MOODY'S ANALYTICS

CWCapital

ANALYSIS
AUGUST 3, 2020

COVID-19 and Distress in the CMBS Markets

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Introduction

In early June, Moody's Analytics and CWCapital published a paper that provided a sense of where and how distress was manifesting in CMBS markets.[1] Given how the COVID-19 crisis has persisted (and arguably become even worse), we provide an update in this paper on the worst affected property types and geographic markets—and offer our thoughts on how conditions in the CRE debt markets will likely evolve through the rest of the year.

[1] "COVID-19 and Distress in the CMBS Markets" by Daniel Warcholak, David Salz, and Victor Calanog (June 9, 2020). Available upon request.

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The Economic Situation

Consensus forecasts maintain that 2020 is likely to register the worst decline in US GDP since the Great Depression, with Moody's Analytics currently forecasting a 6.9% decline for the year as a whole. The bulk of economic contraction is likely to have occurred in the second quarter, given shutdown policies that were subsequently lifted in various places starting in late April. The Bureau of Economic Analysis's advanced estimate puts the decline at an annualized figure of 32.9%, more than three times the previous record of 10% from the first quarter of 1958.

Still, even as the economy begins to add jobs (a total of approximately 7.5 million non-farm jobs in May and June), it does not look like the crisis is anywhere near over.

1. The latest figures from the Bureau of Labor Statistics show that 22.2 million jobs were lost in March and April as shutdown policies were implemented on a national scale. That essentially wiped out the 22.8 million jobs that were added between February 2010 and February 2020 (non-farm employment levels bottomed out in February 2010).
2. The worrisome acceleration in the number of observed COVID-19 cases in large states like California, Texas, and Florida suggests that some form of lockdown might once again be necessary, or at the very least that economic activity is likely to proceed at a constrained pace over the remainder of the year.

While several possible vaccines are being fast-tracked, there are few predictions that current 2020 trends will turn around and finish as a net positive.[2] Consequently, updated MSA-level predictions for employment change suggest continuing hardship—particularly for geographic areas that are relatively more dependent on the beleaguered leisure and hospitality sector.

Figure 1. Projected Employment Change (2020) – Top 10 Declines

MSA/STATE	TOTAL EMPLOYMENT CHANGE (PROJECTED, 2020)	SHARE OF LEISURE & HOSPITALITY JOBS
Las Vegas-Paradise NV	-15.4%	20.6%
Reno-Sparks NV	-12.8%	13.9%
Fort Lauderdale-Pompano Beach-Deerfield Beach FL Metro Division	-10.7%	8.8%
Miami-Miami Beach-Kendall FL Metro Division	-10.6%	8.9%
Prescott AZ	-10.5%	11.8%
Flagstaff AZ	-10.5%	19.6%
New Orleans-Metairie-Kenner LA	-10.4%	10.0%
Phoenix-Mesa-Scottsdale AZ	-10.4%	7.9%
Orlando FL	-10.3%	15.5%
Carson City NV	-10.2%	10.3%
United States - National Average	-7.3%	9.7%

Source: Moody's Analytics

For perspective, anticipated employment declines in these markets are almost double the actual change experienced between 2008 and 2010, during the financial crisis:

[2] The IMF's latest projections from June 2020 actually worsened their US real GDP forecast for 2020, from a decline of 5.6% in their April forecast vintage to its current -8.0%. https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020

Figure 2. Projected Employment Change (2020) vs 2008-2010 Actual Change

MSA/STATE	TOTAL EMPLOYMENT CHANGE (PROJECTED, 2020)	ACTUAL EMPLOYMENT CHANGE (2008-2010)
Las Vegas-Paradise NV	-15.4%	-9.6%
Reno-Sparks NV	-12.8%	-8.6%
Fort Lauderdale-Pompano Beach-Deerfield Beach FL Metro Division	-10.7%	-5.1%
Miami-Miami Beach-Kendall FL Metro Division	-10.6%	-3.2%
Prescott AZ	-10.5%	-9.6%
Flagstaff AZ	-10.5%	-5.0%
New Orleans-Metairie-Kenner LA	-10.4%	-0.8%
Phoenix-Mesa-Scottsdale AZ	-10.4%	-7.0%
Orlando FL	-10.3%	-4.1%
Carson City NV	-10.2%	-8.4%
United States - National Average	-7.3%	-3.6%

