American Bankruptcy Institute

abiLIVE webinar series

Key Concepts in Post-COVID Real Estate Restructurings

Tuesday, June 8, 2021

American Bankruptcy Institute

Today's Panelists:

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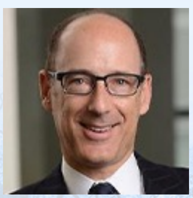

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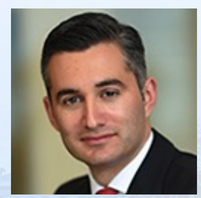

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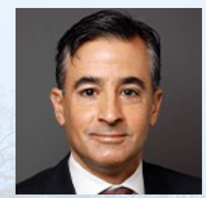

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Market Summary

- Office
- Hotel/Hospitality
- Retail/Malls
- Industrial
  - Logistics
  - Data Centers
- Multifamily

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Market Summary

- Hotels[1]
  - Cap Rates: Q1 2021 vs. Q1 2020
    - Overall – flat
    - Full service up 19 bps
    - Limited service down 9 bps
  - RevPAR is not expected to recover to 2019 levels until 2024
  - Group and corporate travel room night usage is 45% of pre-pandemic levels
  - 2021 room revenue estimated to be approx. 65% of room revenue in 2019

1 Sources: CBRE Hotels Research; Kalibri Labs, Q4 2020

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Market Summary

- Hotels[1]
  - By end Q1 2021, occupancy reached a quarterly peak of 49.2% (21.5% lower than same point in 2019)
  - By end Q1 2021, RevPAR reached a quarterly peak of $51 (46% lower than same point in 2019)
  - At end Q1 2021, hotel employment was at 82% of pre-pandemic levels
  - 16% of luxury hotel properties were closed at end Q1 2021 (down from 54% in April 2020)
  - Closure rate for all properties was 4.6% at end Q1 2021
  - Economy segment is the best performing, just 4% off 2019 occupancy levels

1 Sources: CBRE Hotels Research; Kalibri Labs, Q4 2020

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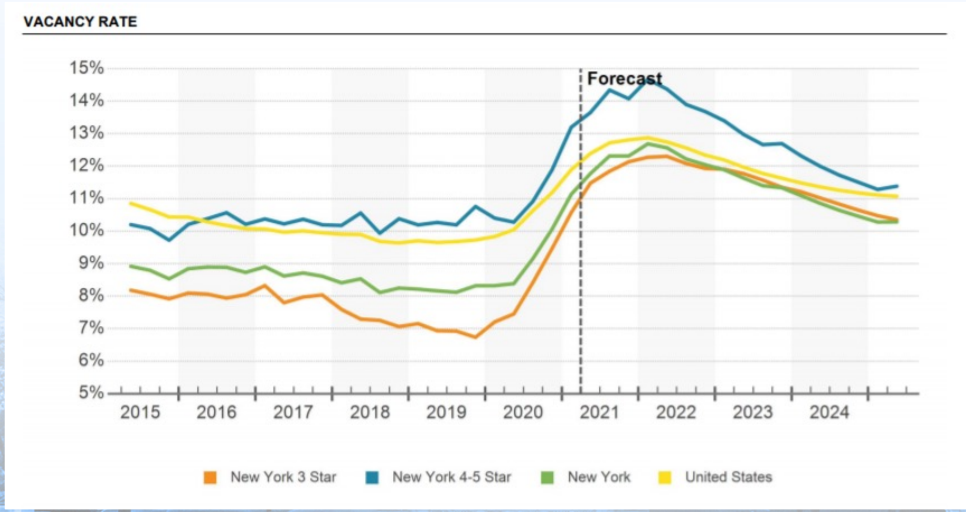
Market Summary

- Office
  - US office space vacancy rate 18.2% in Q1 2021 (up from 17% in Q1 2020) [1]
  - NYC vacancy rate up to 13.5% (from 10% in Q1 2020) and projected to rise



1 Source: AP News; Moody's Analytics REIS

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Market Summary

- Office
  - NYC reports office buildings lost value in past year
    - Market value of office towers in Manhattan “plummeted 25 percent according to city projections … contributing to an estimated $1 billion drop-off in property tax revenue.” (Eavis and Haag, NY Times, April 2021)
    - Commercial property values (Class 4) declined “by 15.8 percent on average” and office buildings “experienced market value declines of 15.1 percent.” (Comments on New York City’s Preliminary Budget for Fiscal Year 2022 and Financial Plan for Fiscal Years 2021 – 2025)
    - According to PwC’s real estate barometer, office space in “the New York metro area is forecast to be in the recession phase of the real estate cycle over the next four years.” 2021 PwC Real Estate Investor Survey.

