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Debt & Equity Capital Edition 2015

CRE CAPITAL:
A Different Kind of Wonderful

Informational Supplement to Real Estate Forum

By its halfway mark, it was clear 2014 was shaping up as an excellent year.

US CRE transaction volume grew 16.4% year over year for the first seven months to $204.2 billion, according to a report by Deloitte. Also, asset prices remained on an upward trajectory with GreenStreet Advisors' Commercial Property Price Index, reporting that they had risen 6.2% in the first eight months of 2014.

Much of this—though not all, steadily improving economic fundamentals are also playing a role—has to do with the robust capital markets. The CMBS market was well on its way to meeting the projected $100 billion in originations for the year by the halfway mark.

It was also clear that REITs were continuing to visit the capital markets with regularity. Equity REITs domestically had raised $51.09 billion in capital year-to-date as of Oct. 17, with debt continuing to be the capital-raising mechanism of choice for REITs.

In particular, US REITs were tapping the at-the-market programs with a vengeance between the first and second quarters of this year, SNL Financial reported. US equity REITs raised a total of $1.08 billion through these hybrid structures in the second quarter, up roughly $478 million, or 80%, from Q1 of 2014, in which $600.6 million was raised.

2015 has all the earmarks of being another good year. But some hiccups could emerge.

And why not? As Ben Butcher, CEO of STAG Industrial explains, the ATM is an excellent way to raise money across a variety of market conditions and stock prices—similar in many ways to dollar-cost-averaging by individual investors.

"It is arguably the most efficient way to raise equity for REITs. The cost of 1% to 1.5% fees and no discount to market price is dramatically lower for the ATM than a typical follow on offering, which is 4% to 4.5% fees and 2% to 4% discount to market price," he says.

Abundant and smart. That has been the capital-market environment for commercial real estate borrowers for the calendar year. The question is, will it continue?

Yes, for several reasons, one being that such trends, barring a Black Swan event, rarely reverse themselves suddenly and sharply. So the good times will continue to roll.

That said, changes are brewing that will mean a different type of experience—a different kind of wonderful, let's say—for borrowers and lenders in the coming 12 months.

In short, CMBS will become more expensive, due largely to new regulatory requirements. At the same time competition for deals will remain intense—so intense that the subsequent cheap money will push up asset prices even further.

Overlay all of this on what has been one of the biggest economic non-stories of the year: when will interest rates start to rise?

Is It Really Goodbye for QE3?

With the Federal Reserve Bank putting to bed its quantitative easing program, the answer should be somewhere between "soon" and "when conditions warrant" but even that is too precise. In reality, though, the impact of the program will be with us for some time. The Fed has only stopped buying these securities; it still holds a massive amount on its books.

"There has always been a concern in the real estate industry about the impact on interest rates when the QE program ends," says Ann Hambly, CEO of 1st Service Solutions.

Also, the principal pay down of bonds on the Fed's balance sheet will still be used to buy agency GSE paper, Jacques Gordon, global head of research and strategy at LaSalle Investment Management says. "The quantitative easing program was part of worldwide demand for US Treasuries. That global demand still exists and reduced deficits means that Treasury will not have to issue as much debt."

It follows, then, that the demand for US T-bonds could remain high relative to supply, which will keep downward pressure on interest rates for the long end of the curve, even after the QE program stops, Gordon concludes.

This uncertainty is a challenge for lenders, says Sam Chandan, president and chief economist of Chandan Economics and adjunct professor in real estate and public policy at the Wharton School of the University of Pennsylvania.

It will also become a challenge for borrowers as time goes on, he adds. "Irrespective of when rates go up, the

loans today are being sized and priced and structured in a way that leaves little room for changes in the rate environment," he says. "We are seeing an increase of loans with IOs and longer-duration IOs, too. In some cases, we're seeing loans where there is no amortization at all." The risk for borrowers will be how they will refinance these loans when rates do finally rise.

Pricing Goes Up, and Up Some More

Pricing, as the Green Street Advisors stat at the beginning of the article showed, continues to rise. In large part this has been due to the liquidity in the system, aggressively seeking out appropriate investments.

"Strong capital flows, from both equity and debt sources, are boosting the liquidity of the commercial real estate market and driving transaction activity," according to a Marcus & Millichap report. "Equity capital of all stripes—from local investors and 1031 exchanges to institutions that include REITs, private equity and sovereign wealth funds—has accelerated acquisitions and portfolio repositioning to capitalize on the low cost of capital, consistent revenue streams and rising prospect for appreciation."

However, as competition shows no sign of diminishing, fears are growing that assets are becoming overvalued.

The at-the-market program is arguably the most efficient way to raise equity for REITs. The cost of 1% to 1.5% fees and no discount to market price is dramatically lower for the ATM than a typical follow-on offering."

Ben Butcher
STAG Industrial

MMI noted in that report that the wave of liquidity has pushed property prices to record or near-record levels in core markets and now is working its way to secondary and tertiary markets. "Property sales are increasing in nearly every metro, but investors are increasingly targeting assets in non-core markets as they pursue yields and opportunities with less fervent bidding activity," it found.

Certainly that sentiment was reflected in a survey conducted by Marks Paneth & Schron, which found that 54% of respondents called Manhattan overvalued compared with other major global cities.

The bottom line is that cheap money leads to higher asset prices, Chandan says. "For any individual transaction, it's a borrower's market and will remain that way. Any individual borrower will find he has access to low-cost financing and a range of lenders that will quote deals. But all this capital is driving up prices and that is not going to stop."