Source: Moody's Analytics

With this relatively bleak outlook to provide context, it will come as no surprise that distress in CMBS markets continued to ramp up in June and July.

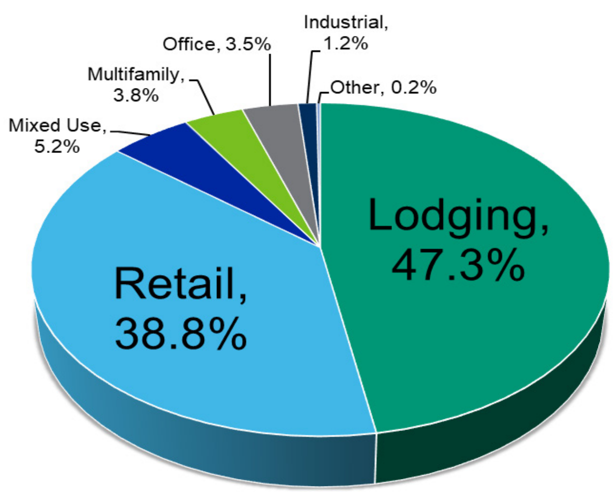
The Evolving Face of Distress in CMBS Markets

We can see clear evidence of the "first wave" of distress in the market. Initial delinquencies (those 30 days or less) appear to have peaked in May. According to CMBS data monitored by Moody's Analytics, approximately $34.8 billion has subsequently moved into special servicing, more than triple the overall specially serviced balance in just four months. As of July 26, the 60-89 day delinquency rate for CMBS loans is 1.60%, up from 0.04% on March 15 (pre-COVID). Note that initial delinquencies (30 days or less) saw declines in both June and July. We attribute this decline to both the partial reopening of the economy in certain areas, and what was likely an initial shake-out of already distressed borrowers and sponsors who would seek relief in any event.

CWCapital reports similar evidence of this "first wave" in the form of initial borrower relief requests. For CMBS Conduit, SASB and Agency multifamily, the number of new requests peaked in April with steady declines in May, June, and July. Note again that the initial wave has resulted in specially serviced loan volume more than triple that of early 2020.

Of those relief requests, approximately 47.3% are related to hotels, 38.8% retail properties, and 5.2% mixed use (a similar composition of distress as previously observed in early June).

Figure 3. Share of Rent Relief Requests Received, by Property Type



Source: CWCapital

CW Capital also noted that some 18% of the initial requests resulted in direct transfers to special servicing, 31% were approved in some form, 14% are under review, and 37% were rejected for various reasons including actual operating performance, borrower capacity, and other premature requests.

Unsure of the length and depth of the COVID-19 crisis, many borrowers initially sought short-term (90-180 day) relief including the ability to use existing reserves to pay debt service, relief from ongoing property improvement reserve funding, DSCR covenants, and the ability to obtain government provided relief in the form of PPP loans.

The immediate distress in the CMBS market has changed from dealing with initial relief requests to dealing with both special servicing transfers that occurred in the last three months and with the potential for more transfers as the initial granted relief expires. Jim Shevlin, President and Chief Operating Officer at CWCapital, noted, “At this point, our focus has to shift from the initial borrower relief requests to how we are going to deal with the underlying problems. In many cases, that underlying reason for distress has not changed in a material way. The special servicer’s work will be critical to recovering value for CMBS investors.”

