescription drug market, but the market hasn't seen a major structural sales disruption thus far.

While the percentage of retail collateral in CMBS transactions has declined in recent years, it still had the second-highest exposure within conduit deals YTD November 2017. Our findings clearly show that malls can exhibit extreme default and loss rates. However, we still see the inclusion of this property type as helpful to diversifying multi-loan pools as long as the properties are underwritten based on an evaluation of their location, competitive landscape, and long-term performance trends.

Multifamily: lowest correlation with unemployment of major property types

Multifamily properties displayed NCF margins that ranged from about 49%-53% during the 15-year evaluation period. Notably, multifamily property cash flows showed the lowest correlation with unemployment levels, at only -0.20. We believe this is likely due to the fact that our study period contains the housing boom and then bust, which significantly affected both the supply and demand for the multifamily sector, rather than unemployment not being a significant factor affecting the performance of multifamily loans. In fact, the correlation between the two variables over the past five years is approximately -0.80.

Given their strong performance, multifamily loans have historically been underwritten to lower DSCs relative to other property types, which likely led to them having one of the highest propensities to fall below a 1.0x DSC, at 36% (though they were the second-lowest percentage to actually default, at only 31%). Additionally, multifamily properties show the lowest loss severity in the sample for loans that met our definition of default. While multifamily properties in secondary and tertiary markets had a higher tendency to fall below a 1.0x DSC, the default and loss severity rates for multifamily in primary, secondary, and tertiary markets were very similar, thus resulting in a similar loss given default for each of these sub-sectors.

Conduit CMBS exposure to multifamily has been muted in the last few years, at 8% YTD November 2017 and 10% in 2016, compared with 15%-16% in 2014 and 2015, as GSE lending stepped up considerably. Unsurprisingly, both multifamily and industrial properties have generally performed the best over time, but older vintage industrial properties have inferior performance, and construction is increasing in both sectors.

Office: suburban properties have a greater sensitivity/correlation to unemployment than CBD properties

Office properties displayed an average NCF margin of 56% during the past 15 years, with the margins for suburban offices slightly higher than for CBD properties. Overall, office properties had the second-highest loss given default (16%), after lodging properties. However, suburban office loans had much higher default and loss severity rates than those of loans secured by CBD office properties. While the margins of the two were similar, we do note that suburban property NCF maintains a higher sensitivity/correlation to unemployment. In addition, suburban properties may have a relatively harder time re-tenanting in distressed periods, which may only be partially captured by margins and the overall unemployment rate.

Office exposures in conduit deals have climbed lately, at 40% this year, compared to 29% in 2016. As recent CMBS composition leans toward a high concentration of office properties, we highlight the significant differences in the performance of CBD versus suburban office buildings. We also note that the percentage of single-tenant office properties in 2017 conduit transactions has increased along with the overall market number (16% in 2017, 12% in 2016, and 10% in 2015), which creates greater event risk at lease maturity or upon a potential tenant default.


Industrial: the older the property, the lower the NCF margin

Both location and year built (which proxy obsolescence) are critical factors that should be evaluated in any analysis of industrial properties. Strong properties can easily attract tenants by their location in infill areas within highly populated areas with strong barriers to entry. Strong properties should also be located near multiple transportation networks or close to the consumer of the final warehoused product. However, the physical quality, amenities, and ceiling height offered by the property are equally important, in our view. Tenants look for modern standards that include at least 30-ft. clear heights, multiple high-loading docks, truck parking, and flexible uses. Older properties typically have lower ceiling heights that may become obsolete if they don't fit the needs of today's warehouses and distribution centers. Keeping this in mind and looking at available information, we analysed industrial loans by year built.

We observed that the older the property, the lower the NCF margin. Loans secured by properties built before 1970 had an average NCF margin of 64%; properties built from 1990-2000 had an average margin of 73%; and those built from 2000-2010 had the highest margin of 77%. Although loans secured by industrial properties had similar default rates, loans secured by properties built before 1970 had a loss severity rate that was about double that of loans secured by newer properties.

Industrial exposures have recently been steady, at 6% of conduit pools in both 2017 YTD and 2016.

Our Analysis Highlights Stabilized Cash Flows & Valuations

Although the U.S. economy is in its eighth year of expansion, we continue to analyze all property types in a manner that considers both upward and downward market fluctuations by deriving an expected stabilized NCF and valuation for all property types. This study clearly demonstrates that the NCF margins for most property types have an inverse correlation with unemployment rates such that an increase in unemployment levels will typically result in a corresponding decline in NCF margins. Furthermore, we found that, in general, property types with lower NCF margins generally experience higher default and loss rates (noting certain exceptions such as regional malls, which have strong margins, but are experiencing new extraneous influences creating the highest loss given default rate of any property type) once they become distressed. 



Borrower Beware! Selected Silent Issues in CMBS Loan Documents¹

Negotiating loan documents requires a borrower's counsel to seriously contemplate the needs of the borrower, the operation of the property and the interplay of both considerations with the proposed financing. Unlike other types of agreements that focus on the past, loan documents are almost entirely focused on the unknown future, which is decidedly more challenging.

Loan documents are living agreements that govern the relationship between the borrower and the lender for the duration of the loan. The goal of both borrower and lender should be for the agreements to cover every scenario that may arise so as to avoid any ambiguity or surprise down the road. This is particularly important to a borrower on a CMBS loan, given that the lender after a securitization will be replaced by a servicer that services potentially thousands of loans and whose interests and motivations may be very different than the lender at closing. Borrowers are anxious to document each potential pitfall when negotiating loan documents, but borrowers are at a disadvantage given that there are no standard CMBS loan documents to provide for an easy comparison of basic terms. The form of loan documents can vary depending on the lender and the lender's legal counsel.

Document Issues

Typically, the key business and legal terms that are fundamental to both borrower and lender are reflected in an agreed term sheet that counsel will use to draft the documents. Most form documents, however, contain a number of issues that are important to nearly every borrower and that do not clearly and easily present themselves to the borrower and its counsel. These key issues fall into one of two categories that make them particularly challenging and "silent." First, there are terms potentially missing from the forms circulated by lenders that are vital to the borrower. The second category are terms that on their face appear reasonable, but can create issues for the borrower unless appropriately modified. Loan documents often number hundreds of pages and these issues, to the unsuspecting borrower and its counsel, can cause significant problems when the parties, and potentially a court, will be reading each word as a guide to resolve a conflict.

This article presents some examples of these issues that the authors have encountered in loan documents used in the CMBS market. The issues are organized generally by topic. In addition to raising the issues, the article provides the

borrower with suggested resolutions and, where appropriate, the reasoning behind the suggested approach. Each loan, just like each property and each borrower, is unique and has its own characteristics and requirements that the lender requires in order to close the loan. In most cases, however, a lender should be willing to consider these suggestions without the need for serious negotiation given the general market consensus on these points.

Payments, Prepayments and Defeasance

Late Fees

If the borrower is late in making any required payment a lender will typically charge a flat late fee calculated based on the amount of the late payment. Late fees are meant to compensate the lender for the hassle and additional costs incurred as a result of the late payment and are in addition to any default interest charged. Although late fees apply to late payments of interest and amortized principal (to the extent applicable), it is not customary to require the borrower to pay a late fee for a failure to repay the outstanding principal and interest on the maturity date or upon acceleration of the loan. A late fee, which is often up to 5% of the defaulted amount, calculated on the outstanding principal amount of the loan, could result in an enormous windfall to the lender if there is a default at maturity (even if, for example, the refinancing is delayed by only one day). Borrower's counsel should ensure that an appropriate exception from the general rule to pay a late fee is included in the loan agreement for maturity defaults.

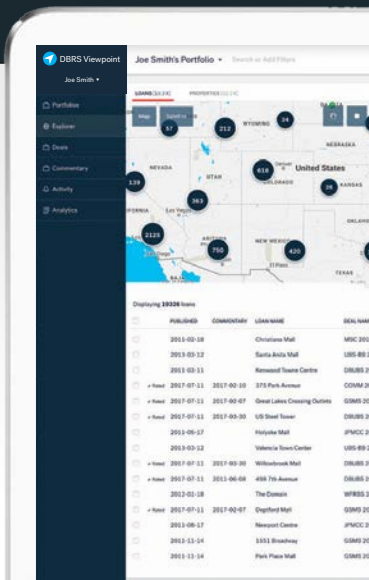
Prepayment following Casualty/Condemnation

Following a casualty or condemnation, a lender will typically have the option under certain circumstances to require that the insurance proceeds or condemnation awards be applied to prepay the loan. A borrower should ensure that such a mandatory prepayment not be subject to a prepayment penalty or fee. This issue is well covered and is oftentimes a standard exception from the general rule requiring a prepayment fee. Another issue exists, however, with respect to prepayments following a casualty or condemnation that may be less obvious. If the lender applies casualty or condemnation proceeds to prepay a portion of the loan, the borrower should have the ability to voluntarily prepay the remainder of the loan (or the release price of the effected property in a multi-property transaction) without requiring the payment of a penalty or fee, even if the loan is not otherwise be prepayable at that time. If a casualty occurs and the lender requires that the insurance proceeds be applied to prepay the loan, the borrower may not have the necessary funds to restore the property to the condition it was in prior to the casualty and will need a construction loan or some other refinancing in order to complete the restoration.



