

ANALYSIS

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Authors

Daniel Warcholak
Victor Calanog PhD
David Salz

Contact Us

Americas
+1.201.901.1932
info@reis.com

COVID-19 and Distress in CMBS Markets

Introduction

There is typically a clear chain of events that transfer distress in the overall economy to distress in CMBS markets during economic downturns:

1. Economic activity slows, reflected in job losses and/or a pullback in consumer spending.
2. Tenants occupying multifamily and commercial real estate experience stress as business slows; some go out of business and vacate their space, while others attempt to renegotiate lease agreements.
3. Property net cash flow declines, leading debt service coverage to fall.
4. Borrowers use reserves, additional equity may be brought in, forbearance measures are pursued, and other options are explored to bridge the period of stress.
5. Bridge measures are exhausted and defaults increase. Servicers advance loan P&I payments to CMBS bondholders to the extent that recoverability is credible.
6. Losses and associated bond principal write-downs are incurred relative to the recovery available through liquidation values. Certain bondholders may be impacted by the effect of reduced appraisals in advance of actual liquidation.
7. Credit enhancement of senior bonds deteriorates as losses are incurred.
8. High investment-grade bonds are exposed to greater downside risk as losses breach thresholds.

What makes the COVID-19 crisis different is that distress is unfolding much faster, relative to prior downturns. Steps 1 to 4 typically unfolded over several months during the Great Financial Crisis of 2008-09—now, we have gone through all four steps within four to six weeks, beginning in mid-March, when the World Health Organization formally classified COVID-19 as a pandemic. As of the third week of May, the total balance of CMBS loans in special servicing has reached \$32 billion, up \$9.6 billion through the May remittance period as of May 19. The composition of distress, however, is not surprising: hotel and retail loans account for 96% of transfers to special servicing since March 1. For perspective, during the Great Financial Crisis, the volume of CMBS loans in special servicing peaked at \$92 billion in the middle of 2010—two and a half years after the recession began in December 2007. The speed with which CMBS loans are being transferred into special servicing is unprecedented.

For this paper, Moody's Analytics collaborated with CWC Capital, which provides special servicing, technology, and disposition services across all major asset types, including multifamily, office, retail, industrial, hospitality, and mixed use. Papers have been written about the extraordinary stress the commercial real estate industry as a whole is experiencing, given publicly available data from the CMBS markets. But what is the situation like for a special servicer such as CWC Capital? What trade-offs and decisions do they have to make given the kind of relief requests they have been receiving? Will distress become more widespread given the expected duration and depth of this downturn, or will some property types or geographic markets emerge relatively unscathed?

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Distress, in Fast Forward

Prior to COVID-19, CWCcapital was already noting signs of distress in certain segments of the hospitality sector, particularly limited service hotels in oversupplied markets.¹ Formal policies had not been declared to shut down large swaths of the economy, but business and personal travel had likely begun to slow. In a paper that Moody's Analytics published on March 3, the immediate risk to the hospitality sector was identified, given short-term leases and the expected widespread slowdown in trade and tourism.²

As the crisis has unfolded, updated forecasts from Moody's Analytics for year-end 2020 reflect this high correlation between geographic areas expected to incur large employment declines and their share of leisure and hospitality jobs. Table 1 below presents ten major markets with the largest forecasted declines in *total* employment. It is no surprise that Las Vegas tops the list.³

Table 1 Top 10 Major Markets with the Largest Projected Declines in Employment

MSA	State	Forecast Period	Share of Leisure & Hospitality Jobs	Projected Decline in Total Employment
Las Vegas	NV	2020	25.4%	-13.7%
Miami	FL	2020	11.0%	-9.4%
Fort Lauderdale	FL	2020	10.2%	-9.4%
Phoenix	AZ	2020	9.7%	-9.3%
Orlando	FL	2020	19.0%	-8.9%
Palm Beach	FL	2020	13.0%	-8.7%
Tucson	AZ	2020	10.2%	-8.6%
Tampa-St. Petersburg	FL	2020	10.8%	-8.3%
Jacksonville	FL	2020	10.9%	-8.2%
Seattle	WA	2020	9.2%	-7.8%