Evidence of ongoing difficulty can be partially observed in the June 29 announcement of extended forbearance, repayment, and eviction prohibition periods in the Agency multifamily space. Similarly, we understand that CMBS borrower requests have begun to shift toward extended forbearance or repayment periods as well.

Our overriding concern is that property reserves are limited, the end of initial relief periods are coming due (CWCapital counts over 100 properties in this category, including 80 hotels), the COVID-19 crisis appears to be accelerating, and we could easily see several waves of shutdowns, further distress , and borrower capitulation.

Trends in Loan Modification

As servicers continue to process the damage from COVID-19, there appears to be a difference in how loans are being modified for the worst affected property types. While it is still early to determine the best course of action for many of these loans, Moody’s Analytics is noting a much higher rate of lodging loans being modified than retail (in terms of both the number of loans and loan balance). Further review of the comments related to these modifications suggests that most of the lodging modifications involve short-term reserve releases to fund debt service, relief from FF&E replacement reserve contributions, or ability to obtain PPP financing. Retail loan modifications, on the other hand, include a mix of requests for direct forbearance of loan payments over a limited time period and a release of reserves.

Figure 4. Loan Modification Rates by Property Type

Source: Moody's Analytics Structured Finance Portal

What might explain these diverging trends? Early evidence points toward a combination of operational differences and industry sentiment. Generally speaking, retail establishments run very lean in terms of liquid assets, including relatively smaller replacement reserves. The future operations of retail loans are much more dependent on tenant improvement and leasing commission reserves. Restaurants often have no more than a few weeks of reserves to call upon in adverse situations.

In contrast, large hotel chains typically operate with greater reserves and have more options, including regularly funded furniture, fixtures, and equipment replacement reserves, seasonality reserves, and other liquidity or assets. Options have value, and in this circumstance, servicers may be more inclined to allow use of those longer-term fixed asset replacement windows and other means to modify hotel loans and keep the properties maintained at an acceptable level in the short term.

Additionally, the pandemic has accelerated structural change in the retail sector that is yet to be seen in lodging. Every week, news of additional retail bankruptcies or store closures finds its way to the headlines, fueling a greater level of uncertainty for a sector that was already challenged prior to COVID-19. This uncertainty could further reduce a servicer's willingness to "kick the can" on what may be inevitable. The lodging sector is not immune to these uncertainties, but hotel properties may be less subject to a fundamental overhaul of their business model. Households also appear to be showing some willingness to travel as occupancies are trending up from a springtime low of near 20%, although the recent rise in infections may prompt a slowing or even a reversal in this trend.

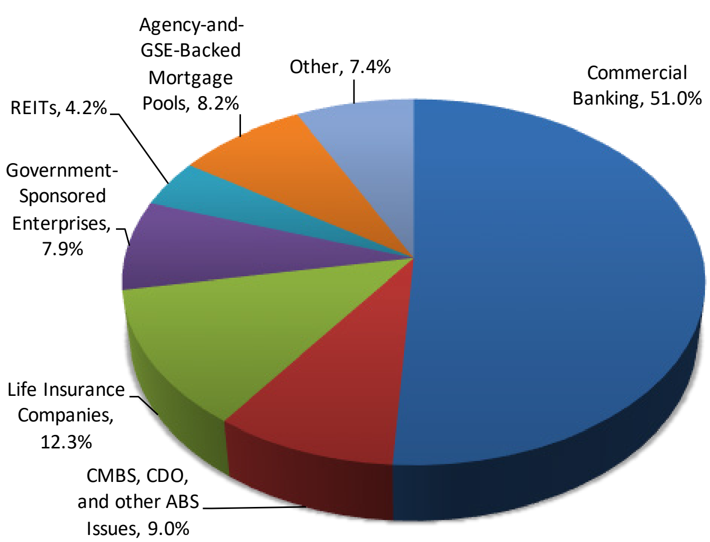
With that said, it should be noted that as long as COVID-19 persists, the lodging industry will likely function sub-optimally. Summer vacation travel will likely be a fraction of what we saw in previous years, and as we approach the fall months, corporate travel (which would normally make up the bulk of lodging sector revenues through the end of the year) shows few signs of a healthy bounce-back.