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LIBOR Replacement

Given the expected death of LIBOR as a benchmark rate, loan agreements with an interest rate tied to LIBOR need to contain a clear mechanism for a replacement benchmark rate with an appropriate adjustment to the spread over LIBOR to reflect the difference between the new benchmark rate and LIBOR. Although floating rate loan agreements have traditionally contained mechanisms to replace LIBOR if it is unavailable these mechanisms require new scrutiny to reflect the expected permanence of the unavailability of LIBOR.

If a loan agreement requires a replacement of the interest rate cap agreement during the term of the loan (e.g., upon a loan extension) the borrower should discuss with the lender a mechanism to comply with the loan agreement requirement if a LIBOR based interest rate cap becomes unavailable. Although it has always been advisable for a borrower to consult with a hedging advisor on the provisions that govern the purchase of an interest rate cap, the need has heightened given the expected unavailability of LIBOR.

Prepayments in the Context of Property Releases and Loan Extensions

The conditions that a lender will require in order to extend the maturity date of the loan or release a property in a multi-property loan can vary. These conditions often require that the property meet a minimum debt service coverage ratio threshold and/or a minimum debt yield ratio. If the loan is not otherwise prepayable without penalty at the time of such extension or property release, the borrower should request the ability to prepay or defease a portion of the loan without penalty so that the property satisfies the required debt service coverage ratio and/or debt yield thresholds. The purpose of the financial tests is to demonstrate the health of the property as it relates to the loan and, therefore, the Borrower should not be prevented from extending the loan or releasing a property if it can reduce the principal amount of the loan to meet the required thresholds.

Defeasance

Defeasance securities generate payments that serve as a direct replacement for the steady monthly payments that the borrower previously paid under the loan agreement prior to defeasing the loan. Some loan agreements require the borrower to purchase defeasance securities that provide for monthly payments through the maturity date instead of the beginning of the period when the loan could otherwise be prepaid by the borrower, or are ambiguous on this point. A borrower should make clear that it only needs to purchase enough defeasance securities to make payments through the first day of the prepayment period or, at borrower's option, any other day during the prepayment period. This construct avoids the need to replicate interest payments that might never have been made and gives the borrower the flexibility to structure the final defeasance payment to fall out on the day in the permitted prepayment period that is most cost effective for the purchase of the defeasance securities.

The ability to defease a loan is a mainstay of fixed rate loan agreements that are destined to be included in either a stand-alone or conduit securitization. Defeasance can be an expensive and a very involved process, necessitating multiple parties and steps to successfully defease a loan. The defeasance provisions require a keen understanding of this process. There are a number of companies with expertise in the process and borrowers on large loans should consider having these experts review these provisions as part of the negotiations.

Transfers and Ownership Implications

"Direct or Indirect" Restrictions

A borrower should pay particular attention to negative covenants and transfer restrictions formulated as prohibiting an action or transfer by a "direct or indirect" equity owner of the borrower. These restrictions could have implications beyond

what the lender contemplates as being integral risks associated with the loan and the property and could be particularly problematic for private equity fund borrowers. Without proper crafting, limited partners could be restricted from transferring their interests or the fund could be required to give advance lender notice of a transfer.

A similar issue arises in connection with restrictions on the incurrence of debt by indirect owners of the borrower and restrictions on pledging upper-tier ownership interests. Although these restrictions should apply to any entity the lender deems as being directly necessary to ensure that the borrower doesn't add unwanted preferred equity or mezzanine debt, a lender will typically allow the fund itself and upper-tier entities that own significant other properties to incur debt and pledge their ownership interests. The contours of the restrictions and exceptions are specific to the facts and circumstances of each ownership structure. These issues are being raised in this article, however, only to highlight some of the more thorny and difficult pitfalls that borrowers need to be aware of.

Individual Owners

If a borrower is owned by a natural person, the individual should consult with estate planning advisors regarding transfers of its ownership interest to accommodate estate planning, including potential transfers following death. A lender may be amenable to permitting certain pre-designated transfers or condition-light transfers to the extent the lender understands the nature and purpose of the estate planning related transfers.

Rating Agency Approval

On a CMBS loan, the Lender will require that the rating agencies that rated the securities approve certain matters that may also require lender approval. The rating agencies typically only agree to review and then approve or disapprove certain requests, but decline to review others. With respect to any matter that a borrower is required to receive rating agency approval before taking an action, the borrower should insist that the rating agency approval requirement be deemed satisfied if the relevant rating agencies decline to review the request. This avoids the pitfall of a borrower not being able to take an action if the rating agency decides not to review it.

Guaranties

Termination of the Guaranty for Individuals

If the guarantor on a loan is a natural person, the borrower and guarantor should consider whether the guaranties should automatically extend to the guarantor's heirs and estate or terminate following the guarantor's death. Guaranties that extend to the estate and heirs could complicate the estate after death and may also have unintended consequences (e.g., forcing the estate to maintain a minimum net worth and liquidity) that could be challenging for the estate. A borrower should consider asking for the ability to terminate the guaranties following death upon the lender receiving a replacement guarantor that meets the pre-agreed requirements set forth in the loan agreement.

Replacement of Guarantor upon an Event of Default

Borrowers should consider requesting the ability to replace the guarantor upon an event of default that arises solely as a result of a failure to satisfy the guarantor financial requirements. This request is sometimes granted by lenders, though it may be challenging to receive if the lender puts significant weight on the guarantor at closing remaining the guarantor during the term of the loan.

Notices to Guarantor

If a guarantor is not involved in the management of the borrower it may consider requesting that the lender add it as an additional notice party under the loan

documents in order to get direct notice of any issues that arise. Advance notice may give the guarantor the ability to interject and fix problems before they become recourse to the guarantor.

Recourse

Objectivity of Recourse Carveouts

A Borrower should be careful that the recourse carveouts are drafted clearly and whether the recourse carveout is triggered can be determined objectively. For example, the carveout of a "misappropriation of funds" in violation of the loan documents points to a clear set of guidelines in the loan agreement that could result in recourse. Conversely, a "misapplication of funds" might be interpreted subjectively to second-guess decisions made by the borrower in spending funds on one item over another, even though neither purpose was expressly prohibited.

Recourse for Economic Failures


Recourse items resulting from a borrower's failure to satisfy monetary obligations to third parties (such as a failure to pay insurance premiums or to prevent unauthorized liens on the property) should only be recourse to the extent of the lender's losses. In addition, the recourse liability should be limited only to the extent the property is able to generate funds to cover such expenses, lender does not block the borrower's access to those funds and the borrower nonetheless fails to satisfy the obligations. Without these limitations, the guarantor is essentially agreeing to full recourse for those obligations as the guarantor will be required to fulfill obligations of the property that the property itself cannot sustain.

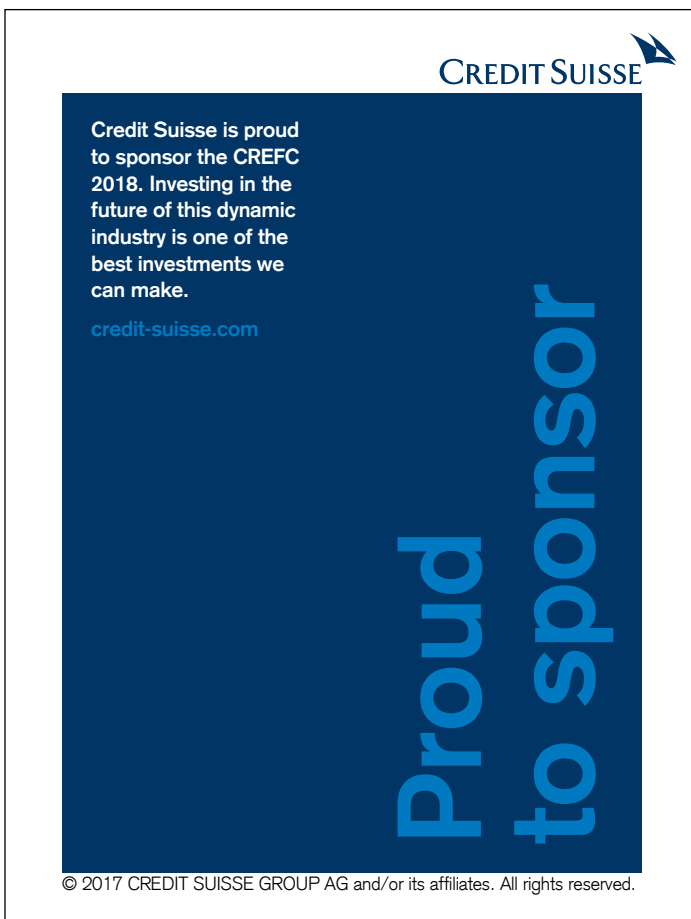
Full Recourse


A borrower should limit the matters that cause the loan to be fully recourse to the guarantor to only material unauthorized voluntary acts, such as an unauthorized transfer of title to the property or the placing of a lien on the property for borrowed money. A borrower should be careful to exclude minor liens, easements and ordinary course disposal of personal property from the transfer restrictions so that they do not trigger the full recourse provisions.

Conclusion

The foregoing points raised in the article give borrowers and their counsel some examples of "silent" issues that could arise in the future and upset the borrower and its otherwise overall business plan for the property. Borrower's counsel are encouraged to develop their own list of "silent" issues over time (be it through the process of negotiating loan documents or guiding clients through unintended results) to use in counseling borrowers to avoid these thorny pitfalls. Being prepared not only allows borrower's counsel to efficiently identify the issues as they arise during the review of loan documents, but it also enables the borrower and its counsel to focus on the issues that may be unique to the property and to quickly present lenders with market established positions on these issues.