Source: Moody's Analytics

"Given COVID-19 transmission channels, it is no surprise that places with a higher share of leisure and hospitality jobs are expected to be hit harder, in terms of overall employment declines," says Sohini Chowdhury, Senior Economist at Moody's Analytics. "Stress on the employment side will also depend on whether a geographic area's employment base is relatively diversified, or more dependent on a specific sector." San Francisco, for example, has an 11.8% share of leisure and hospitality jobs relative to total employment—higher than seven of the ten markets in Table 1—but given that tech firms also generate substantial employment in the city, total employment is expected to decline by a relatively modest 7.7%. The tech sector is not expected to be hit as hard by COVID-19 as other industries.

Retail tenants and property managers have also been experiencing severe distress, given mandated store closures and shelter-in-place policies. Major retailers like JC Penney, J. Crew, and Neiman Marcus have filed for bankruptcy. More specialized retailers like Dean & DeLuca (whose geographic focus in New York City has not served it well, given how hard the city has been hit by COVID-19) and Gold's Gym (which operates over 700 gyms in the United States) have also filed for bankruptcy.⁴ In two research papers we published on the retail sector, Moody's Analytics explored how the sector will evolve in the future, and how a large retailer like Macy's might respond given geographic concentration risk.⁵

¹ CWCcapital offers more thoughts on weakness in the hospitality sector here: <https://www.cwcapital.com/news/cwcapital-markets-update/second-quarter-2019/>

² See "Peak Uncertainty: The Possible Effect of COVID-19 on US Multifamily and Commercial Real Estate" (published on March 3, 2020). Available upon request.

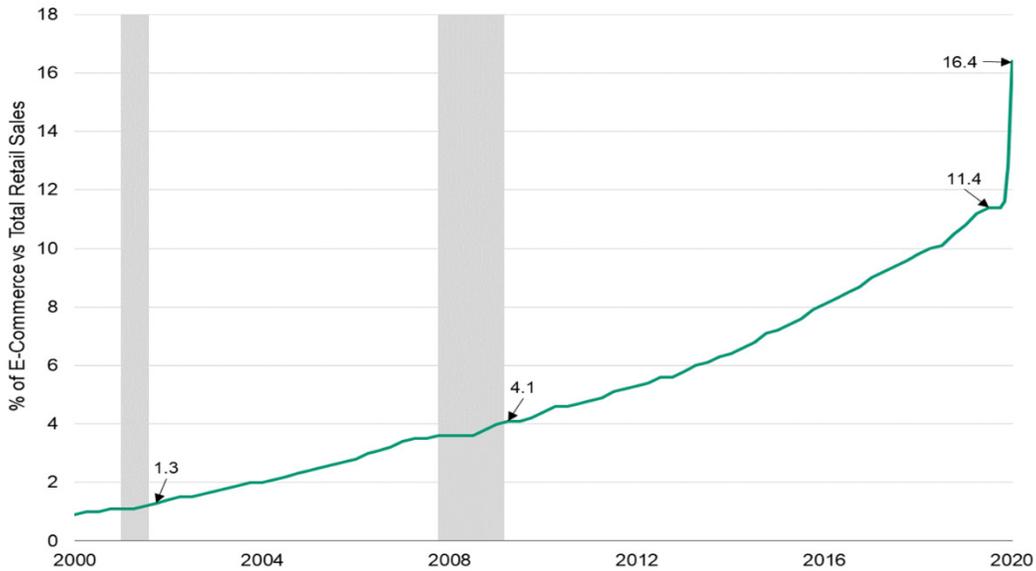
³ Two other Nevada markets, Reno and Carson City, actually make it to the top ten list, but they are typically not considered tier one or major multifamily and commercial real estate markets.

