CBRE FLASH CALL

COVID-19 IMPACT ON MULTIFAMILY REAL ESTATE

MARCH 24, 2020 CALL SUMMARY

Thanks to 8,500 clients who attended CBRE's March 24, 2020 Flash Call - COVID-19 Impact on Multifamily Real Estate. CBRE experts and representatives from Citi, Fannie Mae and Freddie Mac examined current conditions in the capital markets, multifamily sector, public equity and debt markets. CBRE professionals also gave real-time insight into transaction activity.

- Listen to the call recording
- Get the Latest Coronavirus Updates: Visit CBRE's Global COVID-19 Resource Center
- Multifamily is one of CBRE's top investment ideas for the next 10 years. To learn more, explore CBRE's Global Outlook 2030 "The Age of Responsive Real Estate"

CALL PARTICIPANTS

Guests

- Rob Levin - Senior Vice President, Head of Customer Engagement, Fannie Mae
- Richard Martinez - Senior Vice President, Production & Sales, Freddie Mac
- Nick Joseph - Director, Citi Research, Senior Analyst, Residential & Healthcare REITS

CBRE

- Brian McAuliffe, President, Capital Markets, Multifamily
- Spencer Levy, Senior Economic Advisor and Chairman of Americas Research
- Mitchell Kiffe, Co-Head of National Production, Debt & Structured Finance
- David Webb, Vice Chairman, Capital Markets, Debt & Structured Finance
- Shea Campbell, Executive Vice President, Capital Markets, Investment Sales

Summary Notes

- Jeanette Rice, CBRE Americas Head of Multifamily Research

LOOKING FOR CLARITY WITHIN UNCERTAINTY

Uncertainty abounds, but CBRE is turning over every rock to find guideposts

Uncertainty and volatility characterize the current economic and capital markets environment. Multifamily values are stressed and rental income at risk.

- The uncertainty creates great challenges in pricing assets and debt options. Forecasting property revenues has become far less clear, and no asset class is immune from the current environment. However, the capital markets have not shut down. Sales and debt financing deals are getting done. The market continues to function, albeit at a significantly reduced level.
- CBRE will continue to overturn every rock to find guideposts to help its clients understand these uncertain times.
- Most importantly, CBRE and the organizations that participated on the call, wish everyone the best physical and economic health during this time of uncertainty.

ECONOMY

Economy has deteriorated greatly, but there's room for optimism

Recently downgraded CBRE forecasts show an 18% decline in Q2 GDP. Full-year 2020 GDP is expected to be negative 1.9%. The U.S. economy is expected to start bouncing back in Q3 and continue its rebound into 2021. The 2021 GDP is currently forecasted at over 5%. CBRE's view is much closer to a "V" recovery than the views of many other Wall Street and big bank economists.

There are many reasons for broad optimism toward a short recession and a quick rebound:

- The global response to COVID-19 and resulting economic contraction has been massive (examples: International Monetary Fund, China, South Korea, Germany). Response in the U.S. has been just as great or greater with roughly $4 trillion in stimulus (roughly 20% of total GDP), including the "CARES" relief package in Congress that, as of this writing, is poised to be passed late this week. The $4 trillion will go far in filling the tremendous economic loss suffered in Q1 and Q2.
- There's some optimism also on the "how long will it last" question – both the coronavirus itself and the severe curtailment of many industries. Estimates ranges from Treasury Secretary Mnuchin's 10 to 12 weeks to New York Governor Cuomo's "4, 6, 9 months." The timeline is likely to come closer to the shorter outlook, provided the measures put in place are successful. China is beginning to bounce back. Italy's infection rate has begun to improve.
- With all the fiscal stimulus going into the economy, will we move into an inflationary environment? In 2021, the U.S. will likely have slightly more inflation, but nothing like the 1970s. The broad, long-term forces (such as aging U.S. population) that have been keeping inflation down over the past decade are still in play and should outweigh the inflationary influences of the stimulus.

REITS, VALUES, MARKET PERFORMANCE

REITs are a timely window on investor sentiment, but the perspective is not favorable

- REITs' real-time data provide a window on the multifamily market. The perspective is timely, but not favorable.
- From the market peak in mid-February to March 23rd, apartment REIT stocks fell 40% (on par with all REITs, so multifamily is in the middle of the sector pact).
- Another way to look at the huge loss of value is through the implied apartment cap rate. In mid-February it was 4.8%. Today it is 6.9%. Similarly, the implied value per unit has fallen from $390,000 to $275,000.