1 Source: AP News; Moody’s Analytics REIS

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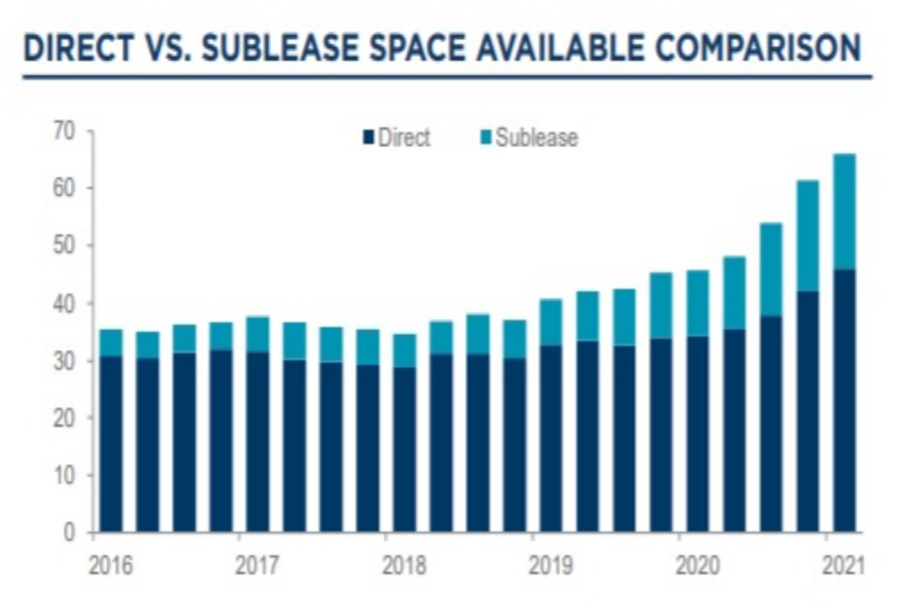
Market Summary

Subleasing as Proxy for the Real Estate Market:

- “Sublease space usually comes with an additional 25% discount…and since firms can sublease on short notice, rising sublease availability can serve as an early indicator of the true state of the office market.” (Putzier, The Wall Street Journal, March 2021)

- “According to CoStar’s data, a record 24 million square feet of office space is available for sublease in Manhattan — a 56 percent rise from the start of 2020, and a figure far outstripping the 16 million square feet on offer at the height of the Great Recession.” (Ruiz, NY Times, April 2021)

- In four quarters since pandemic began, sublease space up by 8.4 msf. Sublease space as a percentage of total available space at 30.1% (up from 25.1% in 2020). (Cushman and Wakefield)



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Market Summary

- Retail[1]
  - ~50 retail space bankruptcies in 2020; fewer than 10 so far in 2021
    - At least a dozen were mall-based retailers
    - Very few mall operator bankruptcies (CBL and PREIT)
  - More than 8,000 retail locations closed since start of 2020
  - Retail sector "comprised 53% of sector defaulters" in 2020
  - Retail space vacancy rate at 10.6% as of Q1 2021 (up from 10.5% in Q4 2020) and effective rent down 1.5% from Q1 2020
    - Vacancy rates for regional and superregional malls at 11.4% in Q1 2021

1 Sources: Moody's Analytics Reports; Wall Street Journal; CNBC; Coresight Research

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Market Summary

- Retail
  - End Q1 2021, estimated e-commerce sales up 39.1% from Q1 2020 and up 7.7% from Q4 2020. Retail sales up 16.8% from Q1 2020 and up 7.7% from Q4 2020.
    - E-commerce 13.6% of all retail as of Q1 2021 (up from 11.2% Q1 2020; flat since Q2 2020).
  - According to Moody's Analytics report, "2020 turned out better than expected for the US retail sector … Although Moody's had earlier forecasted a 15% decline for 2020, operating profit turned out to be flat for the year. Sales grew 8%, also well surpassing our call for 3%-5% growth." (Moody's Analytics, April 29, 2021)

Market Summary

- CRE Investment Down
  - CRE Investment Volume down 38.1% as of 3/31/2021[1]
  - New York City transaction volumes “fell 50% in 2020… totaling $22.1 billion,” which is “the lowest investment activity on record since 2010, the pit of the previous recession.” (Borland, Globest, February 2021)

1 Sources: CBRE Research

Key Case Review

In re CEC Entertainment, Inc. (Case No. 20-33163)

In re Modell's Sporting Goods, Inc. (Case No. 20-14179)

In re Pier 1 Imports, Inc. (Case No. 20-30805)

Key Case Review

- "Mothball Motions":
  - Debtors seeking operational and payment suspensions and deferral of expenses, including lease and vendor payments
  - Section 305(a) of the Bankruptcy Code permits the dismissal or suspension of a case "if the interests of the creditors and the debtor would be better served."
  - Section 105(a) of the Bankruptcy Code allows the court is issue "any order, process or judgment that is necessary or appropriate to carry out the provisions of this title."