⁴ Dean & DeLuca filed for bankruptcy on March 31, and Gold's Gym filed for bankruptcy on May 4.

⁵ See "The COVID-19 Pandemic and the Retail Debacle" (published on April 3) and "COVID-19 and Retail: A Macy's Case Study" (published on April 21). Available upon request.

Aside from the disruptions caused by outright store closures and a contraction in consumer and retail spending, the pressure on brick and mortar retail is likely to intensify given the increased shift to online sales. Moody's Analytics REIS estimates that in the months of March and April alone, the proportion of e-commerce relative to total retail sales spiked by 500 basis points, from 11.4% at the end of 2019 to 16.4% as of the latest figures. The share figure had been rising steadily since the dawn of e-commerce in the late 1990s, but the magnitude of the spike over two months prompted by COVID-19 is historic.

Figure 1 Share of E-Commerce vs Total Retail Sales



Source: US Department of Commerce; Moody's Analytics REIS

To be fair, the 16.4% historic drop in total retail sales in April reduced the denominator significantly, contributing to the rise in the ratio. But the bigger driver was the 20.5% increase in *non-store retail sales* over the same time period, which includes e-commerce as a significant component. This one-two punch of a massive increase in the numerator and a historic decline in the denominator drove the 500-basis point movement in the ratio presented in Figure 1.

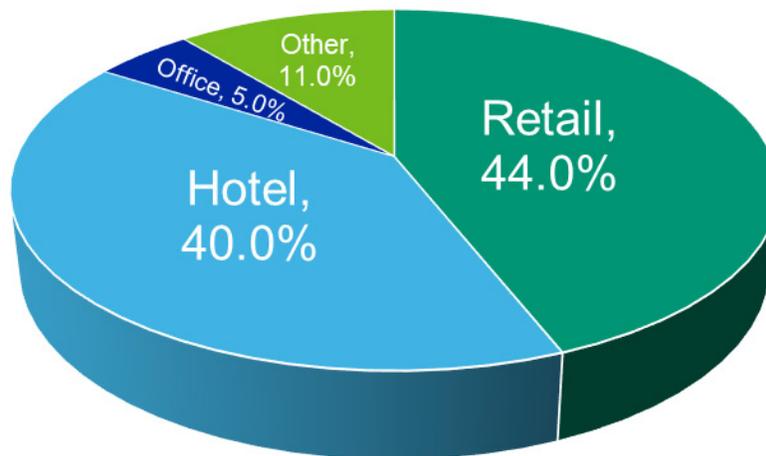
Even with reopening efforts underway, it is unlikely that the hospitality and retail sectors will bounce back swiftly. Moody's Analytics REIS estimates that hotel RevPAR (revenues per available room) will decline by 22.4% year-over-year in 2020 – an historic drop, with most of the stress concentrated in the second quarter. Retail rents are forecasted to fall by 11% over the same time period – almost twice the magnitude of deterioration recorded throughout all of the Great Financial Crisis from 2008 to 2011. As a result, it is likely that the volume of CMBS loans experiencing distress will continue to rise at least through 2020.

The CWCapital Experience

"It wasn't a surprise for us that hotel and retail were at the forefront of property types experiencing distress in CMBS markets because of the nature of this downturn," says Jim Shevlin, CWCapital's President and Chief Operating Officer. "The speed of this downturn is also something we're seeing for the first time. The closest period in terms of the severity of pullback in travel would be the months following the 9/11 attacks. But this time, hotel occupancies have dropped to the low 20s, and on a national basis as opposed to only focused markets after 9/11. How can hotel operators be expected to keep up with principal and interest payments? Some have been making partial interest payments, but servicing debt the way they were able to before COVID-19? That's a tough ask."

