Markets Update

OCTOBER 2020

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In this issue of the CWCapital Markets Update, we review current performance, delinquencies, and developments in the marketplace since COVID-19 began. Uncertainties around the multiple crises of 2020 have continued to unfold. Among the challenges are the pandemic, oil price fluctuations, economic collapse, resultant record unemployment, record federal deficits, uncertain economic assistance packages, civil unrest, and general election tensions.

A few things are clear. The economy has recovered (at least somewhat) from the initial shock of COVID-19. But prospects for a return to “normal” are still far off, and could be jeopardized by a resurgence of the virus and other instability. Commercial real estate will never be the same. Fundamental changes are occurring in both demand and the way Hotel, Retail, and Office properties will be used and valued. From e-commerce, to travel, to work from home, these forces are changing CRE as we watch.

THE ECONOMY:

- **Unemployment** - As of this writing, the US Unemployment rate stands at 7.9% with nearly 20 million persons remaining unemployed as a result of the pandemic. This level is significantly improved from April 2020’s record of 14.7% as businesses regain some of the commerce lost during the early shut-downs. Many workers are also finding new opportunities in jobs created as a result of the pandemic. Unemployment remains somewhat below the benchmark average of 8.8% experienced during the Great Recession (mid 2008-2011).
- **GDP** - Economic volatility reigns. The Bureau of Economic Analysis reported that Third Quarter GDP grew at a 33.1% rate (below the Federal Reserve Board of Atlanta GDPNow forecast) and after an unbelievable drop of 31.4% (annual rate) realized in Q2 2020. To put these numbers in perspective, The Conference Board estimates will be a net -3.5% annual growth rate for the year.
- **Trade Deficit** – The US trade deficit increased to $67.1bn in August, the widest gap in over 14 years.
- **Budget Deficit** – The Congressional Budget Office reported a budget deficit of $3.1 trillion for fiscal 2020, more than 3x the shortfall in 2019. While there has been significant spending on pandemic relief, pre-crisis tax cuts and other stimulus packages contribute a deficit at 15.2% of GDP, the largest shortfall since 1945 and WWII. At some point, we expect investors will regain focus on this issue.

CRE MARKETS:

- We see clear evidence of a “condensed first wave” of delinquencies and defaulted assets.
- Delinquent / defaulted assets began to appear in April 2020 and peaked in June. Since that time, overall rates have slowly moderated with newly delinquent loans falling to 2.38%, the lowest level since April. We believe there remains significant distress under the surface that could drive delinquencies back up in the coming months.
- We estimate that 30% of Hotel exposure across the CMBS universe is now delinquent or defaulted, along with 19% of all Retail assets.
- Property transaction markets remain significantly constrained due to uncertainty of valuations.

CATALYSTS AS WE MOVE FORWARD:

MACRO SHIFTS IN BUSINESS MODELS ARE ONE OF OUR MAJOR CONCERNS:

- Will CRE continue to be profitable assuming the following business model changes?
  - Hotels- travel reductions, room cleaning, distancing measures
  - Retail – acceleration of e-commerce, on-line presence, and the real need for non-essentials, subsitute goods
  - Office - work from home becoming more the norm. Less need for space
  - Restaurants – capacity reductions, distancing, cleaning
  - Student Housing - E-Learning, social distancing and cleaning in dorms, potential for significant revenue reductions from athletic programs
  - Entertainment – prospects for sporting events, movies, concerts, etc.
- Borrower capitulation – the extent to which thinly capitalized and other borrowers capitulate and exercise the put option normally available with CRE loans

UPDATE – THE CWCAPITAL MACRO TRACKER

We are tracking over 24,000 commercial mortgage loans securitized across 774 CMBS 2.0/3.0 and SASB transactions. The overall delinquency / Specially Serviced rate decreased to 12.38% in October 2020. Comparatively, this level still exceeds the highest levels (over 9%) during the financial crisis between 2007-2009. **Our chart clearly demonstrates how the concentrated "first wave" of delinquencies and defaults has moved thru the cycle**. Overall delinquency and specially serviced loans reached a peak in June, declining since that time. Non specially serviced delinquencies declined to 2.38%, the lowest level since the early days of the crisis.

Hotel and Retail properties lead the way with 30% and 20% respectively, of all such securitized assets now in the distressed category. To date, Office and Multifamily has seen a lower level of distress, however, certain subsectors (Student and Senior Housing), have, and are expected to continue to have, disproportionate levels.