Regarding travel and the office sector, on July 27 Google formally extended the option to its employees to work remotely until July 2021,[3] and it is not outside the realm of possibility that other large companies will follow suit. This trend may well result in increased volatility and distress for the office market.

CMBS Is Not The Entire Multifamily/CRE Debt Pool

We have so far focused on CMBS, given its relative transparency and update frequency. However, based on data from the Fed Flow of Funds, CMBS comprises less than 10% of the total outstanding balance of $4.66 trillion supported by multifamily and commercial properties.

Figure 5. Total Outstanding Loans, Multifamily and Commercial Real Estate

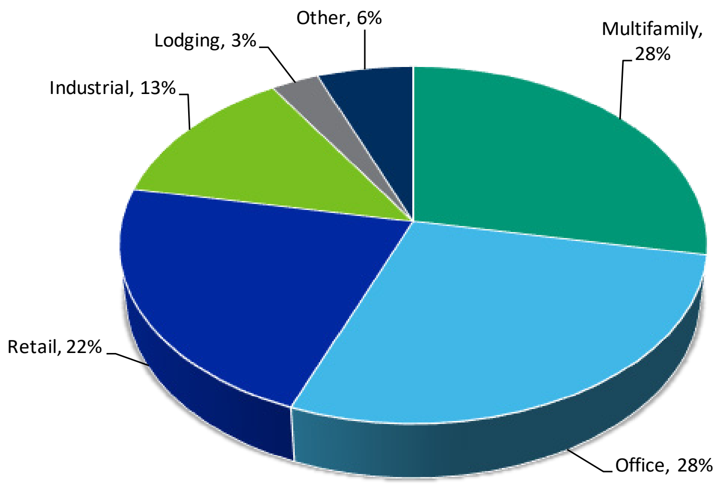


Source: Federal Reserve Flow of Funds report, latest data available as of June 2020.

[3] https://www.wsj.com/articles/google-to-keep-employees-home-until-summer-2021-amid-coronavirus-pandemic-11595854201

Other lender portfolios may not incur as much distress as the CMBS universe: for example, data from the Mortgage Bankers Association shows that life insurance companies (which comprise 12.3% of the total debt pie shown in Figure 5) may have mostly dodged the hospitality bullet, since only 3% of their outstanding loan balance is in lodging. By contrast, CMBS 2.0/3.0 and SASB include over 16% exposure to hotels.

Figure 6. Loan Balances by Property Type, Life Insurance Companies



Source: Mortgage Bankers Association

However, with 22% of life insurance company loans in retail, they still face significant risk given the short- and long-run structural changes facing brick and mortar retail.[4]

Even the Multifamily Sector is Vulnerable

Performance metrics for the multifamily sector have held steady so far—second quarter statistics show that the vacancy rate barely budged, still relatively tight at 4.8% (a mere 10 basis points increase relative to its end-2019 level). However, the trends in both asking and effective rents have turned negative, both registering a 0.4% decline in the second quarter. For some apartment markets like San Francisco, effective rents fell by 3.3% in the second quarter alone. That is the largest decline in effective rents on record for the market since the third quarter of 2001, which was a particularly challenging time since that MSA was facing both the stresses of 9/11 and being the epicenter of the tech market crash.

There is also much speculation as to whether multifamily rental performance metrics have been relatively stable because of the amount of government support for tenants: the Payroll Protection Program as well as moratoria on evictions have likely allowed tenants who may have lost their jobs the ability to either continue paying rent and/or the right to stay in place even if they have been unable to make rent payments. With both programs set to expire over the next few weeks, multifamily fundamentals may soon begin reflecting more distress.