¹ The authors recognize the "Landlord's Checklist of Silent Lease Issues" and "Tenant's Checklist of Silent Lease Issues," by Joshua Stein and S.H. Spencer Compton, as the inspiration for the title. 



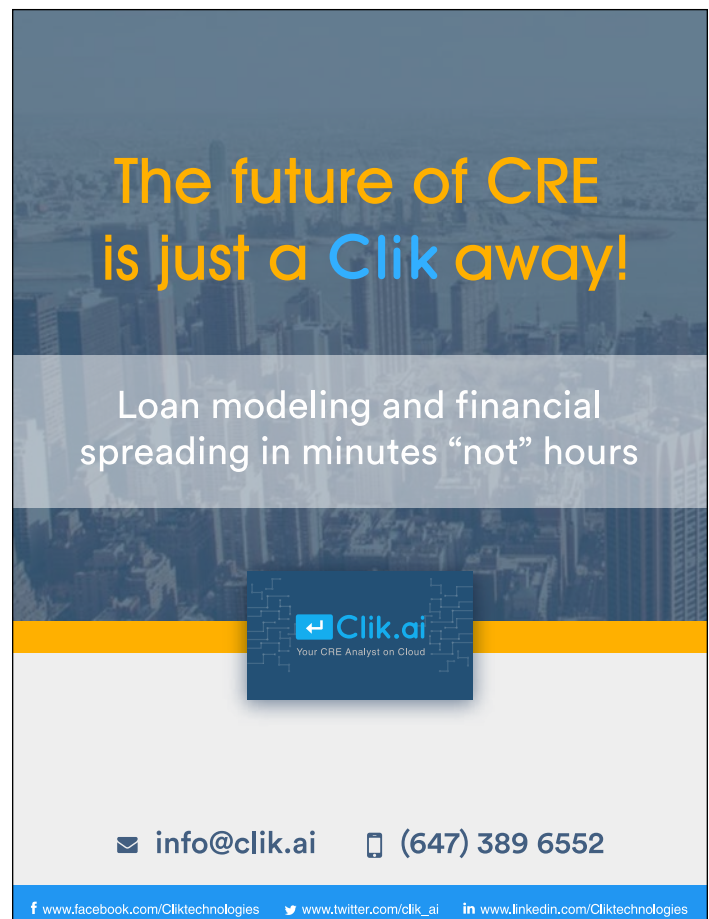
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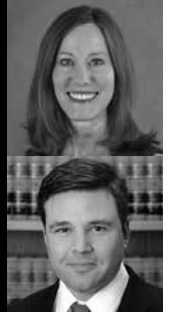
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Buying Opportunities; Avoiding Disasters

Buying distressed debt secured by commercial real estate is all the rage. Billions of dollars have been raised for this investment model with the idea that the wave of CMBS maturities from loans originated during 2005–2007 would turn into defaults and high-yielding opportunities. However, widespread distress did not materialize as expected due to appreciating real estate values and low interest rates. This lack of investment opportunity could push these investors into a reckless buying flurry to deploy capital in 2018. In fact, private debt dry powder levels remain near all-time highs and, as of September 2017, totaled \$214 billion. Of those funds, approximately \$70.7 billion is targeted for distressed debt.¹ Yet, with the October 2017 CMBS delinquency rate at 5.21%², or \$25 billion, it appears there is nearly a 3:1 ratio of capital to distress CMBS debt.

The risk, however, is that few of these investors are set up to do the required due diligence (much of which may need to be done on a moment's notice) in advance of a distressed acquisition. And those who are prepared, in many instances, may not know what to review. Too few buyers know what they are buying before buying it. Too often, critical aspects of both legal and non-legal due diligence that need to be done up front prior to making a distressed acquisition are overlooked, even by the most experienced of debt buyers.

Below we highlight 10 of the more common mistakes acquirers of distressed commercial real estate debt make when going through the due diligence process. Review the list of common mistakes set out below and take heed. Buyers should do their homework up front — to maximize gains and to mitigate buyer's remorse. Sometimes, there is a reason a buyer's bid is the best bid.

The Basics

Buying distressed debt is not new. With the benefit of multiple financial crises, the market has evolved and created a more efficient solution for investors to acquire pools of non-performing loans using on-line due diligence rooms and document images followed by an on-line auction or bid submission process. This is the foundation for today's buying and selling: a bid and ask market. Today's

investors have on-line access to data-rooms instead of rows of banker's boxes. The gig economy has created hundreds of on-the-ground inspection resources. And, there's nothing like Excel to run a model instead of the HPC12.

With all of the information available through a login and portal, due diligence, both in terms of the real estate and any potential legal issues, should be a snap. That being said, without knowledge of what to look for, mistakes (and costly ones at that) can be made. Purchasers of distressed assets do not want to come to regret the price paid for a distressed asset after the fact based upon a fact that could have easily been discovered prior to closing on the acquisition. Do the work up front — and know what to look for — prior to jumping into the distressed debt acquisition pool head first.

Ten Common Mistakes

Below is a summary of what is important, what to watch for and some of the more common mistakes made by even the most experienced professionals acquiring distressed real estate assets:

The real estate. Regardless of the discounted purchase price, the underlying real estate is the primary source of recovery for any commercial real estate loan. If this is not the starting point, don't start.

- **Mistake #1:** Not running a foreclosure search with a reputable title company. Do not cut corners. The hundreds of dollars spent running a foreclosure search at the outset can save tens of thousands of dollars later. Identify judgments that may impact a potential foreclosure action. Make sure that there is no dispute as to the selling lender's priority position as lienholder on the property. Do not assume the seller has correctly identified (or has rights to) the underlying collateral, including access and parking — review surveys and other documents that may be provided as part of a foreclosure search to confirm. A thorough foreclosure search at the outset can prove invaluable.
- **Mistake #2:** Not reviewing leases and the rent roll. Ground leases, property leases and REAs may have unusual clauses and resets impacting the value of the real estate, transfer provisions (including rights of first refusal) and consequently the timing and source of recoverable funds. Do not underwrite an asset based on hearsay and market-speak — think about the bankrupt retailers that were considered creditworthy even five years ago. Step back and think about the underlying business model of the tenant coupled with regulations and the tenant's general business model and overlay that on the underlying lease. Will the tenant be able to support the lease and, if not, what happens to the rest of the tenants at the property once one tenant leaves? Take the time, read the leases. All of them.

- **Mistake #3:** Not understanding special assessments and local municipalities. Buyer beware. Today's rising property values have brought forth a well-anchored party to the transaction — the underlying municipality. The local government has decided to capitalize on the wealth creating special assessments, tax value resets and other revenue generating opportunities. Also, if the buyer's model includes a foreclosure and subsequent repossession of the collateral, make sure that is not going to be an issue with the municipality. The local municipality may have a different agenda — including unique zoning or other laws that prevent subsequent property owners from executing a real estate business plan after taking title. The buyer may be seen as an outsider and as a source of capital — after all, the buyer bought a \$15 million loan, and therefore it must have substantial resources.

"The underlying ground lease contained a provision that required all subsequent buyers of the real estate to pay a 6% transfer fee, upon each transfer, including a transfer by foreclosure. This significantly increased the transaction costs to the lender on the \$20 million loan."

– Asset Manager

- **Mistake #4:** Not understanding the status of litigation. Is a foreclosure action already in process? If so, then counsel should be engaged to review the litigation file to see if there are any issues that may cause the foreclosure process to take longer than anticipated. Real estate recovery laws are driven by the property laws of the state and the venue of any litigation matters in terms of timing. Experienced foreclosure litigation counsel should be able to provide advice to the buyer around litigation benefits and detriments in one forum versus another (e.g., is this a borrower friendly venue? If so, re-think the acquisition or, at a minimum, the pricing for the acquisition). Time is money — identify the litigation pitfalls and make sure the chain of title to the loan is clear and recorded.
- **Mistake #5:** Receiverships. Getting a receiver in place may be the quickest way that the buyer, as the debt acquirer, can start generating revenue from the loan. But the laws in various jurisdictions vary as to whether a lender is entitled to a receiver and the powers a receiver may have, including distribution of net operating income prior to a resolution of the lawsuit. Experienced foreclosure litigation counsel will be able to advise its clients on receiverships in a particular jurisdiction and how long it might take to get a receiver in place and what that receiver may (or may not) be able to do once in place. Receivers may collect rent while a foreclosure action is pending, and that rental revenue stream may come into consideration when trying to price the purchase price for the loan. However, receivers can also make recommendations to the court to pay past-due amounts, improve the property and use debt (receiver certificates) or net operating income to make those improvements.
- **Mistake #6:** Not knowing or seeing the property. While free, Google Earth is not a substitute for the time and value of a site inspection. Many commercial real estate professionals have an unusual ability to remember a site once they have seen it. And, once there, it is hard to forget how hard (or easy) it is to find or access the property or the invaluable experience of sitting in the deli as chatty tenants grab a snack. Google Earth rarely has a hard time finding the real estate and does not eavesdrop on tenants in the deli.