CWCapital has seen relief requests come primarily from retail (44%) and lodging (40%), with much of the rest from office (5%) and mixed use (5%). The loan balance associated with the relief requests is approximately \$8 billion, with 7% or \$560mm of that transferring to special servicing.

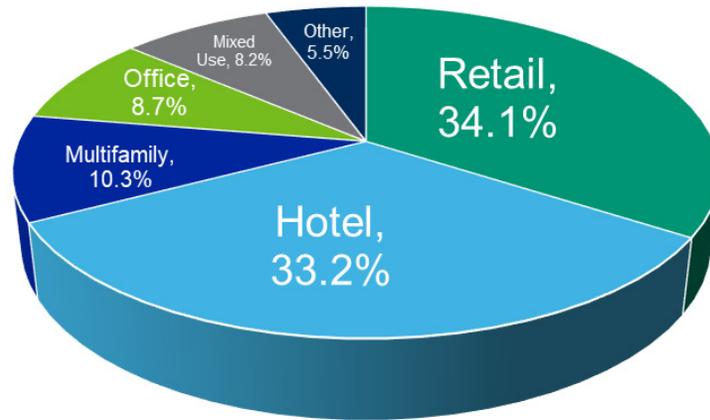
Figure 2 Share of Relief Requests, by Property Type



Source: CWCapital

These proportions are roughly in line with servicer comments for loans in the CMBS universe that mentioned "COVID-19," as tracked by Moody's Analytics.

Figure 3 Share of CMBS Loans Mentioning “COVID-19” in Servicer Notes



Source: Moody's Analytics Structured Finance Portal

Some servicer comments are very specific, and are often indicative of whether or not a loan will enter into forbearance at some point. While relief requests are being evaluated, servicer comments may read like the following:

COVID-19 Relief Requested. Borrower is working with Lender towards possible solution. Subject property is a 177 room Doubletree Hotel located in [city], TX. Property was built in 1924 and renovated in 2012. DSCR is operating below the 1.20x threshold due to an increase in Operating Expenses, specifically Admin. & General (\$337k). Per the 12/31/2019 Financial Statement, YE occupancy was 78% with an ADR of \$149.44 and a RevPar of \$117.00. Per 12/31/2019 Star Report, comp. set occupancy, ADR, and REVPar were; 75.9%, \$159.01, and \$120.63, respectively. Lockbox is now active.

Once the request is addressed, the CREFC Loan Modification Report may read:

New Loan Modification Terms: •For a period of 90 days, Borrower can use the Seasonality Reserve, FF&E Reserve, and CapEx Reserve funds, in that specific order, to keep loan current (not tax or insurance escrows) •Borrower may defer payments to the Seasonality Reserve, FF&E Reserve, and CapEx Reserve accounts (not tax or insurance escrow) for a period of 90 days •Borrower to replenish the Seasonality Reserve, FF&E Reserve, and CapEx Reserve accounts within 12 months of the expiration of the 90-day access period •12-month waiver of covenants (excluding EOD and bankruptcy)