Market fundamentals will be challenged

- Near-term expectations of property fundamentals include higher residential retention (a positive), but lower increases on rents for renewals: "Closer to flat than the previous 3% to 5%."
- New leasing activity is down dramatically.
- Market performance at the upper end should weather the economic uncertainty better given that most residents are in better financial condition. Strong demand for workforce housing leading up to the current period should give this sector an ability to rapidly reach high occupancy levels again when jobs come back.
- Bottom line is that if borrowing costs are escalating and revenue collections are challenged, that means values are stressed.
- Yet, of course, market performance and value are market-by-market and asset-by-asset.

According to Nick Joseph, Research Analyst of Citi, seniors and student housing are of greater concern

Both student housing and seniors housing have moved out of favor:

- Since mid-February to March 23rd, seniors housing and student housing REITs were both down 55%, compared to -40% for conventional multifamily.
- Uncertainty around student housing performance comes from lack of confidence that colleges will all be back to normal operations in the fall. Seniors is more on the demand side. Occupancy rates are expected to fall.
- One silver lining is that capital moving away from the products creates more opportunity for those still active in the sectors.

Metros with higher risk include those with large energy and hospitality sectors

- In the REIT landscape, Washington, D.C. and Boston (among other markets) should perform better over the near term, due to ability of government and tech sectors to weather the economic downturn better than other sectors.

- Houston, Orlando and Orange County, CA will likely fare worse due to the large contractions in tourism and energy. Markets with elevated supply also may fare worse due to much lower overall leasing activity.
- New Orleans and Las Vegas are additional markets with higher risk due to tourism declines, as well as other energy-related metros. Atlanta and Dallas/Ft. Worth should possibly be added to the "at more risk" list, given their huge air travel hubs which serve as economic generators for the metros.

DEBT CAPITAL MARKETS

Credit markets have gotten materially worse over the past week

The credit markets broadly and the multifamily mortgage markets specifically have deteriorated. The markets are volatile. What began as a relatively minor liquidity challenge has turned into a major liquidity and credit issue.

- Broad rate indices provide a sense of the dramatic changes in the credit markets. 10-year Treasuries were 1.88% at the beginning of 2020 and 0.84% as of March 23rd. In the same period, one-month LIBOR fell from 1.73% to 0.93%. The Federal Reserve has issued two 50-bps rate cuts to the Federal Funds rate; the target is now 0% to 0.25%.
- Debt financing costs have risen (though they are coming off record-setting lows). Credit spreads have widened dramatically for all product types and forms of lenders. Interest rate floors are higher. Mortgage rates are higher, causing stress to prospective borrowers, as loan proceeds are reduced.
- Nevertheless, some deals are still happening. For example, CBRE's Mid-Atlantic Debt & Structured Finance team has about 15 deals in the pipeline. They just closed one deal and have four more to go over the next two weeks. Currently, the deals are keeping on schedule.
- Typically, challenges in getting deals closed include the logistics of inspections, getting third-party reports and recordation. What has been remarkable is how well the groups (buyers, sellers, lenders, vendors, etc.) have worked together to find solutions. Flexibility and patience around normally fairly rigid rules have been tremendous.

Debt capital—some doors are shut, others open, but pricing is less attractive

Banks

- Banks are still lending but are being very selective and are definitely favoring "relationship" borrowers. Current underwriting includes increased borrower scrutiny. Banks have either implemented floors or raised spreads recently, but remain competitive. "We are still getting real quotes from banks."

Life Companies

- Most lifecos are taking a "pause" and not quoting new business given the recent spread widening in investment grade corporate bonds. Lifecos are all using interest rate floors, but they are not sure where to set the floors.

CMBS & Debt Funds

- The securitized lenders—CMBS and debt funds—are both very disrupted at the moment and largely out of the market. Some debt funds have closed their operations, but other well-capitalized debt funds not dependent on CLO execution and leverage are looking at new business.

Agencies are "open for business"

- Both Fannie Mae and Freddie Mac are focused on liquidity and stability. They remain "open for business," continuing to quote, rate-lock and close deals. In fact, they both have had high levels of business in the past month.
- Agency spreads have significantly widened, leading to higher mortgage rates – around 4.50% this week compared to rates in the 3.50% range in February. Wider spreads have resulted from recent disruption in credit spreads (much wider DUS and related bonds). While it's not clear when the bond spreads will come in, they appear to have stabilized.
- Deals with the clearest "line of sight" (greatest certainty on rents and asset performance over the near term) will get the most focus by the agencies.
- Fannie Mae and Freddie Mac are generally less enthusiastic about pre-stab, value-add, student and other deals where income is "in the future." Cash-out refinances are also challenging. Assets in markets that are or will get harder hit by this recession, but they will still lend in these markets. Sometimes higher reserves are required for what they perceive as higher-risk loans. Non-standard loan requests also will be less favored.
- Rate-lock policies have evolved due to increased uncertainties on timelines for inspections, closings, etc. Deals are getting rate-locked now much closer to closing dates.