- **Mistake #7:** Not knowing the default. Make sure that it is clear how the underlying loan came to be distressed, and if there are any potential lender claims that pre-date the borrower's default. Not all defaults are created equal and not all buyers will have bona fide purchaser status. Short payment defaults can, in many jurisdictions, be cured under state law, which may quickly get the buyer back to holding a performing loan (which it may not want if, ultimately, the desire is to own the real estate). Also, older defaults could present statute of limitations issues if the prior lender did not act upon the default soon enough. The courts generally do not look favorably upon a lender operating outside the loan documents when it comes to disbursements or response times to borrower requests. The buyer inherits the history and only knows what the seller shares in the due diligence vault, which generally does not include historic emails between borrower and lender, assuming there is a communication trail.

- **Mistake #8:** Not knowing the customer. Yes, that's right, the customer. This is a two-fold inquiry. First, who is selling the distressed loan and what is their reputation? This is critical, and do not hesitate to ask why might the seller be looking to unload the debt, especially in states that offer a short-term non-judicial foreclosure. Approach this with a critical eye. The second part of the inquiry is who is the ultimate borrower? The principals behind the commercial real estate are people. They are investors, owners, and operators with households, commitments, college tuition to pay and retirement accounts. They are beneficiaries of inheritances or property holders because of divorce (i.e., emotional). They are trying to make money — yes, money — i.e., the same goal as the lender. Knowing the borrower and the borrower's track record may allow a buyer to capitalize upon its investment sooner. Does the borrower have a history of being litigious? If so, add time and costs to the model. Do the principals have any assets other than the subject property that the loan purchaser may be able to seize upon in the event there is a personal guaranty? If so the loan purchaser may want to factor this into pricing, as there may be more than just the underlying asset for recovery.
- **Mistake #9:** Not reviewing the lender's loan file, if it is available. State and Federal laws are continuing to move to a more neutral (read: compassionate) venue. The CFPB and other agencies, are designed to improve and document the lender (yes, the note buyer is the lender) and borrower interaction, making sure there is fair treatment. What is fair is not at the discretion of an asset manager servicing a portfolio [read: 15-20 loans, multiple pieces of collateral under each loan and in varying stages of collection] of non-performing loans. The buyer should consider the servicing history and liability it may be inheriting when acquiring a non-performing loan; consider the borrower's efforts to repay the loan and communicate with the prior lender; and consider the emotional history behind the property's ownership. It is rare that a lender does not prevail in its recovery efforts, but it is a time and expense that must be evaluated, and one or two bad loans can easily blow an Internal Rate of Return or Multiple.

"I have a wife and two daughters and would be remorseful if I did not [sincerely] compliment you on that magnificent piece of jewelry."

– Asset Manager

- Mistake #10: Not reading the loan documents. Read the loan documents, all the loan documents. This is where the right counsel makes all the difference. Read the covenants, the non-standard provisions buried in the loan agreement, mortgage or guaranty. Ensure that there is not some inconsistency within the terms of the loan documents that may make it difficult to move a foreclosure action forward. Make sure that the lender is in possession of the original loan

“Don’t worry, you’d never be able to afford it.”
– Principal

documents, in particular the original promissory note, as that in many jurisdictions is the operative document to transfer. Make sure that the loan documents provide for the appointment of a receiver. Make sure that the prior lender is not charging a usurious rate of interest. Make sure that any default notices that

the lender has sent to the borrower comply with the requirements of the loan documents (otherwise, after acquisition the buyer may have to re-send the notices and start the foreclosure or collection process again). Find out what state(s) law governs the documents — the property’s state, the lender’s state, the guarantor’s state. It’s not economical to be in multiple courts trying to enforce rights and remedies.

The Closing

We have outlined some of the more common factors that are pre-bid identifiable due diligence items associated with buying distressed debt. Yes, there are many more, and those factors may make for interesting conversation. Ideally, the buyer, having done its due diligence, is on the secured side of that conversation, having identified and priced buying hurdles prior to closing on a distressed loan secured by commercial real estate.

1 Preqin’s Private Debt Quarterly Update Q3 2017

2 Trepp CMBS Research, October 2017 



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At Long Last, the CRE Market Has a Mezzanine-Loan Index



There are multiple indexes that measure the performance of public and private commercial real estate, property types, different geographies and investor strategy. Examples include the NCREIF Property Index, which is the standard for assessing “core” real estate assets, or RCA’s Commercial Property Price Index, which measures property values.

One key exception, however, has been mezzanine debt, an investment type that grew substantially during the last cycle. Mezzanine loans and other high-yield assets such as B-notes are difficult to measure, in large part because each is relatively unique and most investors are private entities that are loathe to share performance information.

Now, however, the market has its first third-party measure of high-yield commercial mortgage debt performance, created by John B. Levy & Company and S. Michael Giliberto & Company, which have been publishing a quarterly performance index for senior debt — the Gilberto-Levy Index — since 1993. Both indices were co-created by John Levy, president of Levy & Co., and Michael Giliberto, a Columbia University professor and former investment manager. The two companies worked with a group of investment managers to create the new Gilberto-Levy High-Yield Real Estate Debt Index.

The first GL index (GL-1) focuses on senior loans originated by portfolio lenders. The high-yield index — known as GL-2 — tracks the performance of \$8.5 billion of loans held by private entities dating back to January 2010. Mezzanine debt represents 53% of the GL-2 index collateral, with the rest a mix of senior loans and B-notes (32%), preferred equity, second mortgages and blended investments. About 60% of the loans carry a floating rate, while the rest are fixed.

High-yield debt racked up a 7.6% average annual return from 2010 through December of 2016, dramatically eclipsing the 5.3% return achieved by the firm’s senior-loan index over that same timeframe. For 2016, investments tracked in the GL-2 produced a 9.4% return. Returns on mezzanine loans in 2016 were 10.4%. The high-yield index is available on a subscription basis, and the results will be published quarterly, starting with 2017 returns.

Investors’ Long Sought Benchmark

Mezzanine debt investors have long craved a high-yield debt index to create a barometer of performance and guidance for price quotes for deals. Having an index generally improves liquidity in a market, because it helps the perception

that the market is established and provides confidence that investors have a target against which to measure performance.

Unlike senior debt, information about high-yield debt is not nearly as readily available. High-volume lenders such as banks, pension funds, insurance companies and CMBS not only must publicly disclose some information about senior loans, but they are generally willing to share with index creators or trade groups (example: American Council of Life Insurers) that aggregate the data. Mezzanine lenders, on the other hand, tend to be private equity firms that want to keep information closely held, in part because the selling point for many touts their ability to exploit mispricing in the market.

“Investors in high-yield real estate have long wanted to compare their returns and performance against an industry standard benchmark,” said Levy. “Our GL-2 carefully crunches the numbers and variables within financing packages, giving high-yield investors the deep insight that was previously only available to holders of senior loans.”

High-Yield Debt Hard to Measure

Mezzanine loan investments proliferated in the run-up to the last financial crisis. Many lenders originated loans of up to 95% of asset value and either held or securitized the senior portion (generally ranging from the 50% to 75% layer of the capital stack), and sold the junior portions to high-yield investors. In large deals, the mezzanine classes were “tranching” and each class was sold to a different investor.

That turned into disaster when the financial crisis hit in 2008. Property values slipped and many mezzanine investors lost huge amounts of capital as their investments turned underwater. In deals with multiple junior classes, mezzanine investors were forced to fight over control of properties.

The experience not only helped fuel demand for a performance index, but also illustrates the difficulty in creating and maintaining an index. Mezzanine loans represent different portions of the capital stack, they are subordinate to senior loans and have different terms regarding how to handle issues such as reserves, servicing, recourse and cross-collateralization.

The reaction among mezzanine investors has been mixed, with some happy that a benchmark is finally available, while others were less enthused. “All mezzanine loans are not created equal. Senior loans are more homogenous,” said one veteran debt investor. Said another: “Since mezzanine debt is typically heavily tranching, a ‘one size fits all’ index probably does not fit all.”

Levy and Giliberto, however, say that doubts expressed by some investors are unfounded. The index is broken down by leverage levels to provide an apples-to-apples comparison of the portion of the capital stack. If a high-yield lender originates a 60%-LTV loan and sells the first 40%, the remaining mezzanine portion of 40% to 60% will be grouped differently than a junior loan in the 60% to 80% portion of the capital stack. What's more, subscribers will be able to customize report components to align with their given investment profiles.

In addition to returns, the index will enable market players to measure over time a host of questions surrounding mezzanine debt, including:

- Appropriate pricing for loans given their position in the capital stack.
- How much managers' returns come from extension and exit fees.
- Tracking strategies, such as the difference in performance between loans backed by stable properties and those on construction or transitional assets.
- The magnitude of losses and how terms such as reserves and recourse impact that.
- Defaults, although since the data starts after the last financial crisis during an up cycle for commercial markets, no GL-2 index loans are in default.

Lenders Maintaining Discipline?

Since the recovery began eight years ago, property values have increased steadily and the total volume of commercial mortgages outstanding has risen to record levels. That sounds a lot like the situation preceding the last market crash, but Levy and Giliberto say that lenders are not nearly as aggressive as they were in the run-up to 2007. Senior lenders are not writing loans with as much leverage as they did in 2006-07. Lenders are “exercising a reasonable amount of discipline,”

Levy said. However, loan spreads have come down over the last couple of years. For example, debt that may have yielded 11%-12% in the years just after the financial crisis would yield 200 basis points less in today's market.


Whether lenders have learned the lessons of the last cycle or will gradually write more aggressive loans is to be determined. Whatever happens, though, for the first time there will be a way to measure what happened and why, and the impact in the high-yield debt market. 