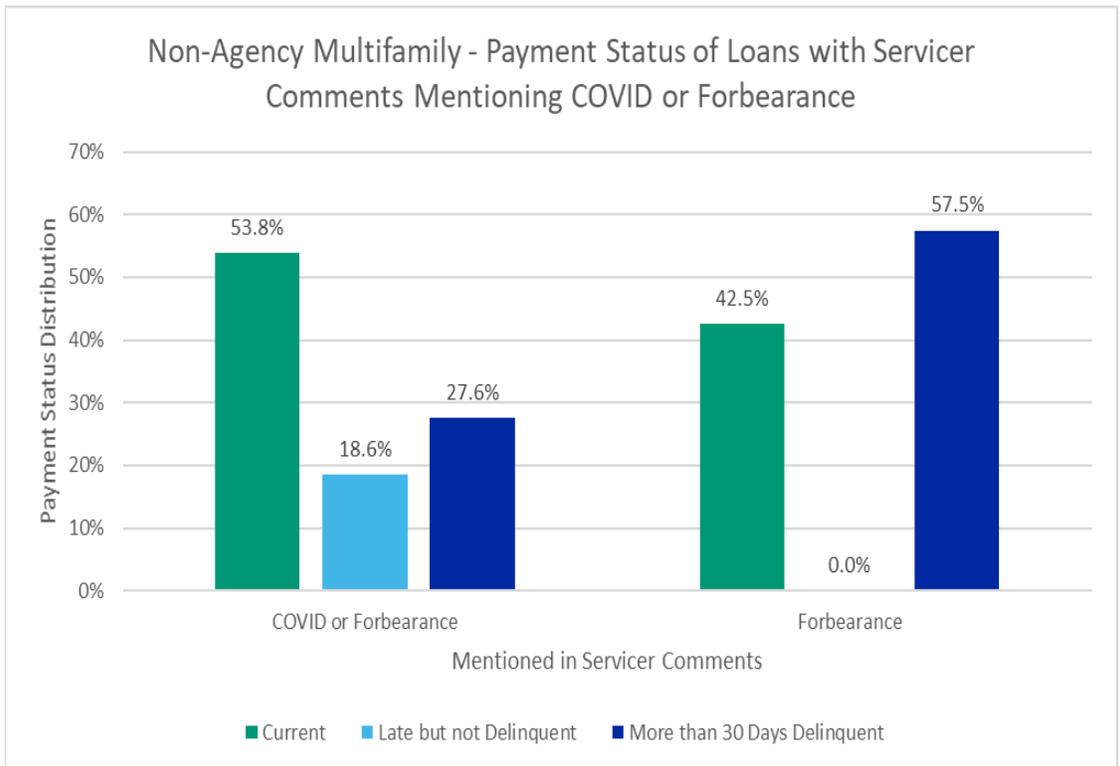
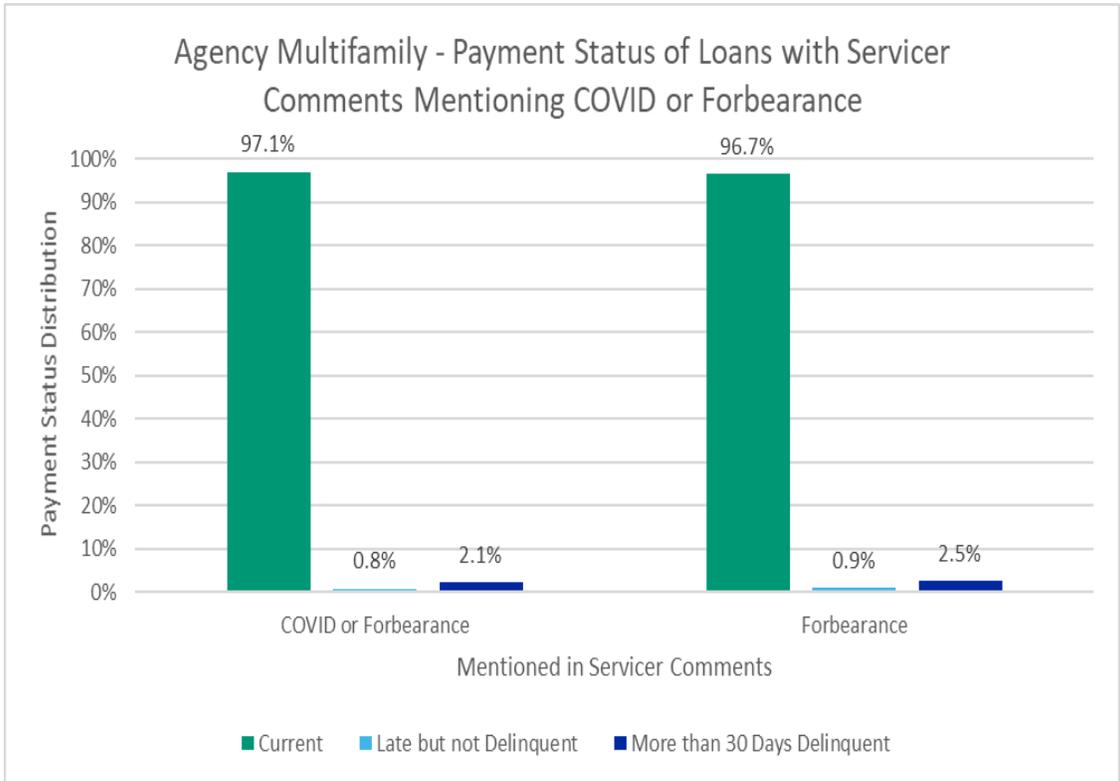
Moral Hazard. CWCapital has rejected some 29% of relief requests because after reviewing the request, many were found to have been *preemptive*: Tenants/borrowers actually had the capacity to pay, but were asking for relief because broad distress in the environment provided an opportunity to do so. “We were always concerned about moral hazard given COVID-19,” said David Salz, Director and Data Strategist for CMBS and Structured Finance at Moody's Analytics. “If most tenants are going through distress, why shouldn't every tenant—even ones perfectly capable of meeting their debt obligations—ask for relief?” Special servicers like CWCapital therefore need to evaluate whether or not relief requests are valid, and in the interest of all stakeholders.

