

CRE loan defaults: Where do we go from here?

By Kingsley Greenland, President and CEO of [DebtX](#), the world's largest marketplace for whole loans.

The commercial real estate world has been bracing for two imminent and potentially momentous events: the full rollout of the COVID-19 vaccine and the impact of loan payment deferrals on bank balance sheets.

On one hand, the vaccine offers hope of an eventual return to normalized cash flows. On the other, the forthcoming earnings reports and regulatory filings marking the end of the deferral period are likely to reveal the full impact of the pandemic.

So what's likely to happen to CRE values and, consequently, CRE loan defaults?

It all depends on the asset type. Retail, office, hospitality and small-business loans are at the forefront of potential problems. Industrial is doing quite well. Multifamily is treading water.

The river of red ink will likely begin to flow in the new year. That's due not only to the pandemic itself, but also from longer-term secular trends that have been accelerated by COVID-induced changes in the economy.

Call to action

To manage the growing volume of nonperforming or underperforming loans, bankers and lenders would be well advised to remember the painful lessons of the past.

Ten years ago, in the wake of the Great Recession, the best course of action was to sell troubled loans rather than wait for a recovery. The same lesson is relevant today for bankers and lenders.

Those who wait for values to return to pre-pandemic levels will be sitting ducks. They will be swallowed by institutions with 1) regulatory and shareholder support to acquire weakened banks; 2) the advantage of a stronger balance sheet; 3) a focus on new loan origination and profitability instead of expensive and time-consuming loan workouts.

Retail meltdown

Since retail has been hit so hard, it's a good place to start a marketplace assessment. Unfortunately, it doesn't look good for those with significant exposure to CRE loans for retail properties.

As Black Friday sales demonstrated, shoppers continue to move online. In-store sales the day after Thanksgiving were down 4% compared to a year ago, while online shopping was up 78%. The record-setting rates of coronavirus infections and government stay-at-home orders drove up the numbers, but this year's data confirms the continuing trend of fewer shopping trips to brick-and-mortar locations.

Retailers pinning their hopes on a robust, post-vaccination recovery should think twice. They may not be around to enjoy the rebound.

Through mid-August 2020, 29 major retailers went bankrupt. Those failures accounted for nearly 6,000 store closures. Coresight Research has an even more dire prediction: 25,000 retail store closures by year-end. That's on top of the 9,500 retail store closures last year.

Big shopping malls, the traditional pillars of retail, are also headed for the shoals. Morgan Stanley says 30% to 35% of shopping center malls will go away, and 20% of malls owned by real estate investment trusts will likely be sold.

The snowball of the bankruptcies is already speeding downhill to bankers and lenders. Vacancies diminish property values and negatively impact loan-to-value ratios. Reduced cash flow — or no cash flow at all — leads to defaults, reduced profitability, and lower share prices for loan originators or those with the loans on their balance sheet.

The office: What is the new normal?

The same dynamic of rising vacancies, strained LTVs and skinnier cash flows in retail is also altering the office market.

A key takeaway from the pandemic is that work-from-home employees don't need to be in the office to be productive. That's clearly reflected in PwC's 2021 Emerging Trends in Real Estate analysis, which said 94% of employers either agree or strongly agree that more employees will be allowed to work from home at least part time in the future.

The realization that there may be less need for office space has sent office REITs reeling.

Many big tenants in urban centers are renegotiating or breaking leases in REIT-owned buildings. REITs are also selling assets in anticipation of what is to come. The result is that office REIT share prices are down more than 30% this year through the end of November, according to Nareit, the REIT trade association.

As important, the appeal of big cities — on the rise for many years — has now come to a halt due to the pandemic. Although the appeal of urban living may rebound once COVID-related restrictions are lifted, people are opting out of cities for now.

Zoom calls and work-from-home have prompted a flight to the smaller metros and suburban areas. Recently, Oracle has announced their headquarters will move to Texas, and Goldman Sachs is potentially moving a large money management division to Florida.

The multimillion-dollar question is whether the office environment will return to pre-pandemic occupancy levels. In all likelihood, the answer is no. If that's indeed the case, the tremors in the office space have just begun.

Is hospitality in peril?

The pain in the retail and office market is just starting, but it has been making headlines in the hospitality space for months. The slowdown in business and leisure travel has decimated hotels and the entire travel industry.

The fallout is evident in the rising volume of CRE loan sales collateralized by hospitality properties. Since August, DebtX has offered more than \$350 million in hotel loans. Over the past six months, distressed debt funds have raised billions to buy the troubled debt.

Overall, hotel loan prices are now trading about 12% to 18% less than a year ago. It's important to remember this is not a "discount." It's the current market pricing. However nostalgic property owners or banks might be for previous values, current value is what it is.

The good news is that there are sectors of CRE loans trading at the same level a year ago. That's the result of continued oversupply of purchasing capital looking for risk-adjusted returns.

Collateral damage from the travel bust and the hollowing out of cities has also leveled small businesses. Many have always been operating on the edge, but now they are headed off the cliff. The volume of distressed small-business loans for sale at DebtX has climbed sharply in the past six months. The longer the current and new lockdowns go, the worse off it will be.

A bright spot

The fallout has been less severe in two other areas: industrial and multifamily.

In fact, industrial is a pocket of CRE strength. The accelerating adoption of e-commerce has resulted in exceptional demand for warehouse and industrial space, for data centers, as well as demand from logistics companies and other parts of the expanding e-commerce supply chain. In September, Amazon alone announced it would open 100 new warehouses.

The need for industrial space also comes with a silver lining: It is absorbing the glut of retail vacancies. According to CBRE, 13.8 million square feet of retail space has been repurposed into 15.5 million square feet of industrial space over the past three years.

The story hasn't been as positive in multifamily, which is trading water only because of government stimulus payments to renters and PPP business loans.

Rents are down in 41 of the largest 100 cities, according to the Apartment List National Rent Report. Since March, the haircut has been worst in cities with high concentrations of tech workers, who can do their jobs remotely with ease. New York rents are down 17%, San Francisco (-23%), Boston (-16%) and Seattle (-12%).

The bottom line for banks and lenders

The good news for banks, and by extension, the U.S. economy, is that many institutions have set aside substantial loan loss reserves already.

These reserves can provide ample budget for quickly moving impaired CRE loans (COVID-impacted and pre-COVID problems alike). They can also optimize balance sheets to take advantage of post-COVID opportunities.

This shock absorber should motivate banks and other lenders to dispose of bad loans to the deepening pool of distressed debt investors. At issue is how quickly bankers will act.

History has shown that banks that rid themselves of problem loans faster will emerge as winners. This virtuous cycle of liquidity and capital redeployment will transform the farsighted into stronger, more profitable and more formidable institutions.