BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

SPECIAL REPORT CAPITAL MARKETS 4Q 2020

Composition of Active Lenders Adapts to New Market Dynamics; Investment Activity Making Steady Recovery

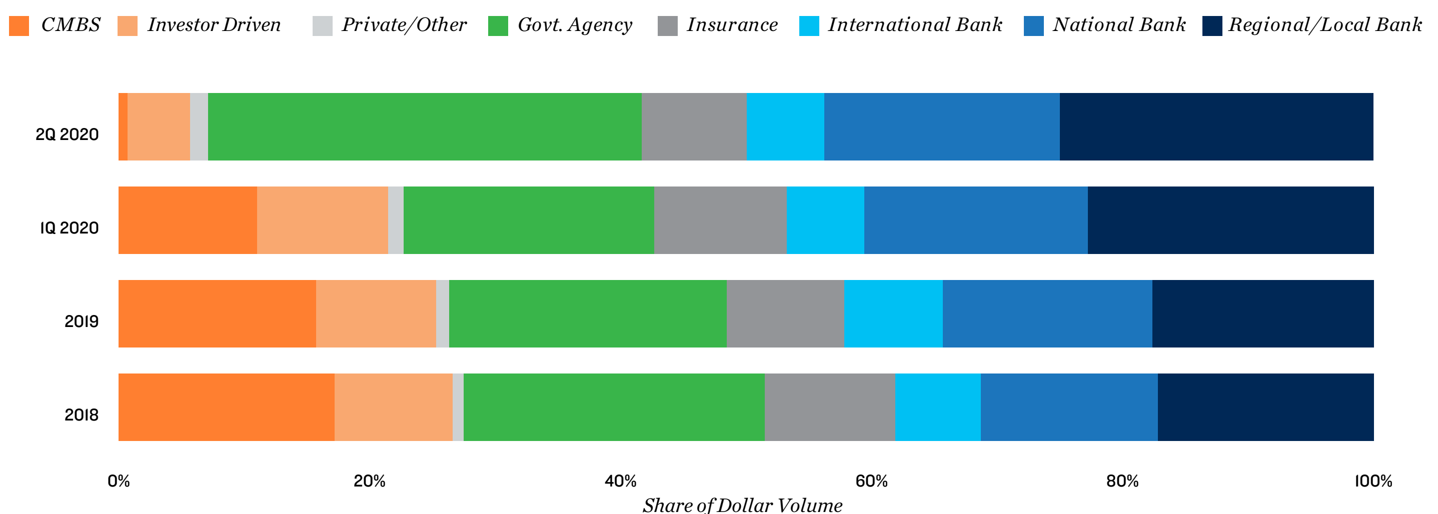
Capital markets remain healthy with array of active lenders. As the nation progresses through the final months of the year, the lending landscape has vastly improved from the onset of the pandemic, which brought lenders and investors to pause as they assessed the impact of the coronavirus. Access to debt capital, though, has been far more abundant than during the global financial crisis, with the Fed taking extreme steps to shore up credit markets and ensure liquidity flows. Following the second-quarter uncertainty-driven investment slowdown, buyers have become increasingly active with more lenders in the market. While sales activity remains well below activity seen a year ago, transaction velocity climbed approximately 25 percent from the second quarter to third quarter with a shift in priorities to reflect evolving opportunities and risks.

Lenders adjust strategies for a post-pandemic environment. Underwriting criteria has become more conservative with many lenders facing substantial headwinds, resulting in fewer options for some borrowers. While liquidity has remained ample, loan-to-value ratios contracted as the health crisis unfolded, now resting in the 50 to 70 percent range, dependent on the deal and borrower. Debt service coverage ratios have also shifted, rising to the 1.6 percent to 1.9 percent range. In some cases, more weight will be placed on the strength and experience of the borrower than the asset itself.

Alternative lenders narrow financing gaps left by big banks. Government agencies were aggressive originators in recent quarters to account for a much larger share of lending activity. Debt service reserves are now often required for multifamily mortgages and most underwriting assumes no rent growth for roughly two years. Local and regional banks have stepped up to close the lending gap as well, financing debt across most property types. Debt funds are also working to fill the void left by larger banks and CMBS lenders that continue to analyze existing portfolio performance, focusing on more challenged sectors including retail and hospitality. Yield-hungry investors are returning to the market, seeking to lock in low rates in a haven from geopolitical risks and the greater volatility of other asset classes, helping to support sales activity in the fourth quarter.

Retail sector facing greater fragmentation. CMBS lenders, life companies and banks continue to fund borrowers for essential retail such as grocery-anchored multi-tenant properties, drugstores, and single-tenant assets with a national credit tenant. More impacted segments, including smaller restaurants, gyms, movie theaters and hotels, face a significantly shallower lender pool and lower LTVs due to the elevated delinquency risk of these assets. Many lenders are still working with borrowers, though, to provide payment relief for troubled assets, limiting foreclosures and greater price fluctuations.