TABLE 1
G-L 2 Pilot Study Loan Profile

		Fully Funded Principal Amount	
	Total	6,854,643,195	
Payment Type	Floating or adjustable rate	4,225,530,694	62%
	Fixed rate	2,437,709,858	36%
	Other or unknown	191,402,643	3%
Loan Type	Senior*	2,202,759,702	32%
	Second Mortgage	413,701,989	6%
	Mezzanine	3,643,441,899	53%
	Preferred Equity	232,951,337	3%
	Other or unknown	361,788,268	5%

*Includes all investment strategies using senior or whole loans. These are primarily B notes and other splits into multiple priorities for receipt of cash flow and allocation of losses. Exception: Loans in which lender funded both senior and mezzanine loans and retains 100% interest are included in “Other or unknown”.

TABLE 2
Investment Performance: G-L 2

	Annualized Returns and Volatility				
	G-L 2 (High-Yield CRE Debt)				G-L 1*
	All Loans Total	Mezzanine Total	Floating Rate Total	Fixed Rate Total	All Loans Total
Average return (geometric mean)					
CY 2016	9.4%	10.4%	10.1%	9.8%	2.9%
3 years (as of 12/31/2016)	8.1%	8.0%	8.8%	7.7%	4.9%
5 years (as of 12/31/2016)	7.9%	9.5%	7.6%	8.6%	4.5%
Full period (2010 through 2016)	7.6%	8.9%	6.5%	9.7%	5.3%
Volatility (annualized)	3.2%	4.4%	3.0%	6.0%	2.6%

*G-L 1 is the Giliberto-Levy Commercial Mortgage Index, which includes only senior whole loans with fixed rates

CY Calendar Year

Volatility is measured as the standard deviation of monthly total returns

1. Not surprisingly, high-yield CRE debt outperformed conventional senior loans over the pilot study period.
2. Mezzanine loans delivered higher returns than the senior-loan-only G-L 1 and the overall high-yield G-L 2 over most time horizons.
3. Many factors drive reported returns. Interest rate movements certainly are one. We believe ups and downs in Treasury yields and low LIBOR rates underpin some of the observed differences in investment performance.



WHAT TO DO ABOUT RETAIL? READ ON

CREF World's next three articles focus on retail. So, it's possible that by the time you're reading this in early January 2018, the retailer winners and losers from this past Holiday season's sweepstakes have been tallied already, with more store closings on the horizon. Inevitably, retail property owners will take inventory of those winners and losers in an attempt to stay ahead of their tenants' health or lack thereof and position themselves for the years ahead. The three articles that follow focus on the U.S. mall (wait are they still around?), the staying power of off-price department stores (love 'em) and E-commerce's impact on traditional grocery stores.

The enormous transition in retail due to the growing impact of e-commerce has escaped no one. Sure, we know industrial properties seem to have fared well under the E-commerce umbrella and that room demand in the hotel sector has suffered amidst the ascendancy of Airbnb. The questions that lurk beneath are: What's the next 'Big Thing'? How and which property markets will be most affected? What's to be done to protect? The irony of the retail story is that while e-Commerce has gained market share swiftly over bricks and mortar retail, the percentage of e-Commerce sales as a percent of total retail sales remains relatively benign at just 9.10% (as per the U.S. Census Bureau). That said, while total retail sales increased by just 4.5% in 3Q17 over 3Q16, e-Commerce sales rose by 15.5% over the same period. The trend is not our friend in this regard.

It's for this reason that this January's CREFC Conference features a fella who knows a thing or two about selling groceries (Walter Robb, former Co-CEO of the Fortune 500 Whole Foods Market) and another (Seth Mattison) who stands ready to shed some light on workforce trends and generational dynamics that will indeed impact who wants to live where and the benefits of experiential shopping and dining over sofa-sitting, lap-top hugging cyber sales.

The U.S. Mall Sector: Skating on Thin Ice

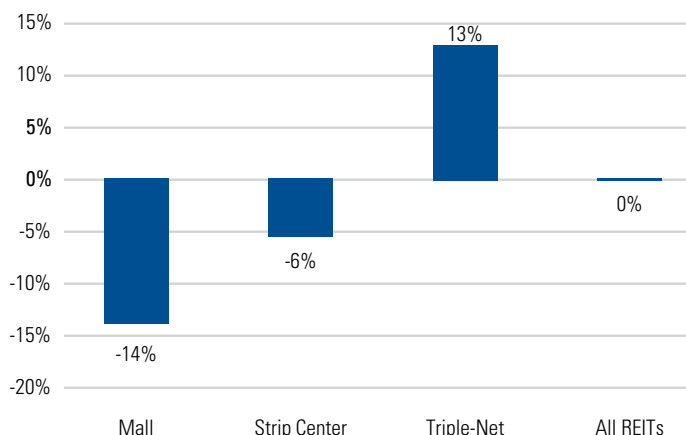


Retail as we know it is going through a dramatic shift, and the negative narrative is loud as ever. Consumer behavior is changing, retailers are trying desperately to compete, and owners of retail real estate are working to ensure their properties are positioned for the future. But not all the news is bad. Some landlords should be positioned not just to survive, but to do quite well. The best malls will attract new/expanding concepts, and will be able to retain some rent-negotiating power.

In the public market, mall REITs have been trading at large discounts to the underlying value of their assets for quite some time. This investor skepticism has spilled over to strip centers which are now also trading at discounts. While mall REITs own 80% of aggregate mall value in the U.S., these signals from the public market can have important, and often overlooked, implications for private market players. Is the narrative in the public market — which has materially impacted share prices — correct, or are private market values on the decline as well? Regardless, the net asset value (NAV) discounts are steep and understanding the forces driving them can help identify areas of risk and opportunity in the sector.

EXHIBIT 1

Observed Premium/Discount to Unleveraged Asset Value



Source: Green Street Advisors, December 1, 2017

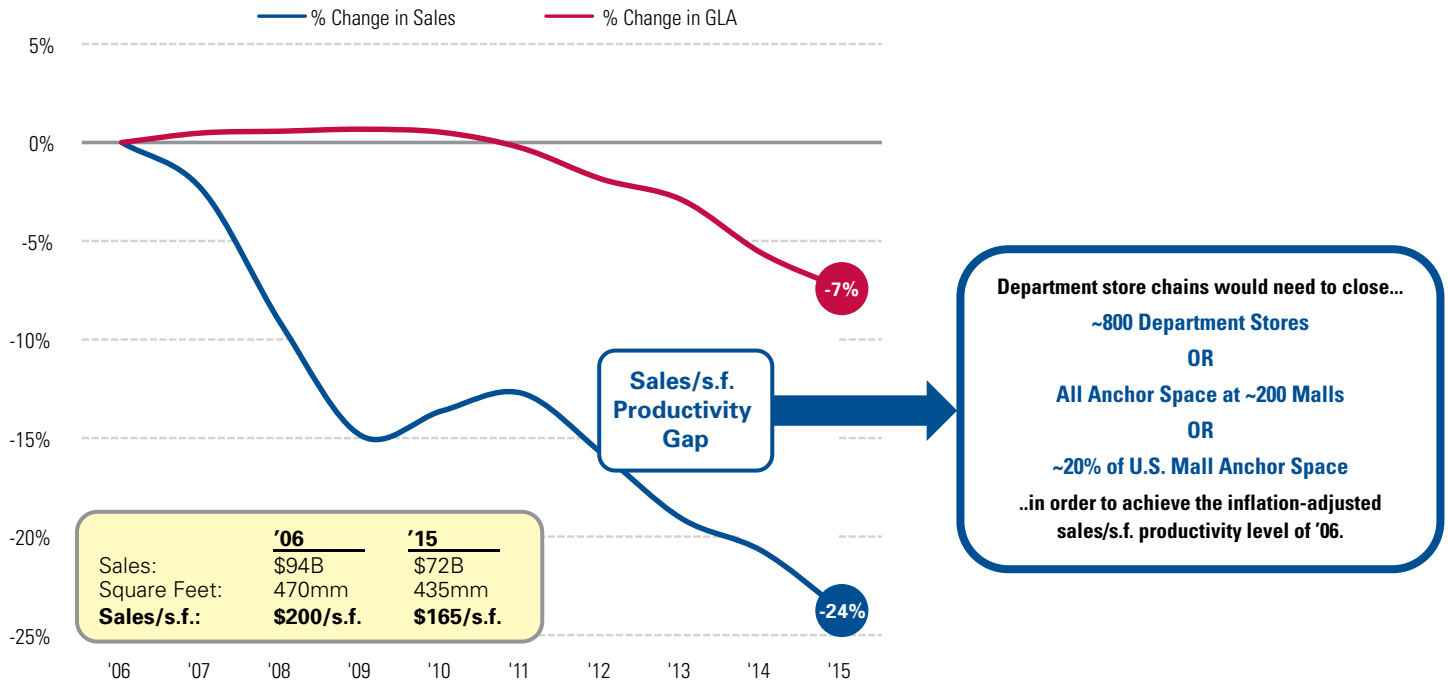
It's no secret that the U.S. is over-retailed, and we have substantially more retail square feet per capita than any other country. For example, the US has about 20 square feet of retail gross leasable area per person while the UK has roughly 5 square feet. Green Street sees the low-productivity malls and power centers/community centers at the greatest risk for attrition due to ecommerce. These retail properties will have the hardest time remaining competitive. Retail centers can be better positioned to compete by incorporating defensive strategies, such as adding grocer or service tenants. E-Grocery has not yet been widely adopted in part because of the cost of delivery, the need to be home for pick-up and the desire to choose produce. Moreover, experiential concepts continue to be major traffic drivers to retail centers.