But Who Are the Winners? With distress concentrated in the hospitality and retail sectors for CMBS loans, it appears that other property types might be better positioned to weather the storm. “We are relatively optimistic about industrial properties,” said Shevlin of CWCapital. “We aren't seeing much distress come in for CMBS loans supported by industrial properties, and the shift to online retail will likely boost this sector's fortunes.”

Multifamily is also likely to be hit relatively less hard, given that housing is a basic good, and performance metrics like rent growth and vacancy levels for the rental housing market were strong before the COVID-19 crisis hit. In the CMBS world, however, there appears to be a stark difference between agency multifamily MBS and non-agency multifamily MBS. Figure 4 shows the payment status of agency and non-agency multifamily MBS, where the terms “COVID-19” or “Forbearance” appear in servicer comments. Note how the majority of agency MBS loans are current, but only about half of non-agency MBS loans are.

Figure 4 Agency vs Non-Agency Multifamily MBS

Payment Status for Loans with Servicer Comments Mentioning 'COVID-19' or 'Forbearance'



Source: Moody's Analytics Structured Finance Portal

Specifically, there are roughly the same amount of agency and non-agency multifamily loans with COVID-19 and/or forbearance in the servicer comments —approximately \$2.2 billion. The significant difference is the volume of servicer comments mentioning forbearance: agency multifamily has \$1.9 billion in loans mentioning forbearance, with non-agency multifamily reporting \$239 million. We believe that this difference may be partially related to standardized forbearance programs offered by agency lenders such as Freddie Mac that are not otherwise available to the non-agency borrowers. In addition, the greater mix, quality, and unique circumstances sometimes associated with non-agency properties, as well as the individual approaches of servicers, could result in fewer uses of the term “forbearance” at this time. As time progresses, the true differences in credit quality between agency and non-agency multifamily will be seen.

Conclusions: What's Next for CMBS?

Further processing of the existing CMBS book will be the central theme in the month of June: there are no issuances planned, given the ongoing uncertainty of the COVID-19 crisis. On the positive side, there may be green shoots from reopening and increased economic activity. On the downside, without a credible, reliable treatment and vaccination protocol made widely available, prospects for a quick return to “normal conditions” are dim, at least for the rest of 2020. More loans are likely to move into special servicing. However, with additional time for borrowers to gather and report better data, there will be better perspective on the road ahead, with greater clarity between servicers and borrowers on next steps such as forbearance or modification.

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