Health Crisis Shifts Lender Composition



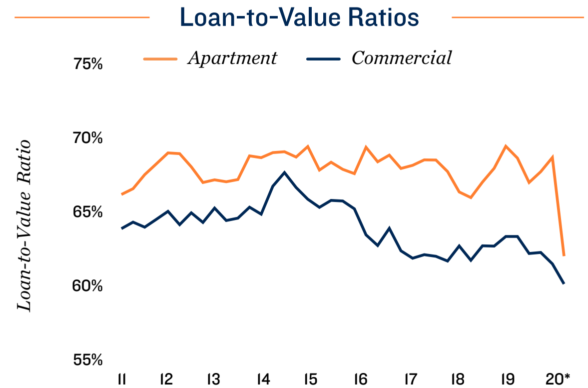
Source: Real Capital Analytics

Lending and Borrowing Landscape Bifurcated; Low Interest Rate Climate to Motivate Investors

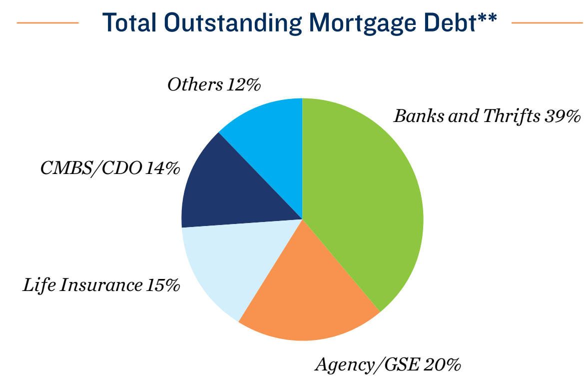
Lenders eager to invest in multifamily and industrial assets. Assumptions surrounding operating expenses, vacancies, market concession rates and supply trends are being closely examined by lenders, leading some to shift their focus to more pandemic-resilient investments. Apartments and industrial properties have been able to draw greater interest with banks and non-agency lenders remaining active originators, most often funding five- to seven-year loans with rates in the upper-2 percent to mid-3 percent range. Evolving ecommerce trends, challenges in the single-family home market and limited capital expenditure requirements have helped to ensure financing remains available at favorable terms for both asset classes. Looking ahead, the agencies have a combined multifamily lending cap of $140 billion in 2021, with at least 50 percent of originations dedicated to affordable housing. Most lenders have been more selective when assessing office properties in spite of strong rent collections, favoring suburban office deals while requiring LTVs closer to 50 percent for buildings in larger downtown markets. Life insurance companies have been targeting lower leverage deals in the sector as well as focusing on multifamily and single-tenant retail assets.

Record-low interest rates to encourage investment activity. Freddie Mac and Fannie Mae are originating loans in the upper-2 to low-3 percent range for gateway and secondary markets, while interest rates in smaller markets can reach the mid-3 percent territory for well-capitalized buyers. Life insurance companies are offering rates in the 3.1 percent to 4 percent range with LTVs of 50 to 70 percent, though some premier properties have been able to achieve rates in the mid to upper-2 percent band. Most banks, credit unions and CMBS lenders are offering debt in the 3.25 to 4.25 percent range, and debt funds start slightly higher in the 3.5 to 4 percent territory. Stricter criteria and risk mitigants for CMBS loans have led to fewer options for many borrowers though. The Federal Reserve's commitment to keep the federal funds rate near zero through at least 2023 should hold interest rates near historical lows over the coming quarters, providing commercial real estate investors with compelling risk-adjusted returns in contrast with other asset classes.

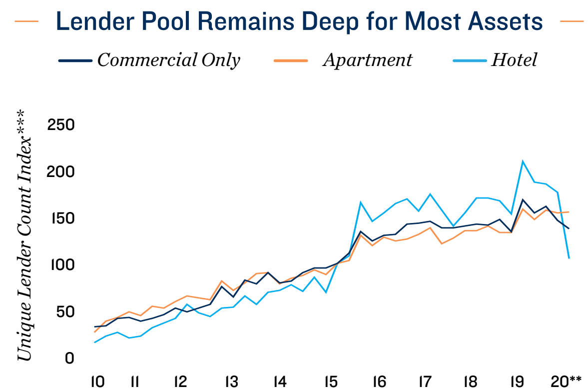
Loan-to-Value Ratios



Total Outstanding Mortgage Debt**



Lender Pool Remains Deep for Most Assets



* Through third quarter
** Through second quarter
*** Index Q2'15 = 100
Sources: Mortgage Bankers Association; Real Capital Analytics

For information on Marcus & Millichap Capital Corporation, contact:
Tony Solomon
Senior Vice President, National Director | MMCC
Tel: (310) 909-5500 | tony.solomon@marcusmillichap.com

For information on national commercial real estate trends, contact:
John Chang
Senior Vice President, National Director | Research Services Division
Tel: (602) 707-9700 | john.chang@marcusmillichap.com

Prepared and edited by
Michael Murphy
Research Analyst | Research Services

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Sources: Marcus & Millichap Research Services; FHFA; Mortgage Bankers Association; Real Capital Analytics

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