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CAPITAL FOR RETAIL IN 2019 – STILL AVAILABLE, BUT HAVE WE LEARNED OUR LESSON FROM THE GREAT RECESSION?

by Gary Glick

For the first time since the Great Recession of 2008/2009 economists and real estate professionals are finally acknowledging the possibility that the slow but steady expansion in the commercial real estate markets may begin to falter in the coming years. However, despite these predictions, capital for retail real estate acquisitions and for financing retail re-developments appears to remain plentiful. The real question in 2019 will be how much of this capital is deployed. The good news is that most experts are not seeing many of the signs that led up to the Great Recession, such as huge amounts of leverage and overbuilding. To date, most capital providers in the retail real estate sector have continued to remain fairly rigorous in their underwriting standards.

Several factors are creating headwinds for the commercial real estate industry. The first is the increased cost of borrowing in large part due to the Fed's conservative but consistent increases in the federal funds rate in 2018. The federal funds rate is now between 2.25 and 2.5 percent, but the Fed is now indicating it is inclined to pursue a more conservative stance toward rate hikes in 2019. Despite the actions of the Fed, ten-year treasury yields retreated in the last quarter of 2018 creating an inverted yield curve with short-term rates, a key precursor to prior real estate recessions.

Another factor relates to the uncertainty and turmoil surrounding the Trump presidency. The President's tariffs have added significant costs to many retail goods as well as

to the cost of construction of retail projects. His immigration policies have also exacerbated a shortage of construction workers, driving up labor costs. Additionally, the turmoil surrounding the Mueller probe and the wild swings in policy and rhetoric from the President have created geopolitical uncertainty and factored into major swings in the stock market, all of which contribute to economic disruption.

Although the passage of the Tax Cuts and Jobs Act of 2017 (the "Tax Cuts Bill") created a boost in the economy during the first half of 2018, specifically spurring job growth, consumer confidence and GDP expansion, the U.S. economy started to wane in the second half of 2018. For the most part, the Tax Cuts Bill has not caused major U.S. companies to invest in long-term expansion as hoped. Rather, in many cases, companies used the tax benefits from the Tax Cuts Bill to buy back stock and pay dividends. Further, the Tax Cuts Bill has worsened the explosion of the federal deficit, which in the long term can be expected to create major strains on the economy.

As has been the case for many years now, the media has once again spent much of 2018 mischaracterizing the present condition of the retail industry. Many stories continue to present the view that Amazon will hasten the demise of brick-and-mortar retailers and shopping centers. Nothing could be further from the truth. If anything, Amazon is leading to the revitalization of the retail industry. To compete in the present economy, retailers have had to "up their games." New retailers in the food and entertainment sectors have filled the void left by traditional retailers that have downsized or gone out of business, and existing retailers have created omni-channel strategies (i.e., seamless engagement with the retailer's business and offerings over internet, mobile devices, social media, and brick-and-mortar outlets), with a particular emphasis on enhanced customer service and brand loyalty over social media. Retail developers understand the United States presents more business growth opportunities than virtually every other developed country. As a result, many retail assets are being repurposed in whole or in part to capture these growth opportunities. Retail developers are now adding hotels, multifamily units, medical and recreational uses to projects that are no longer viable for only retail uses. Those developers and retailers that adapt to the new economy can thrive over the next decade.

Capital for retail development in 2018 remained plentiful, and we expect the same will hold true in 2019, including capital for investment sales as well as financings. However, the lack of attractive product for all this capital is creating stiff competition among providers of equity and debt, so much so that in certain circumstances underwriting standards have started to slide slightly to attract product. However, the relaxation of underwriting standards is nothing approaching that which contributed to the Great Recession.

Although investment sales for retail developments in 2018 remained reasonably consistent with sales in 2017, most experts expect investment sales to gradually decline over the next few years due to rising interest rates and a lack of attractive supply. Core properties in major markets are tougher to find and, when found, are priced exceptionally high. The low returns on such deals often do not meet the yield requirements of pension funds, life insurance companies and other investors. However, "there are opportunities in retail where prices have over-corrected to the downside. Investors see an opportunity to get in at a lower basis and be able to reinvest or re-tenant the asset or add value," notes Steve Pumper, an executive managing partner in Transwestern's capital markets and asset strategies group.

Rising interest rates could create an added obstacle to the ability for buyers and sellers to bridge the pricing gap blamed by many observers for slowing sales activity over the past two years. "There is ample liquidity on the debt side across the capital stack spectrum. However, there is still a disconnect between buyers and sellers on cap rates," says Michael Rotchford, vice chairman and co-head of Savills Studley's Capital Markets Group. It isn't likely that new debt issuance volume will increase until there is an agreement between buyers and sellers

on where cap rates should be, according to Rotchford. "We might be in a stalemate for another year or so, but I don't project declining volumes as a result," he says. Despite this stalemate, many investors are still willing to take risks to capture appreciation for those primarily focused on wealth enhancement. This is apparent in the push by private equity toward value-add and opportunistic funds.

