SummerStreetAdvisors

Tapping the Brakes: A Slowdown Beats a Crash

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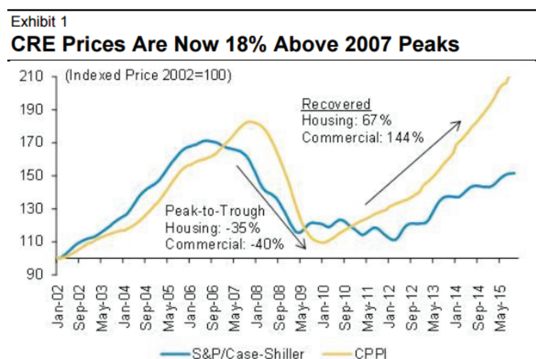
As an avid cyclist, I've learned to appreciate and adapt to the changing seasons, especially in New England. If only real estate investment cycles were as predictable as the seasons.

Commercial real estate debt and equity markets had a pretty smooth ride for the past several years, but the road has gotten a bit bumpy lately. The question is whether the volatility is a sign that the real estate market is headed for trouble. Fundamentals like rent growth and occupancy rates are favorable, and the economy is chugging along, but a credit crunch can hurt the business as badly as an economic slowdown, but that's not what this looks like. It actually appears that investors learned their lesson in the last cycle and are "tapping the brakes" now to avoid a crash down the road.

Prices for prime office, retail and hotel properties are 18 percent higher today than the pre-recession peak in 2007, according to Morgan Stanley, whose analysts predict that prices will not continue to rise in 2016. Equity REIT investors apparently have come to a similar conclusion, as the sector lost 6.6 percent over the 12 months ending January 31, according to Lazard Global Real Estate Securities. The loss of value has meant many REITs are trading far below their consensus net asset value; in other words, investors believe the properties are overvalued.



Source: Real Capital Analytics, Morgan Stanley Research

On the debt side, CMBS investors have also pulled back from the market, seeking wider spreads partly in response to

Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

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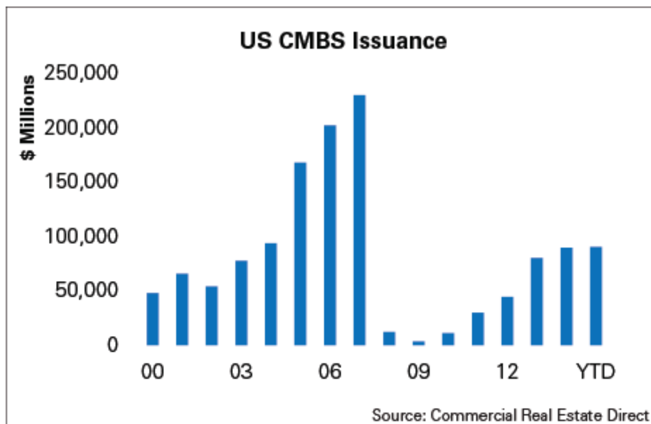
perceived loosing of underwriting criteria. As a result, total CMBS issuance finished 2015 at about $100 billion, slightly below the $110 billion predicted earlier in the year. More significantly, a panel of bank and conduit executives at a recent Mortgage Bankers Association conference noted that some lenders have lost money on warehoused loans, and agreed that investor demand for CMBS this year will fall far short of the $180 billion in expiring conduit loans.



Additionally, Kroll Bond Rating Agency is forecasting a down year for CMBS in 2016—as low as $60 billion—due to the current market malaise, as well as uncertainty surrounding risk retention.

Tightening Regulations

Investors aren't the only ones looking up the road for signs of peril. Government agencies are also trying to serve as watchdogs. In fact, one reason CMBS issuance slowed down last year may have been the challenge of complying with Dodd-Frank and the SEC's Rule AB mandating credit risk retention, better disclosure and more stringent reps and warrants. Securitizers with deals in the pipeline in the fall, when the new rules took effect, had to contend with the lack of clarity on compliance.

Perhaps the biggest sign that commercial real estate could be overheated came from the FDIC and other government regulators who warned banks in December they were getting too aggressive on commercial real estate loans. By September, outstanding bank debt to commercial property topped $1.8 trillion, about $170 billion more than at the pre-recession peak, according to CoStar. And banks aren't sure they're pricing construction loan risk correctly. Although underwriting terms look solid compared to 2006-07, spreads to Treasuries are much thinner today than 10 years ago, leaving little cushion if prices drop.

This may be a good time to acknowledge that volatility in the capital markets is not limited to worries about commercial real estate. The diminishing interest in CMBS and REITs is part of a larger concern over the state of the global economy, which roiled stock markets around the world in January. In fact, the main reason that real estate is viewed as overvalued is the rush of capital from foreign nationals and sovereign funds looking for a place to store their money for the long term. For the past two years, we have been hearing about foreign capital sources buying trophy properties at cap rates that approach zero, on the idea that these assets have a better chance to retain their value over the long term than stocks or bonds.

In the past, real estate cycles have come about because supply and demand can never seem to maintain equilibrium for long. When demand is strong and supply is weak, rents zoom up and developers rush in until a recession hits, and then supply is strong while demand is weak. Even if the market could maintain balance on its own, the influence of alternative investment strategies comes into play, flowing into commercial real estate when it outperforms other asset classes, and flowing out again when the situation changes. All too often, the complicated machinery of global investment markets breaks down and real estate values go into a tailspin.

This time could be different—possibly. The last recession was so deep and so broad that its shadow still looms large over global investment and capital markets. The memory is still fresh in our minds, and we're watching markets closely to make sure it doesn't happen again, or at least not while the wounds are still healing. Plus, any financial executives who choose to forget the recent past have tough new disclosure and accountability rules in place to remind them.

Seen in this light, the current volatility looks like it could be a path to a relatively stable future. If volatility is a wake-up call, the market appears to be responding to it by slowing growth. That could be enough to forestall a down cycle and achieve the balance that allows markets to move forward smoothly. Or not. Unlike the passage of the seasons, capital markets don't rise and fall on a predictable schedule. We could see the market peaking, with a downturn in the near future. But by tapping the brakes now, investors are demonstrating that they are paying attention to the road ahead and are taking steps to avoid a crash.