E-commerce growth in the U.S. has been nothing short of spectacular. E-commerce is a formidable competitor for almost every property type. Green Street expects two-thirds of retail sales growth in the foreseeable future to come from growth in e-commerce. Ecommerce currently accounts for ~20% of estimated brick-and-mortar sales (excluding motor vehicles, building materials, food and gas) and is growing at a much faster pace, which is estimated at 10% to 15% growth over the next five years.

Department stores continue to be a meaningful headwind in the mall sector. The department store industry is in a structural decline and the business is not getting better. Productivity continues to plummet, which should mean that more stores will close. Store closures are not enough, the business is in desperate need for reinvention. If meaningful changes aren't made, the downward spiral of sales declines and store closures will likely continue. If there is hope for the department store concept to be relevant, it will need to evolve dramatically.

EXHIBIT 2

Cumulative Change in Department Store Sales vs. Change in Square Footage



Source: Company disclosure, Green Street estimates

Mall landlords are addressing this issue. Most operators are strategically recapturing department store spaces and working to get ahead of the problem. The modest pace of department store closures thus far has opened up the opportunity for mall landlords to bring in new tenants. When landlords have been successful at gaining this space back, they create value both by making improvements that allow them to attract higher rents. Since department stores pay negligible amounts of rent, nearly every alternative tenant would pay more.

However, repurposing space comes at a cost. The cap-ex profile for U.S. malls has moved higher as capital is needed for redevelopment for expected anchor box repurposing. In a recent detailed study, Green Street increased its mall REIT cap-ex reserves to 17% of NOI, on average. Lower-productivity mall REITs have outsized capex burdens relative to NOI and could struggle to finance an acceleration of anchor redevelopments.

Big box issues are no longer exclusive to malls. Strip centers have had to address their fair share of bankruptcies and there may be more to come. Mall landlords are looking for new big box tenants and now have their eyes on those that have traditionally operated in strip centers. That said, Green Street does not see a mass exodus leaving strip centers to malls.


On the mall side, Green Street expects a greater deceleration in fundamentals compared to strip centers due to modest declines in occupancy and an absence of sales growth. On the strip center side, the deceleration should be softer with occupancy holding steady and rent growing modestly. Mall fundamentals significantly accelerated out of the downturn and then leveled off, whereas strip centers started slow, but then improved steadily. Fundamentals between the two retail sectors are now converging, and the growth outlook over five years is comparable.

However, below the surface, performance is bifurcating. 'A'-mall fundamentals are holding up better and are expected to outpace strip centers in the aggregate. At the other end of the spectrum, low-productivity mall fundamentals should continue to deteriorate.

Similarly, grocery-anchored centers are driving strip center fundamentals higher, whereas power center fundamentals may be declining. Grocery-anchored centers are less exposed to the current retailer-related headwinds — despite the likely acceleration of e-grocery adoption. Even though it's a tough and low-margin business, fundamentals for grocery-anchored centers appear healthier and more resilient than any other retail property type. There is also occupancy upside in terms of the small shop tenants due to a slower recovery out of the recession.

For 2018, Green Street is expecting same-property NOI growth to decelerate for most mall REITs in light of waning tenant health. The low-productivity mall REITs will experience continued retailer disruption and outsized operational deterioration in their portfolios.

In today's retail environment, negotiating leverage is in the tenant's favor. There are more mature retailers strategizing to close stores than new concepts looking to open them. New retailers exist, but the days of opening 100 stores over the next five to seven years are long gone. The question becomes, "Who is best positioned to weather this storm?" A few distinct advantages are access to capital, large properties with large cash flows, and strong balance sheets.

DJ Busch is managing director and head of retail real estate for Green Street Advisors, a global real estate research firm. For more information, please visit www.greenstreetadvisors.com or sign up for Green Street's eNewsletter and blog. 



Food Fight — Traditional Grocery Stores Should Benefit From Growing E-Commerce

Thin margins, fierce competition, and a glut of space have shrunk traditional grocers' market share over the past 10 years. As a result, some lenders and investors have shied away from grocery-anchored shopping centers. As the landscape shifts, Morningstar Credit Ratings, LLC expects more industry consolidation, with large format stores getting bigger and small-format stores becoming more specialized. Meanwhile, more consumers are buying groceries online, as that segment grew 24.4% last year, according to Inmar Willard Bishop, LLC, a Long Grove, Illinois-based consultant, the biggest jump of all grocery formats. However, growth in e-grocery is welcome news for commercial real estate, as a key determinant of success is keeping costs down by being close to customers. As Amazon.com's purchase of Whole Foods Market Inc. suggests, the growth of grocery delivery platforms will increasingly depend on brick-and-mortar locations.

Grocery in Transition

Long thought to be immune from e-commerce and economic downturns, some traditional grocers, defined as those that offer a full line of groceries, meat, and produce with at least \$2.0 million in annual sales, have been plagued by shrinking margins, competition, and oversaturation, forcing them to close stores or shut down completely. Over the past several years, A&P, which had nearly 16,000 stores at its peak in 1930, went out of business, as did several regional players such as Fresh & Easy, Marsh Supermarkets, and Bottom Dollar Food Stores.

TABLE 1

10 Largest Grocery Anchors in CMBS

MSA	\$ Current Balance	% of Total Grocery Store Exposure
Ahold Delhaize	2,845,285,265	16.7
Kroger	2,446,976,079	14.4
Albertsons (including Safeway)	2,079,538,316	12.2
Whole Foods Market	1,626,875,742	9.5
Publix Super Markets	1,293,704,793	7.6
Sprouts	756,059,916	4.4
Aldi	689,729,807	4.0
Giant Eagle	675,668,000	4.0
Trader Joe's	540,885,191	3.2
Save Mart Supermarkets	521,404,442	3.1
Total	13,476,127,552	79.1

*Figures may not sum to totals because they are rounded.

Source: Morningstar Credit Ratings, LLC

Retail space devoted to food sales in the U.S. has hit a record high, while traditional grocers' share of the market has fallen. Square footage of food retail space at traditional grocery stores per capita last year registered more than 2.5 square feet per person, from less than 1.5 square feet in 1980, according to CoStar Group, Inc. But demand hasn't kept up with store growth. Total U.S. traditional supermarket grocery sales in 2016 fell 5.9% from 2015, while industrywide average same-store sales growth has declined since 2012. Falling sales have disproportionately affected traditional supermarkets, as their market share sunk to 44.6% in 2016 from 90% in 1988, according to Inmar Willard Bishop.

Large-format stores are getting bigger, and small-format stores are becoming more specialized, further squeezing traditional grocery sales and profits. Non-traditional grocery outlets' share of sales shot up to 40% in 2016 from 2% in 1988, led by supercenters and wholesale clubs such as Walmart (AA-/Negative), Costco (AA-/Stable), Sam's Club, and SuperTarget (A/Negative). On the other end of the spectrum, limited-assortment vendors that operate stores about a third the size of a typical American grocer, such as Aldi, Lidl, Save-A-Lot, and Grocery Outlet, are fast-growing and are collectively planning to open over 1,000 new stores in the next few years. Inmar Willard Bishop Analytics reports that the limited-assortment category had the second-highest growth rate in 2016 sales,

behind e-commerce. Consumers are also opening their wallets at niche grocers. For example, fresh format stores, which include Sprouts Farmers Market, Inc., saw sales grow 3.8% in 2016, while the number of stores rose by 7.5% to more than 1,500 locations, according to Inmar Willard Bishop Analytics. Growth was driven by supermarket brands, including Lunds & Byerlys, Lowes Foods, and Mariano's, transitioning to a fresh format. Nontraditional formats such as convenience stores, drugstores, and dollar stores, have also taken a bite out of traditional grocers' sales. After supercenters, dollar stores were the top-performing non-traditional format in 2016, posting a year-over-year sales gain in food and consumables of 4.2%, according to Inmar Willard Bishop Analytics.

While online shopping for groceries continues to lag general merchandise and home and apparel, the number of households buying food online is increasing. In 2016, online grocery had the greatest increase in sales at 24.4%, fueled increasingly by millennial consumers and retailers offering the convenience of both delivery and so-called click-and-collect service, where consumers order online and pick up at the store, according to Inmar Willard Bishop Analytics. Further, the number of households in the U.S. that are using online channels to purchase food has increased about 4 percentage points since 2014, up to 23% in 2017, according to a study by FMI and Neilson, while online penetration in grocery is about 3% of the overall market. Grocery delivery services from Shipt to Instacart, Peapod, LLC, AmazonFresh, and FreshDirect are playing a major role, as fewer people have time to shop. These delivery services also benefit supermarkets, allowing them to continue selling groceries on alternative platforms and remain competitive with meal-subscription companies such as Hello Fresh and Blue Apron. This shift in shopping patterns has implications on retail space requirements. In addition to keeping grocery shopping convenient for consumers, delivery and pickup services may reduce the need for the current number of stores, while also diminishing space requirements of individual stores. Changing consumer habits will also shift demand for grocery space, as fewer households cook. According to the Harvard Business Review, the percentage of consumers who love to cook has dropped by one third in 15 years.