One may ask if all the distress associated with 2020's multiple crises has presented itself at this point. Even considering the declining delinquencies, we remain skeptical. More thorough analysis reveals additional risks across several CRE asset types including Retail, Office (yet to adjust to macro trends of work from home, downsizing, distancing), and potentially Multifamily as continued unemployment leads to re-concentration of households.

SPECIALLY SERVICED RATE DECREASED TO

12.38%

in October 2020

DISTRESSED SECURITIZED ASSETS

30%
HOTEL

20%
RETAIL

UPDATE – THE CWCAPITAL MACRO TRACKER

Type	Month	Defeased	Current	Late <30	30	60	SS	Total	% Non-SS Delinq	Delinq + SS
$ Balance	Jan-20	20,927.0	473,400.6	4,966.5	112.1	9.4	6,833.3	506,248.8	1.01%	2.35%
	Feb-20	21,503.5	475,176.9	5,021.5	251.3	28.5	6,937.6	508,919.3	1.04%	2.40%
	Mar-20	21,712.8	481,429.2	4,021.4	136.2	3.1	10,286.9	517,589.6	0.80%	2.79%
	Apr-20	21,921.1	452,001.6	**27,233.7**	584.4	11.8	16,967.1	518,719.7	5.37%	8.64%
	May-20	21,942.0	430,475.6	**23,399.5**	**17,536.6**	237.7	26,589.6	520,180.9	7.92%	13.03%
	Jun-20	22,175.5	426,529.8	**14,174.4**	**12,595.3**	**5,849.6**	37,871.2	519,195.9	6.28%	13.58%
	Jul-20	22,010.7	430,659.0	6,714.8	**7,091.8**	**4,845.4**	**46,185.4**	517,507.1	3.60%	12.53%
	Aug-20	22,236.6	431,426.1	6,637.7	4,408.0	**2,982.5**	**48,159.2**	517,507.1	2.72%	12.06%
	Sep-20	22,302.2	427,267.9	8,472.3	4,374.7	1,379.3	**49,819.1**	513,615.4	2.77%	12.47%
	Oct-20	22,135.0	425,882.7	8,045.4	2,966.5	1,149.8	51,149.5	511,328.9	**2.38%**	**12.38%**
% of Total	Jan-20	4.13%	93.51%	0.98%	0.02%	0.00%	1.35%	100.00%	1.01%	2.35%
	Feb-20	4.23%	93.37%	0.99%	0.05%	0.01%	1.36%	100.00%	1.04%	2.40%
	Mar-20	4.19%	93.01%	0.78%	0.03%	0.00%	1.99%	100.00%	0.80%	2.79%
	Apr-20	4.23%	87.14%	5.25%	0.11%	0.00%	3.27%	100.00%	5.37%	8.64%
	May-20	4.22%	82.75%	4.50%	3.37%	0.05%	5.11%	100.00%	7.92%	13.03%
	Jun-20	4.27%	82.15%	2.73%	2.43%	1.13%	7.29%	100.00%	6.28%	13.58%
	Jul-20	4.25%	83.22%	1.30%	1.37%	0.94%	8.92%	100.00%	3.60%	12.53%
	Aug-20	4.31%	83.63%	1.29%	0.85%	0.58%	9.34%	100.00%	2.72%	12.06%
	Sep-20	4.34%	83.19%	1.65%	0.85%	0.27%	9.70%	100.00%	2.77%	12.47%
	Oct-20	4.33%	83.29%	1.57%	0.58%	0.22%	10.00%	100.00%	2.38%	12.38%
$ Balance by Prop Type	Hotel	1,423.0	58,298.9	2,228.8	1,055.1	499.5	21,701.9	85,207.2	4.44%	29.91%
	Retail	2,973.9	101,389.6	2,453.1	885.8	248.0	20,658.7	128,609.1	2.79%	18.85%
	Mixed	1,040.0	33,716.7	737.9	260.3	299.4	2,125.9	38,180.2	3.40%	8.97%
	Office	5,491.2	136,710.7	1,870.8	465.3	20.6	2,821.5	147,380.1	1.60%	3.51%
	MultiFam	5,702.5	40,313.5	430.0	171.2	79.2	1,444.1	48,140.4	1.41%	4.41%
	Mfg Hsg	1,685.3	6,028.4	20.5	7.2	-	47.0	7,788.5	0.36%	0.96%
	Senior	35.0	1,252.8	-	-	-	-	1,287.8	0.00%	0.00%
	Indust	1,407.4	27,995.6	166.1	96.0	3.2	1,620.5	31,288.8	0.85%	6.03%
	Self Stor	2,113.7	13,033.5	52.6	4.0	-	3.1	15,206.9	0.37%	0.39%
	Special	227.3	4,658.5	79.5	-	-	616.6	5,581.8	1.42%	12.47%
	Other	35.7	2,484.7	5.9	21.4	-	110.4	2,658.1	1.03%	5.18%
		22,135.0	**425,882.7**	**8,045.4**	**2,966.5**	**1,149.8**	**51,149.5**	**511,328.9**	**2.38%**	**12.38%**