Mortgage forbearance is expanding

- Fannie Mae and Freddie Mac's regulator (FHFA) announced guidance on March 23rd for allowing multifamily asset mortgage forbearance. At the heart of the guidance is concern for the hardship which many families in rental housing are suffering.
- While the specifics of the plans are still being formalized and could evolve further through the crisis, multifamily property owners with Fannie Mae and Freddie Mac loans may qualify for a three-month forbearance on mortgage payments. Borrowers will need to demonstrate that their properties' revenue streams have been severely impacted by COVID-19.
- The missed mortgage payments are then to be paid over a 12-month period after the end of the forbearance period. Forbearance will not be held against the borrowers.
- Very importantly, owners receiving agency forbearance must suspend evictions of all residents who have been financially impacted by the coronavirus for the forbearance period. Owners also need to work with residents to develop 12-month repayment plans.
- Banks have also been given leeway and encouragement by the FDIC to give short-term mortgage forbearance, and many banks have stepped up with programs in place.

Tougher environment for construction and value-add financing

- Banks are very, very selective in quoting construction loans or bridge loans. However, CBRE did just quote an Atlanta construction loan, so some financing is available. The lender perspective is that, "It's a two-year horizon for rents, not six months," as noted by Shea Campbell.
- By and large, financing for value-add deals are off the table. Underwriting of post-renovation rents is extremely difficult to determine. New renovations have largely stopped.

INVESTMENT SALES

Deals are still happening, but the investment sales landscape has changed significantly

- Nearly all assets that went to market prior to March 11th have continued to be marketed with sellers taking a "wait and see" approach on how buyers will price assets.
- Transactions that were well along in the due diligence and/or closing process are proceeding towards closing. Buyers and sellers are working together to complete the transactions. Usually more time is being granted to the buyers to overcome logistical challenges of inspections, etc.
- In a couple of closed transactions last week, there was a material price adjustment prior to closing; however, in those instances the seller was very motivated for liquidity to solve other issues.
- Deals where the buyers had a locked rate at the lower mortgages than currently in the market are also likely to complete the deals.
- Most of the deals that were in very early stages of marketing at the beginning of the coronavirus period are being pulled and moved to the sidelines. CBRE's weekly survey of investment professionals (as of March 23rd) found that about 90% of the offerings expected to hit the market in the last two weeks have been delayed.
- Marketing strategies have changed. Many assets still going to market are being shown to a select group of investors (rather than the more typical broad marketing approach used in the pre-coronavirus period).

Private capital, especially 1031 buyers, dominate current investor landscape

- Private capital represents over 85% of recent bids. The biggest capital source still in the market is the 1031 buyer.
- Institutional capital has fallen to only about 10% of bidders while public REIT investor interest has evaporated.
- While a lot of investor capital has gone to the sidelines for the near term, investment capital for multifamily assets is not disappearing. "When we return to a stabilized environment, there will be lots of debt and equity."

BOV activity declining but still important for many prospective sellers

- BOV (broker opinion of value) activity has declined, but is still happening. CBRE's weekly survey of investment professionals (March 23rd) found that multifamily BOV activity is currently expected to decline by 65% in the next 30 days.
- Still, CBRE is seeing a steady stream of BOV activity. Furthermore, pitches for new sales opportunities are still happening. Owners may be holding off from putting new deals on market, but many want to be ready to get their assets on the sales market when the time is right.
- In addition to actual pricing opinions, CBRE's role of providing salient market and capital markets intelligence and strategic advice seems to be more important than ever to sellers.

Due diligence logistics create challenges; virtual tours provide some solutions

- The normal flow of property tours, due diligence, closing processes and more are all being disrupted by social distancing policies, travel bans and other complications from COVID-19.
- Technology is helping overcome some of the challenges, with virtual tours leading the adoption list. Virtual tours are not just a "here and now" solution, they are here for the longer term.
- Other challenges exist like recordation office being closed, tours of occupied units, etc. But patience, creativity and technology continue to help find solutions. That said, more time for due diligence is being asked (and granted) for most deals.