Shifts in CMBS Lending

The shift has implications for commercial mortgage-backed securities as the number of traditional stores is forecast to decline. The traditional format store count is expected to drop by 24.6% by 2021 with a forecast 3.5% decline in dollar share of sales, according to Inmar Willard Bishop Analytics. However, we are not overly concerned, because projected growth in nontraditional formats will buoy demand for existing grocery space as fresh format, super warehouse, and dollar formats are projected to grow store counts 48.0%, 29.7%, and 24.5% by 2021, respectively, and e-commerce is projected to grow sales 25.0%. But as grocers, retailers, and delivery services evolve, their physical needs in commercial real estate spaces will change. Grocers will see pressure to adapt to delivery and pickup models, which may necessitate smaller footprints for in-person shopping, with a focus on fresh groceries, but this will be offset by more warehouse space for pick-up and delivery of commodity and more shelf-stable items.

Investors and lenders are taking a step back, as the spread in the capitalization rate, or the required return, between different classes of grocery-anchored centers has expanded over the past several years. While the spread between Class A and B grocery-anchored centers for the first half of 2017 was consistent, the spread between Class A/B, which tends to be premium assets with strong sponsorship and superior locations, and C expanded to its widest point since 2010 and is expected to expand further in the second half of the year, according to CBRE Group Inc. Class A and B cap rates rose by roughly 10 basis points in the

first half of the year from the second half of 2016. In contrast, Class C properties registered a 20-basis-point increase. Further, the difference in cap rates hit a seven-year high, widening to 176 basis points.

Lenders appear to be more selective and less tolerant of risk in grocery-anchored properties, as they have shifted to lower-leveraged, lower-balance loans. The percentage of grocery-anchored loans with balances below \$20.0 million grew by 16% over 2015 levels, while the volume of loans above \$50.0 million shrunk by 34.8%. The average loan-to-value ratio fell to 62.4% through the third quarter of 2017, from 69.2% in 2014.

Further, overall retail acquisition and lending volume have declined. CBRE reports that year-over-year acquisition volume for retail properties declined 32.2% in the third quarter, outpacing the total market decline of 9.2%. Further, the Mortgage Bankers Association reports that its retail lending index slid 16% for the first six months of 2017, compared with the same period in 2016.

A closer look at grocery-anchored loans with exposure to bankrupt tenants provides some context to the risk narrative. Among all A&P, Haggen, and Marsh Supermarkets brands in CMBS, representing more than \$1.50 billion in unpaid principal balance, just five loans were liquidated, resulting in \$7.5 million in losses. We forecast another \$89.5 million in losses on specially serviced loans, resulting in a low loss severity of about 6.5%.

We found that many vacant stores were re-tenanted by other grocers. Shortly after declaring bankruptcy in September 2015, Haggen sold over half of its 164 stores to several grocery chains, including Albertsons, and in March 2016 accepted Albertsons' bid to purchase 29 of its 32 remaining Haggen-branded stores. Since A&P filed for bankruptcy protection in July 2016, 16 of the 51 stores on Long Island, New York, that closed or sold are still vacant, with plans for four of them pending. Among securitized commercial mortgages, Sprouts took Haggen's space at Venice Crossroads Shopping Center in Los Angeles, which secures a \$30.0 million loan in COMM 2013-LC6, and Gelson's Markets took Haggen's space at the Mercantile West Shopping Center in Ladera Ranch, California. The property secures a \$39.5 million loan, which is 81.4% of BACM 2005-3.

Markets with rising retail vacancies bear watching, however. According to CoStar, 20 markets had rising retail vacancies as of the second quarter, up from eight in the third quarter of 2016. Some of the major metros with rising retail vacancies include Houston, with almost 50 new grocery stores opening in the metro area, with more under construction or planned. Inside the Houston Loop, the interstate that surrounds Houston, Whole Foods and HEB Grocery Co., LP were the most active, delivering new stores in Montrose, Memorial Drive, and Uptown. Farther away from the city center, Kroger (BBB/Stable), Aldi, and HEB had the most openings. Separately, Dallas' strong economy, the rise in population growth, and consumer spending are spurring growth in grocers, including national names like HEB, Kroger, Trader Joe's, and Whole Foods.

Grocers to Watch

Industrywide average same-store sales growth has dropped since 2012. Traditional grocers have been fighting back by getting bigger, while same-store sales growth has sagged. Notable acquisitions over the past few years include Kroger purchasing Harris Teeter, Ahold's \$28.0 billion purchase of Delhaize, and Albertsons' acquisition of Safeway. Despite increasing sales of 5.0% year-over-year in 2016, Kroger, the largest grocer in the nation with nearly 2,800 supermarkets and 1.0% comparable-store sales growth, is opting to invest less in its physical retail and

more in digital initiatives. The company plans to expand, relocate, or open only 55 locations by the end of the year, compared with the 100 it budgeted for in 2016. Publix, which posted 1.9% 2016 comparable-store sales growth, down from a peak of 5.4% in 2014, has set aside \$1.85 billion to buy more centers, build stores, and renovate existing sites. Separately, Smart & Final, Whole Foods, and Supervalu all posted negative comparable-store growth in 2016.

With an overleveraged balance sheet and negative same-store sales growth, Albertsons could be the most at risk. The Boise, Idaho, retailer, which is privately owned and operated by private-equity investors, including Cerberus Capital Management, took on debt of more than \$7.60 billion to acquire Safeway in 2014. The company, which had grown through acquisitions to 2,324 stores at the end of 2016, from 1,075 in 2013, in July terminated a tender offer for \$500 million of bonds, citing financing issues. Overall same-store sales turned negative in fiscal 2016 because of declining customer traffic and competitive pricing pressure. This was followed by negative same-store sales growth of 2.1% for the 16 weeks ended June 17, 2017, and a 1.8% decline for the 12 weeks ended September 9, 2017. Further, the company put its plans to go public on hold shortly after Amazon's (A/Stable) deal to buy Whole Foods was made public.

Physical Storefronts Are Important

As some grocery stores pull back, fears of death by Amazon's purchase of Whole Foods may be overblown, because we believe that growth in grocery-delivery platforms will rely on existing brick-and-mortar locations. To dominate in grocery delivery, especially with perishable items, operators must be able to deliver from sites that are close to the consumers to keep costs low, according to Cushman & Wakefield. With few options existing among urban distribution facilities, Amazon purchased the roughly 460 Whole Foods scattered across the country to serve as distribution centers. These stores are in densely populated areas, averaging nearly 62,000 households within a three-mile radius versus nearly 34,000 on average for U.S. neighborhood centers, according to CoStar.


Whole Foods' share of the U.S. grocery market is just 1.7%, while Amazon has 0.8%. By comparison, Walmart has around 17% and Kroger is just under 9%. Albertsons, in third place, is around 6%, according to statistica.com. Even though Whole Foods locations aren't set up to accommodate widespread distribution, we expect to see Amazon inject its industry-leading logistics, technology, and data expertise to ramp up its e-grocery store presence.

As Amazon's strategy evolves, its purchase of Whole Foods has implications for CMBS. While the growth in fulfilling on-demand delivery is likely to be in the form of brick-and-mortar locations, Amazon's ability to lower the cost of goods and its aggressive growth ambitions could be the biggest risk to CMBS. We found 229 grocery-anchored properties in CMBS (19.6% of grocery-anchored loans by balance) that are within five miles of a Whole Foods store that could be most affected. Further, over 150 of these (13.0%) are within three miles of a Whole Foods store. However, restrictive lease provisions are hampering Amazon's growth strategy. According to a GlobeSt.com article, competitors such as Target have stipulations in their leases that restrict what Amazon can do with its newly acquired stores, including pickup lockers and delivery operations.

Reason for Resiliency

Despite rising competition from nontraditional players, oversaturation, and the threat of online grocery shopping, it would be a mistake to write off traditional grocers. Such companies could even benefit from the increased acceptance of online sales, as they rethink their approach to convenience and play defense as titan Amazon enters the fray. We're already seeing evidence that both traditional and specialty grocers are looking for ways to better accommodate consumer demand for ordering groceries online, including partnering with delivery services. Given more conservative lending standards and strong demographics of more popular in-fill locations, making them desirable distribution centers, we believe that traditional grocers will prove resilient.

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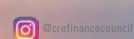
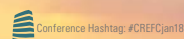


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As Off-Price Department Store Sales Decline, Different Strategies Emerge

Historically, the underlying assertion was that department store retailers would not open off-price stores close to their full-line brand if it cannibalized sales. However, with department stores struggling, fewer off-price department stores opening, and different location strategies emerging, sales siphoning could be taking place.

Declining sales in what has been a high-growth segment prompted us to take a closer look at the sector. This included possible strategy changes in the distances retailers will put between future off-price department store locations and full-line stores, as well as factors that could be contributing to falling sales.

For those CMBS investors that have a meaningful exposure to transactions with centers containing off-price department stores, it is worth following these evolving trends as they have the potential to influence loan performance. The off-price segment, which has been a bright spot in the struggling retail sector, may now be facing its own challenges. How this all plays out is still too early to tell, but it seems to be clear that the off-price business model is being re-assessed.

KBRA, as part of its analysis, looked at CMBS exposure to the off-price department store segment. In total, we identified 54 CMBS retail property loans which included 71 off-price department stores with a total principal balance of \$8.5 billion. The related loans were securitized in 87 transactions, inclusive of 21 loans with pari-passu notes that were spread across multiple transactions.