FEATURE – FOCUS ON RETAIL TENANTS

WE REMAIN SKEPTICAL THAT WE'VE SEEN IT ALL:

As we have written, some 20% of all securitized retail loans are now in the distressed category, second only to hotels. Several trends, including e-commerce, the long-term decline of shopping malls and significant overbuilding were already in place when the COVID-19 pandemic and resulting economic distress arrived. The question is, after 7 months into the crisis, has all the distress in securitized retail presented itself?

After analyzing current business trends, metrics, and exposures, we remain skeptical. In fact, of the 25 largest listed retail tenants whose core businesses could be subject to pandemic initiated shifts in consumer preferences, **less than 20% of the properties they occupy have recorded delinquency or default**. We believe this percentage could increase over time, specifically in anchored retail, as the pandemic driven shift continues, business resources run out, rents are curtailed or abated, and sponsors can no longer carry the properties.

We aggregated data from over 34,000 retail properties (520mm sq ft) for this writing. But rather than initially focusing on the property or property type, we reviewed the top 5 listed tenants (or shadow tenants), no matter the format, to determine the level of exposure to the businesses, and most importantly, how are those businesses doing. Specifically, are the businesses subject to structural change in consumer preference and spending patterns. To identify risk, we reviewed each tenant's current credit rating, change in most recently reported revenue versus prior year, share price change year to date, general market commentary, and press releases.

Some interesting trends we are seeing:

DECLINES IN RETAILERS DEPENDENT ON WOMEN'S APPAREL

Declines in retailers dependent on women's apparel (as well as business attire)– as work at home continues, formal wear, business wear, casual, and accessory demand falls. This is most evident at tenants like Ross Dress for Less, TJ Maxx, Dillard's, and Marshalls. Kohl's is launching their own line of "athleisure wear" to adjust. Each of the retailer's report revenue declines 17%-20% versus last year. And most of these retailers appear in anchored retail as opposed to mall formats like a JCPenney. On average, only 13% of the properties with this exposure show as distressed.

HOME GOODS / DISCOUNT

Home Goods / Discount - Revenues at both Burlington Coat Factory and Bed Bath and Beyond have fallen over 15% year over year. Big Lots appears an exception so far. We generally expect gains in home goods and "stay at home" activity sales as pandemic closures and generally curtailed in-person continue. Our concern is that product mix, on-line presence, and stiff competition in the e-commerce space could present challenges for both. This exposure will likely be highlighted across retailers as the crisis continues. On average, 12% of the properties with this exposure show as distressed.

ARTS AND CRAFTS

Michael's Stores reported a decline in revenue of nearly 6% year over year, and maintains a Single B credit rating, lowest among the top 25 we analyzed. Our concern relates to increasing competition from online crafts and retailers, and constrained consumer spending during challenging times. Both could jeopardize what should be increasing revenue and healthy margins during pandemic "stay at home time". Only 6% of properties showing this exposure show as distressed.

In conclusion, we believe there remains the potential for more delinquency, distress, defaults, and liquidations in the retail sector in the coming months. Specifically, within Anchored Retail. This concern is driven mainly by what we believe are macro shifts in consumer preference and acceleration of e-commerce trends. More time at home means more sweatpants and t-shirts, more e-commerce, less time in the store, less business wear, less browsing and less opportunity for non-essential buying. These macro trends may well continue past the end of the pandemic.

