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Real estate investors, bracing for recession, prepare to seize on potential distress

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KRISANAPONG DETRAPHIPHAT, GETTY IMAGES
The growing threat of a recession and deal slowdown in the wake of higher interest rates has some real estate groups preparing to seize on potential distressed opportunities.

The growing threat of a recession and deal slowdown in the wake of higher interest rates has some real estate investors preparing to seize on potential distressed properties or loans.

Real estate insiders say much of the investment market remains in a stalemate and price-discovery mode — some sellers aren't willing to adjust pricing, and buyers are applying more scrutiny around deal terms and where they invest.

A lot of capital was raised in 2020, at the onset of the Covid-19 pandemic, in anticipation of a wave of distress, which mostly didn't materialize. But now recession threats and rapidly raising interest rates have increased the potential for distress in the coming months.

"There are funds and groups coming together that want to play in the distressed market," said George Mitsanas, principal at San Francisco mortgage banking firm Gantry Corp., which has an $18 billion portfolio of serviced commercial mortgages spanning more than 2,100 loans nationally.

Mitsanas said he also expects family offices to see opportunity. "A number of my clients are billionaires where their leverage has always been low, and they have a tremendous amount of capital … If there’s a disruption in the marketplace for good deals, I think the family offices will swoop in and start increasing their real estate holdings," he said.

The office market is commonly cited as the property type that may face the biggest issues, which could present opportunities for those looking to buy distressed properties.

Estimates of how much office building values may decline because of pandemic changes to work vary. One recent analysis by the Mortgage Bankers Association found, if widespread hybrid work persists, companies would need around 80% of the office space they previously needed, resulting in building income and values dropping 10% to 20%.

Distress isn't apparent yet, although there are warning signs. Trepp LLC's commercial mortgage-back securities' special servicing rate rose to 4.94% in September, a hair higher than the August rate of 4.92%. Loans enter special servicing when financial issues arise, affecting a borrower's ability to stay current on payments.

Trepp noted in its report that September CMBS data reflects market suspicions that August was an inflection point for specially serviced loans.

"The office sector has a large concentration of loans with near-term maturities and tenants with expiring leases," it said. "Lockdown periods during the pandemic displayed the ease at which companies can implement a work-from-home policy, and if many of the major tenants in the office sector shed their leases and opt to implement a full or hybrid WFH model, this could have a major impact on the CRE market."

Looming maturities and lease terminations are starting to be reflected in the special-servicing numbers, according to Trepp.

Scott Sherman recently launched Torose Equities, a Miami company targeting value-add deals, including office buildings, in the Southeast.

Sherman said, since the pandemic, he's been looking to buy office properties, a sector where he hasn't seen many active buyers, given the questions over remote and hybrid work's long-term impact.

"That’s where I’m seeing the best opportunities," he continued. "Looking forward over the next year, with rates rising, there's going to be a lot of potential distressed situations to take advantage of."

That doesn't exclusively mean distressed properties, but also potential issues when owners can't refinance maturing debt.

South Florida is somewhat of an anomaly, as companies continue to relocate there, Sherman said, fueling demand for office space. But in other places, the outlook is cloudier.

Real estate dislocation

The level and depth of distress in any property type is impossible to ascertain. But most market observers aren't predicting a repeat of the global financial crisis fallout for commercial real estate in the late 2000s.

The political environment, both domestically and abroad, are also wild cards for what happens in the broader economy. The war in Ukraine and outcomes of the U.S. election are creating uncertainty, Mitsanas said, and questions investors have to ask include whether there's going to be an energy shortage this winter.

"Are interest rates going to stay high? What about inflation? Those uncertainties have people nervous," he said.

But, he added, most real estate owners have plenty of reserves if a rainy day becomes a storm.

Adam Ducker, CEO of Bethesda, Maryland-based RCLCO Real Estate Consulting, said in the past month or two, it's become a more commonly held view there will be distress.

"It may not be 2009 levels of distress but enough to change investment strategy, create a new fund, reposition something," Ducker said. "There’s been a meaningful change around the energy of this in the last 30 days."