International investors have remained very active in U.S. property markets. Real Capital Analytics (RCA) researchers put 2017 cross-border acquisitions at 11 percent of all commercial real estate investment dollars, or $51.6 billion in purchases. Although down from a 15 percent market share in 2015, such acquisitions are about average for the post-2013 period. As noted in 2017 *Emerging Trends in Real Estate* (published by the Urban Land Institute and the accounting and consulting firm pwc) ("*Emerging Trends*"):

> "...during the first quarter of 2018, Canadian firms were the most significant source of inbound capital, with $20.3 billion. China was second, at $8.9 billion, and Singapore third at $7.7 billion. This year, Los Angeles also is making the list of top acquisition cities for offshore capital. But internal policy issues in China mark a potentially significant change, evident in 2018's second quarter, when China was a net seller for the first time since it entered the U.S. market. The amount of China's dispositions was not huge—$1.3 billion, compared with $54.1 billion in total acquisitions since 2000. Depending upon government decisions back in Asia, the Chinese could be lightening their U.S. portfolios going forward. On balance, while the mix of offshore capital sources may shift—South Korea, Germany, and the Middle East are stepping in as China pulls back—the outlook of one entrepreneur sums it up: 'Globalization is here to stay.'"

In the debt markets, the gradual and robust return of the real estate industry beyond the expectations at the start of this decade has come about in no small part due to lending discipline and prudence. This is the result of the painful lessons of overly exuberant behavior in the early 2000s, behavior that mispriced risk in lenders' spreads, the rigor of borrower credit analysis, and, most particularly, unachievable projections on the part of underwriters. Most real estate experts are signaling that late-cycle conditions had begun to appear in 2018, with rising inflation potentially on the horizon, as well as higher mortgage and capitalization rates in 2019 and beyond. Nevertheless, many real estate experts expect underwriting will remain or possibly become more favorable to borrowers due to more competition. Except in rare instances, the main sources of debt capital are seeing the volume of funds available for real estate placement rising incrementally.

Depository institutions hold approximately 32.2 percent of the nation's approximately $15 trillion mortgage volume. Battered in the Great Recession, banks have recovered nicely and are enjoying exceptionally strong profits, some of which are attributable to the Tax Cuts Bill. In addition, the possibility of some regulatory rollback in Dodd-Frank financial institution restrictions will free up additional debt capital for the real estate sector in the coming year and beyond. However, because of the competition in the debt markets, banks may have to relax underwriting standards if they want to continue to grow market share. Since the cost of capital for banks is so low relative to the rest of the market, they are well positioned to do so.

Responding to aggressive competition from nonbank lenders, many banks have expressed an increased tolerance for risk, prompted in part by a positive outlook for property market fundamentals and decreasing uncertainty about prices and cap rates. Improving conditions have encouraged banks (especially bigger banks)

to entertain larger loans for development projects, and to expand the geography of construction lending. However, underwriting standards such as loan-to-cost ratios and maturities have been holding steady for the most part.

In stark contrast to bank lending, conduit lending is trending downward in large part due to competition from other debt providers and will be fortunate in 2018 to match the $87.8 billion originated in 2017. Overall CMBS lending will likely be capped in the $80 billion to $100 billion range for the near future. On the positive side, the simplicity and quality of CMBS has improved markedly.

The mortgage portfolio of life insurers grew by about 8 percent from 2017 to 2018. As in past years, the life companies continue to remain conservative in their underwriting policies and deal structuring. Like banks, life companies continue to be impacted by competitive pressures from other debt sources. In early 2018, life company spreads were at their lowest levels in four years. Very little difference exists in the contract interest rates being agreed to on five-, seven-, and ten-year fixed-rate loans.

Life companies provided a significant amount of construction and mezzanine lending, continuing a trend from the past few years. However, the vast majority of this lending is linked to permanent mortgages that remain the primary debt vehicle for life companies. Because of the smaller share of the riskier debt held in life companies' portfolios, life companies are likely to be less affected by mild recessionary headwinds than other financial institutions in the real estate capital market.

The big news in the real estate debt markets is the rapid growth of unregulated debt, mostly from private debt funds. Outside the formal regulatory oversight of the conventional banking system, these debt funds can offer the higher leverage and greater speed sought by most borrowers and can pass on that attendant price premium to their investors. However, these vehicles still represent a small (but growing) percentage of commercial real estate debt.

In addition to competing with traditional lenders, debt funds are offering investors a way to manage end-of-cycle risk, providing collateral to protect investment downside, versus funds focused on filling the middle of the capital stack with preferred equity. Equity yields may be higher, but they are more vulnerable to losses in a downturn.

With fewer deals available to lenders, many are chasing higher returns with mezzanine lending programs. Debt funds and private equity firms are not the only ones proving mezzanine financing: banks and life companies also have created platforms for such loans, albeit as a small percentage of their loan portfolios. In most cases, however, banks are making these loans with the aim of selling them off their balance sheets—but they nonetheless must accept the risks of holding junior debt until they can find willing buyers. With traditional debt spreads narrowing, these mezzanine lenders can reap yield in the low double digits. However, as loan to value ratios rise, the risk to these lenders becomes greater, especially if the economy falls into a recession.

2019 likely will be a transitional year for debt and equity capital for retail developments and acquisitions. We expect reasonable stability based upon still historically low interest rates and an economy that, while suffering around the edges, continues to remain relatively strong. Although volumes may edge down over the coming year or so, the fundamentals remain strong and we expect providers of debt and equity to remain fairly disciplined compared to the period leading up to the Great Recession. Retail is in the middle of a transitional period, but one that is long overdue and that will likely lead to a more stable future for retailers and retail developers. We continue to remain optimistic about the availability of capital for retail but are understandably wary of both political and economic factors, summarized above, that could lead to instability in the commercial real estate markets or possibly a mild recession.