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Ann Hambly
1st Service Solutions

More Demand On the Horizon

One school of thought has been that as interest rates do rise, as they inevitably will, real estate—REITs especially—will become less attractive. From an economic perspective, that should be the case but the demand for CRE assets appears to be outpacing even monetary policy constraints.

This month the S&P Dow Jones Indices and MSCI Inc. announced they were elevating real estate into its own asset class in the Global Industry Classification Standard structure starting in 2016.

The drivers behind the decision are telling for what they say about the growing importance real estate is playing in many portfolios, not to mention diversification's role.

"Feedback from the annual GICS structural review confirmed that real estate is now viewed as a distinct asset class and is increasingly being incorporated separately into the strategic asset allocation of asset owners," says Remy Briand, managing director and global head of equity research at MSCI. "Investors told us that there are significant differences between public real estate and financial companies and, therefore, real estate deserves a dedicated GICS Sector."

Indeed, one of the commercial real estate sector's chief selling points, so to speak, for investors is the diversification it offers portfolios. Real estate, in other words, has a low correlation to other asset classes including stocks and their presence in a portfolio will smooth out a volatile cycle.

Presumably that was one of the reasons why the California Public Employees' Retirement System increased its allocation to commercial real estate earlier this year while pulling out of hedge fund holdings.

With assets totaling $300.3 billion as of June 30, 2014, CalPERS has about $25.9 billion in real estate. It is not the pension fund's main asset class allocation but it is also not the smallest. Rather it sits somewhere in the middle of a plethora of approaches that range from growth to liquidity to infrastructure to absolute return to income.

An increased CRE allocation was a smart move given the current environment, according to Stephen Culhane, who heads the investment management practice at law firm Kaye Scholer. "Institutional investors are always assessing and reassessing their allocations," he says. "Commercial real estate valuations are strong and it is

perceived as a bit of a safe haven, particularly for non US and long-term investors."

Regulator Risks, As Always

Regulatory risk is also looming over the commercial real estate capital markets. Exhibit A is the credit risk retention rules mandated by the Dodd-Frank Act that were recently finalized by a slew of financial agencies. These rules will shape a number of financial products and lending activities, from mortgages to highly leveraged corporate bonds to commercial mortgage-backed securities going forward—and at least in the case of CMBS, their effect won't always be pretty.

The changes will be significant for the CMBS market, starting with higher pricing that could range from an additional 25 basis points (according to estimates by regulators) to between 35 and 50 bps (according to industry associations). The new rules are also expected to limit capacity.

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> Chandan Economics

To be fair, these final rules—adopted by the Office of the Comptroller of the Currency, the Department of the Treasury, the Federal Reserve Bank, the Federal Deposit Insurance Corp., the US Securities and Exchange Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development—are not as bad as the industry originally feared.

"The whole process has been an evolution," CREFC president and CEO Steve Renna says. Over time this "evolution" moved considerably more in the direction that CREFC and other industry associations had advocated, he says.

Briefly, for the CMBS industry, the final rules eliminated the Premium Capture Cash Reserve Account that had been proposed in the earlier risk-retention proposal. This onerous requirement, which would have required all issuer profits to be placed in a first-loss position, had been tentatively dismissed about a year ago, but to have it jettisoned from the final rules is a relief. Also gone from the final rules are cumbersome cash flow requirements.

The heart of the rules—a doubling of the amount of risk that has to be retained to 5% stayed in place—but further negotiations with regulators made this rule far more flexible to implement, Renna says.

The bottom line is that B-piece buyers have a lot of flexibility in figuring out the best way to raise capital they need for the additional retention. In addition, the retention can be divvied up between the issuer and B-piece buyer. "We asked for flexibility and optionality in fulfilling the risk retention rule and the regulators provided that," Renna says. "They also originally said the B piece would have to retain the risk for 10 years. We said five and they agreed."

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> CREFC

Unfortunately, they wouldn't budge on the single-asset loan criteria, he adds.

CREFC had been lobbying to keep certain loans that were conservatively underwritten—namely securitizations based on a single asset such as one building or a single credit—exempt from the risk retention rules. "No lender wants to keep that big of a loan on its balance sheet and it wasn't necessary, from an investor protection standpoint, to apply risk retention to these loans," Renna says.

The regulators didn't agree, and Renna believes the consequence will be that these loans will be pushed into the cheaper—and less transparent—corporate bond market. "The regulators didn't make a strong case for why they decided this," he says. "These loans don't belong under risk retention."

Congressional Agenda

At least, though, the rules are in place and the industry can make appropriate adjustments. The bigger unknown is what will happen in the next two years now that the midterm elections are over. More gridlock? A greater sense of partnership between the Obama Administration and now Republican-controlled Congress? Early signs suggest it will be the former more than the latter, which leaves commercial real estate executives wringing their hands.

There's a clear concern about the lack of direction in many federal policies, says Jeffrey D. DeBoer, Real Estate Roundtable's president and CEO. He points to the dithering over the Terrorism Risk Insurance Act, which is scheduled to expire on Dec. 31.

Without TRIA, "financing for CRE projects will be directly threatened, job creation will suffer as it did after 9/11 and businesses can expect a general slowdown as many financing contracts will be found to be in technical default without terrorism insurance."

Remember at the beginning of this discussion, it was stated that current trends would continue, "barring a Black Swan event." Just a friendly reminder that they do exist and can come in unexpected form and from seemingly friendly hands. +