In our review, we leveraged publicly available information from SEC filings, individual owner/department store websites, management disclosures, as well as online searches.

Times Are a Changing for the Off-Price Department Store

The Distance Conundrum

In the past, department stores wanted to make sure that their off-price distribution channels didn't compete directly with their full-line business. This was intended to limit off-price stores siphoning off sales from their full-line offerings and to avoid the dilution of brand identity. Over time however, some retailers observed that there could be benefits by positioning their off-price and full-line offerings in closer proximity. Macy's went one step further, introducing Backstage, a store-within-a-store concept. Although several of the Backstage stores are up to eight miles away from their nearest full-line location, Macy's has situated the majority of its Backstage offerings within its traditional department stores. Furthermore,

all the announced openings for Backstage are slated to be positioned within full-line Macy's stores. One potential benefit of this strategy is that value shoppers may get more exposure to traditional Macy's offerings — and purchase more goods in the process.

On the other hand, Nordstrom is a retailer that may be going in the other direction. Based on KBRA's analysis which utilized Nordstrom financial disclosures through 2Q, 2017, the distance between Nordstrom Rack and the retailer's full-line offerings will increase in the future. Of the existing stores, approximately 42% of the off-price locations were situated within five miles of the nearest full-line store — the comparable figure for scheduled openings is just 17%. Perhaps this has to do with the availability of real estate. However, it could also signal that the retailer is trying to mitigate the potential for cannibalization and brand dilution.

The following tables display the distances between off-price stores and their full-line counterparts for both existing locations, as well as those that are scheduled to open.

EXHIBIT 1

U.S. Store Openings Show Signs of Slowing

Macy's Backstage (Open)			Macy's Backstage (Scheduled to Open)		
Distance (Miles)	Store Count	% of Stores	Distance (Miles)	Store Count	% of Stores
In Full-Line	38	84.4%	In Full-Line	7	100.0%
0-1	2	4.4%	0-1	-	-
1-3	1	2.2%	1-3	-	-
3-5	2	4.4%	3-5	-	-
5-10	2	4.4%	5-10	-	-
10+	-	-	10+	-	-
Total	45	100.0%	Total	7	100.0%

Nordstrom Rack (Open)			Nordstrom Rack (Scheduled to Open)		
Distance (Miles)	Store Count	% of Stores	Distance (Miles)	Store Count	% of Stores
0-1	38	17.2%	0-1	2	11.1%
1-3	37	16.7%	1-3	1	5.6%
3-5	17	7.7%	3-5	-	-
5-10	31	14.0%	5-10	4	22.2%
10+	98	44.3%	10+	11	61.1%
Total	221	100.0%	Total	18	100.0%

For many off-price department store retailers, it appears that U.S. store openings have been slowing, as several company 10Q and management discussions do not mention the addition of new U.S. locations. For instance, Saks OFF 5TH (124 existing stores) only opened two U.S. stores in Q1 and Q2 2017 while opening five stores in Canada and five in Europe during the same period. This is in contrast to 2015 and 2016, during which the retailer had a net increase of nine and eight U.S. stores, respectively. Although the retailer plans to open approximately 25 Saks OFF 5TH stores in Canada over the coming years, public filings made no mention of new U.S. locations. Meanwhile, Neiman Marcus announced on

September 12th that it will close 10 of its 37 remaining Last Call off-price stores. Earlier, in July, the retailer indicated that it would be assessing its “Last Call” portfolio to ensure that it had the right mix of brick and mortar and online stores.

On the other hand, Nordstrom Rack opened six new U.S. stores in the first half of 2017, has 11 more planned for this year, and is slated to add another seven in 2018 and 2019. Macy's Inc. Q2 2017 10Q report indicates that it intends to make some store additions as well, as seven additional Backstage locations are planned by the end of its current fiscal year.

Same Store Sales Comps Decline

For years, department stores watched as off-price apparel retailers such as Ross Stores and TJ Maxx lured value-oriented shoppers by selling brand name goods at steep discounts. It seemed to take a while for many of the major department stores to warm up to the off-price concept, perhaps due to concerns of cannibalization and/or brand dilution. That has changed through time. In fact, off-price formats, such as Nordstrom Rack and Saks OFF 5TH, have a larger presence by store count than their respective chain's full-line offerings. However, the sector doesn't appear to be immune to the pressures of e-commerce and changing shopping preferences. Chains with off-price department store offerings that report sales suffered declines in same store performance through both Q2 2017 and the six-months ending July 2017. Meanwhile, Ross Stores and TJ Maxx have continued to post positive comparable same store sales over the same time periods.

Ross Stores, Inc., which operates 1,363 Ross Dress for Less stores and 198 dd's Discounts, posted comparable store sales increases of 4% through the first half of 2017 and 4% for the second quarter of this year. Marmaxx, another discount retailer with locations that are effectively a combination of TJ Maxx and Marshalls, also posted higher sales. The retailer reported a comparable same store sales increase of 1% for the first six months of this year 2017, and 2% for Q2 2017.

This was in contrast to off-price department stores. Where store sales data were available for the segment, it indicated declining trends. Nordstrom Rack had a comparable same stores sales decrease of 0.9% for the six months ended July 29, 2017 and a decline of 1.0% for Q2 2017. In addition, the Hudson Bay Company reported that HBC Off Price (Saks OFF 5TH, Gilt, and FIND @ Lord & Taylor), reported a comparable same store sales decrease of 4.6% for the twenty-six week period ending July 29, 2017 as well as a 2.3% decline for Q2 2017.

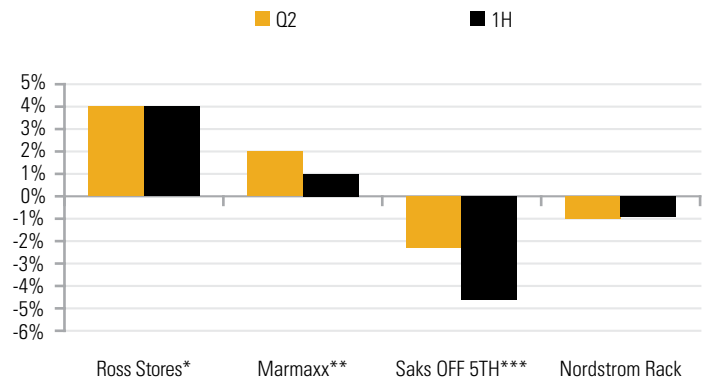
A contributing factor to the sales declines could be the growth within the segment. Off-price stores are arguably “over-retailed”, prompting more competitive pricing and discounting within the sector. In addition, off-price stores may also be losing out to the aggressive sales, promotions and coupons that seem to have become a pervasive part of the full-line store strategy. Of course, it is likely that rapid growth and convenience of e-commerce shopping is also taking its toll on off-price store sales, as it has with other bricks-and-mortar formats.

Nordstrom in its Q2 2017 management discussion stated that Nordstrom Rack, on a quarter and year-to-date basis, experienced a decrease in the average selling price per item sold, partially offset by an increase in the total number of items sold. Saks OFF 5TH in its Q2 2017 discussion stated that they are in the process of remerchandising its product mix to have a higher concentration of products at the top end of Saks OFF 5TH offering range, which is expected to drive increased traffic and conversion as well as a higher overall basket size.

The chart below shows comparable same store sales for Ross Stores, Marmaxx, Saks OFF 5TH and Nordstrom Rack.

EXHIBIT 2

Comparable Same Store Sales 2017



*Ross Dress for Less and dd's Discounts

**TJ Maxx and Marshalls

***Saks OFF 5TH and Gilt

The Off-Price Department Store Retailers

The table below provides store count information for some off-price and full-line department stores. Although the table isn't comprehensive, it includes many of the major retailers. As illustrated, Nordstrom Rack and Saks OFF 5TH have approximately 1.9x and 3.0x more off-price locations in comparison to the respective chain's full-line offerings.

EXHIBIT 3

Department Stores			
Off-Price	Store Count	Full-Line	Store Count
Nordstrom Rack	221	Nordstrom	117
Saks OFF 5TH	124	Saks Fifth Avenue	41
Macy's Backstage	45	Macy's	666
Neiman Marcus Last Call	37	Neiman Marcus	44
Bloomingdale's Outlet	17	Bloomingdale's	38
Kohl's Off /Aisle	4	Kohl's	1,154
FIND @ Lord & Taylor	1	Lord & Taylor	50

To identify the CMBS exposure to the 449 off-price department stores in our report, we leveraged the KBRA Credit Profile (KCP) platform. We first referenced the KCP database for matches using the off-price department store addresses and different variations of tenant names. We then mapped the remaining off-price department store locations for further potential matches, using online store directories as verification. Utilizing this approach, we identified 54 CMBS retail property loans, which included 71 off-price department stores (16% of study population) and had a total principal balance of \$8.5 billion.

EXHIBIT 4

Off-Price Department Store	Total Store Count	CMBS Stores	CMBS Exposure %
Nordstrom Rack	221	22	10.0%
Saks OFF 5TH	124	22	17.7%
Macy's Backstage	45	11	24.4%
Neiman Marcus Last Call	37	11	29.7%
Bloomingdale's Outlet	17	5	29.4%
Kohl's Off /Aisle	4	-	-
FIND @ Lord & Taylor	1	-	-
Total	449	71	15.8%

With off-price department store exposure fairly sizable within CMBS, investors may need to re-visit both their full-line and off-price department store exposure, particularly for those properties that are close to each other. 🏠

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