Rank	Tenant	SqFt millions)	Avg Size Space	Rating	Revenue change TTM	Share Px vs 1/20	Comment	Mall	Power Center	Anchor	Single Tenant	Total Stores	Delinq / Defaulted
1	JC Penney	17.11	154,179	Bank-rupt	-26.0%	-81.5%	Bankrupt, purchase by Brookfield / Simon pending	108	2	45	1	156	36%
2	Macy's	14.52	198,879	B+	-19.0%	-62.2%	Mall exposure. Plans 125 store closings thru 2022.	72	-	17	1	91	36%
3	Walgreens	13.15	18,515	BBB-	2.0%	-36.8%	UK based business appear to weigh on earning and profit margins	-	-	172	710	905	n/c
4	Kohl's Department Store	11.73	266,610	BBB-	-13.4%	-58.9%	Sales down, no mention of store closures. Launching new athleisure wear brand.	9	14	89	21	135	7%
5	Walmart	11.73	451,185	AA	4.6%	22.3%	Improving performance	3	-	72	23	99	n/c
6	Dick's Sporting Goods	9.91	145,771	BB	1.0%	24.0%	Plans hiring. Optimizing athletic / leisure wear offerings	53	11	112	4	186	n/c
7	Ross Dress For Less	9.54	257,951	BBB+	-17.1%	-20.2%	Steep declines in women's apparel sales. Raised $1bn debt.	10	24	286	3	338	10%
8	Hobby Lobby	8.96	288,917	-	Priv	Priv	Private company.	6	3	124	22	158	n/c
9	Burlington Coat Factory	8.70	241,661	BB-	-16.3%	-10.5%	Declines, but seeking to add 30-50 smaller, more productive stores in 2020 expansion.	23	8	92	5	131	13%
10	Dollar Tree Stores	7.71	428,510	BBB-	5.7%	2.8%	Dollar store stable during pandemic	1	3	478	14	705	n/c
11	Dollar General	7.58	11,432	BBB	17.3%	40.9%	Dollar store stable during pandemic	-	-	119	663	802	n/c
12	Lowe's Home Improvement	7.44	323,378	BBB+	12.0%	49.5%	Strong demand for essentials and do-it-your-self during pandemic	1	10	36	12	59	n/c
13	Best Buy	7.31	174,004	BBB	0.8%	40.4%	Demand for Geek Squad, electronics, laptops, etc. Sales stable.	17	11	146	14	191	n/c
14	Home Depot	6.89	405,080	A	8.5%	32.6%	Strong demand for essentials and do-it-your-self during pandemic	4	2	40	11	57	n/c
15	Big Lots	6.53	815,843	-	10.6%	88.5%	Home goods / close-outs. Furniture approx 25% of sales. Buy online, pickup curbside model.	2	3	185	3	203	n/c
16	TJ Maxx	6.01	353,714	A	-15.7%	-8.6%	Women's apparel, other clothing, continue to decline during pandemic.	7	8	178	2	203	7%
17	Bed Bath & Beyond	5.84	188,463	B+	-15.2%	40.3%	Home goods reailer showing revenue declining over 2 yrs. Closing approx 200 stores over next 2 years.	11	19	156	1	189	11%
18	BJ's Wholesale Club	5.35	162,238	BB-	10.1%	83.3%	Significant increase in digital sales, curbside pickup. Adds grocery service..	3	1	17	29	50	n/c
19	Marshall's	5.22	260,978	A	-15.7%	-8.6%	Women's apparel, other clothing, continue to decline during pandemic.	10	9	143	1	174	12%
20	CVS	5.17	23,180	BBB	16.2%	-19.6%	Expects to hire 15,000 workers to manage COVID, Flu surges.	-	-	142	223	395	n/c
21	Kroger Super-markets	5.08	1,694,638	BBB	6.1%	16.3%	Grocery / Food. Stable	-	-	86	3	90	n/c
22	Food Lion	4.90	1,633,316	BBB	0.0%	17.7%	Grocery / Food. Stable	-	1	136	2	141	n/c
23	Target	4.69	246,676	A-	10.2%	30.4%	Diversified, stable	14	3	21	2	43	n/c
24	Dillard's	4.57	217,536	BB-	-20.3%	-34.0%	Women's apparel, businesswear, other clothing, continue to decline during pandemic.	20	1	7	-	28	21%
25	Michaels Stores	4.24	249,404	B	-5.7%	22.7%	Competes in arts and crafts space with e-commerce, Target, etc. Acquired AC Moore in 2019.	2	14	157	1	186	6%

SOURCES

The third-party Information set forth herein may be derived from any of the following sources:

Bloomberg
CBRE Capital Markets
Citibank Research
Commercial Mortgage Alert
CoStar
CRE Direct
FHLMC
International Council of Shopping Centers
Intex Solutions
Morningstar Research
Moody's / RCA CPPI
National Real Estate Investor
Real Capital Analytics
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