One early warning indicator is the proportion of rent collection losses that Moody's Analytics REIS has been tracking closely since the beginning of the pandemic. After holding relatively steady—and even posting what some analysts might call surprising improvements in May and June—rent collection losses at the national level began to spike in the first half of July.

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[4] For an extended discussion about the retail sector and its prospects, see "The COVID-19 Pandemic and the Retail Debacle" (April 3, 2020). And for some perspective on the likely *beneficiary* of retail's woes from the rise of e-commerce, see "Why Industrial (Warehouse) is Likely to Fare Better" (June 17, 2020). Both available upon request from Moody's Analytics REIS.

Figure 7. Rent Collection Losses Over Time

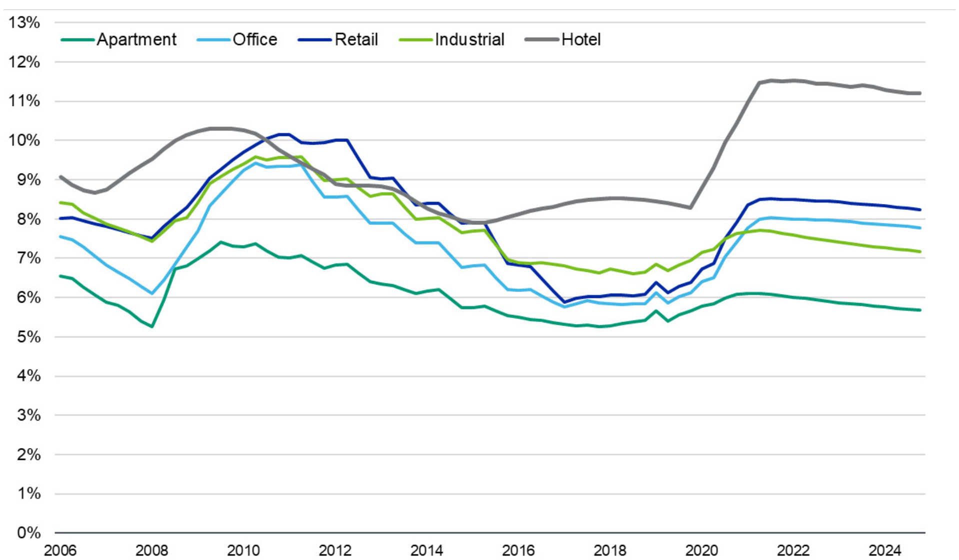
TIME PERIOD	AVERAGE % OF TENANTS DELINQUENT ON RENT PAYMENTS
April	4.9%
May	4.7%
June	3.8%
July 1-15	7.5%

Source: Moody's Analytics REIS

CWCapital's Shevlin observed, "Different institutions have been flexible and supportive about forbearance and other arrangements for potentially distressed multifamily properties. Multifamily agency loans, for example, still have very low delinquency rates. In the short term, these are good solutions, but the longer the COVID-19 crisis persists, special servicers may ultimately have to deal with the impact of job losses, record unemployment, and the resulting economic distress which can affect any property."

The latest forecasts from Moody's Analytics REIS suggest that distress will manifest in different ways across property types. Over the course of 2020, REIS expects multifamily property values to fall by 6.9% and industrial property values (focused mostly on warehouse/distribution properties) by 8.8%, with office (-17.2%), retail (-19.2%) and lodging (-20.5%) the sectors that we forecast to incur the greatest declines.

Figure 8. Cap Rate Historical Trends & Forecasts, by Property Type



Source: Moody's Analytics REIS

Figure 8 suggests that value declines will reach bottom by next year, assuming that COVID-19 is brought under some semblance of control and that economic activity then resumes at a faster pace. If the time frame under discussion, however, is anywhere from another six to twelve months of uncertainty, we expect the distress and volatility in the CMBS markets to continue.