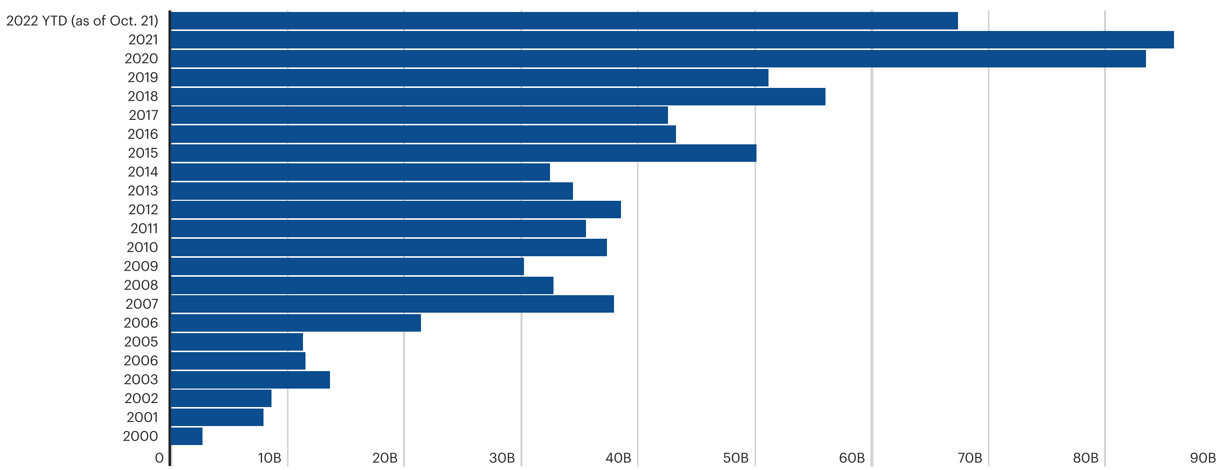
While office space gets a lot of the attention, Ducker said the market is bracing for real estate dislocation in general.

For example, in the multifamily market, which has been on fire during the pandemic, deals that closed at high values and low capitalization rates won't necessarily see distress but are pricing so differently now than they did less than a year ago. It's become more difficult to refinance or get construction financing, Ducker added, which may present opportunities.

"At the moment, there’s a historically high level of money that’s been earmarked for real estate investing that hasn’t been invested," he said.

ANTICIPATING DISTRESS

Amount of U.S. distressed debt dry powder at year end



Source: Preqin Ltd.

Share

Office sector one to watch

Workspace Property Trust out of Boca Raton, Florida, recently closed on a $1.1 billion portfolio deal that included 8 million square feet of suburban office space in 14 U.S. markets.

It was notable for its size but also because it exclusively included office space.

It was a challenging deal to close because of rapidly escalating interest rates. Workspace recently had a deal-closing party for the portfolio and handed out replica mallets because the sale was like whack-a-mole to get to the finish line, said Roger Thomas, Workspace co-founder, president and chief operating officer.

"We were able to craft together alternative balance-sheet financing, which many people had suggested we would never get that accomplished," Thomas said. "We managed to get it done. If it had gone much longer, I’m not sure if we would have been able to hold it together."

Such is the environment now for most commercial real estate deals, even for property types like industrial and apartments.

But Thomas said he remains bullish on suburban office's future — given demographic shifts to the suburbs and an increasing unwillingness to commute long distances multiple days a week — and is looking for opportunities.

And there's not a lot of competition in the suburban office buying market right now, Thomas added, as many public real estate investment trusts have pivoted from office more broadly.

"In this challenged market, you’re not going to see people starting up at this stage in the game," he said. "They’re going to wait for the markets to come back."

He said it's possible his company will go through a bit of a quiet period as the markets settle. But because some owners will be coming up against debt maturities, that can be where a company like Workspace can get a deal done.

Sherman, who previously started Tricera Capital LLC, a real estate company that bought retail properties as that sector went through a repositioning, said buying potential or outright distressed properties requires creativity and figuring out how each deal is different.

"Borrowers that now have this issue are going to be faced with a choice: Do they give back the keys, put in more capital or find some other potential way to fill the hole?" he said. "I think that’s where I’d like to try to find opportunities, where we come in and fill that hole."

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Ashley Fahey
Editor, The National Observer:
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