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Key Case Review

- Rent Abatement:
  - Courts permitting abatement or deferral have done so only during orders precluding operation of the business, *not* where debtor could reopen but did not due to COVID concerns or to avoid losses
  - Key inquiry: “Frustration of Purpose”
    - What is the stated purpose/use of the lease?
    - Was debtor *prohibited* from carrying out stated purpose?
    - Fact-intensive

Key Case Review

- Force Majeure:
  - Trumps state law - If lease includes force majeure broad enough to cover COVID, debtors have not been permitted to rely on common law defenses
  - If force majeure provision excludes payment obligations under the lease, rent is not excused.
  - Where force majeure *has not* excluded payment obligations, courts have held that COVID and resulting government orders triggered the clause

Key Case Review

- Post-Petition Rent Extensions:
  - Courts extended the period during which the debtors are required to commence the payment of post-petition rent
    - COVID = “cause”
  - *Pier 1* extended beyond the 60-day statutory period – very extraordinary circumstances
  - Majority of bankruptcy courts extended payment only by the 60 days permitted in Section 365(d)(3)

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Key Case Review

- Lender access to courts
  - Courts initially willing to grant mothball motions establishing procedures for creditor action (temporary stays, modified notice/objection procedures, etc.)
  - Later concerns raised over limited access/undue burden on creditors
- Treatment of deferred rent
  - Postpetition/future rent is capped under the Bankruptcy Code 502(b)(6)
  - Argument rent due prepetition but deferred is still unpaid prepetition rent

Key Case Review

- Partial payments
  - Debtors can offer landlords partial payment in exchange for standstill and reservation of rights – going rate appears to be approx. 30%
- Valuation issues
  - Courts reluctant to rely on appraised values
  - Emphasis on values dictated by the market (i.e., price a buyer would pay after marketing process)

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Out-of-Court Strategies

- Many CRE Assets have avoided restructuring
  - Very liquid market - incremental financing available
  - Reliance on stimulus/protection programs
  - Sponsors/owners putting in money
  - Lenders forbearing
- "Amend and Pretend"
  - Uncertainty regarding cash flows/valuation
  - Complex capital structures
  - Lenders don't want the keys
  - Predicting/shifting risk

Out-of-Court Strategies

- Appointment of a Receiver
  - May not get the Receiver you choose or want
  - Cost/expenses vs. benefit must be evaluated
  - Consider confidence in operator/manager; enough capital to reopen
- Deeds in Lieu of Foreclosure or Consensual Foreclosure
  - Key is to have good management partner
  - Evaluate desire to be in particular business
  - How much cash is needed to carry expenses/make necessary investments

Out-of-Court Strategies

- UCC foreclosure
  - UCC calls for 10-day notice and ad in newspaper, but courts generally require more
  - Need broker, marketing materials, 60-90 marketing period
  - Gives parties time to negotiate alternative arrangement
  - But also gives borrower time to prepare a bankruptcy proceeding
- Article 9 Sales
  - "Public" vs "Private" sale
  - Reasonable notice
  - Sale must be "commercially reasonable"
  - Impact of pre and post-COVID issues

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Valuation

- Use today's value vs. "wait and see" approach
- Reliability of appraisals? Cash flow projections?
- Who should bear the risk?

Hotels:

- Selecting base year
- Travel patterns (leisure, business, international)
- COVID resurgence/variants
- Employment levels
- "New normal" adjustments

Office:

- Workforce – return rate, working habits
- Completing lease terms or renegotiating for less space/shorter term
- Impacts on rent levels
- Incentives to entice new tenants
- Combined office/retail

Retail:

- Quality/brand strength
- Type/model of shopping venue
- Anchor businesses
- Leasing projections
- Urban v. Suburban

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Valuation

Hypothetical Manhattan Office Building: 5-Year Mortgage Maturing Q1 2021 Backed into a 15% Decline Q1 2021 Value

Building Finances With Pro Forma 15% Value Decline as of Q1 2021		
Date	Q1 2020	Q1 2021
Building Area*	100,000	100,000
Cap Rate	5.30%	5.30%
Hypothetical Rent/SF	$65.00	$56.38
Vacancy Rate	7.50%	8.30%
Effective Gross Income	$6,012,500	$5,170,333
Operating Expenses* (40%)	$2,405,000	$2,405,000
NOI	$3,607,500.00	$2,765,332.71
Value	$61,383,633.96	$52,176,088.87

Inputs from Co-Star[3] and PWC[4]

*Assumptions made for this hypothetical
** Market offered discount is 9 months of free rent for new 10-year leases
Assumes vacancy rate is constant through this period.

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Assuming Q1 2021 Mortgage Maturity

Valuation

Date	Q1 2020	Q1 2021
Building Value	$ 61,383,633.96	$ 52,176,088.87
LTV	80%	70.0%
Loan	$ 49,106,907.17	$36,523,262.21
Net Debt		($5,698,702.84)
Annual P&I	$2,794,446.12	
DSCR	1.29	
5-Year Balloon Payment	$42,221,965.05	

Assumptions:

- 25-year amortizing loan
- 5-year maturity date, requiring balloon payment Q1 2021
- Annual interest rate, 3%
- Max LTV at loan inception, 80%
- Max LTV at maturity date for a refi, based upon market conditions, 70%

Definitions:

- DSCR: Debt Service Coverage Ratio

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Post-COVID CRE Reactions

- Office
  - Work from home trend
  - Condensing office space
  - Hybrid models
  - “Hoteling”
- Hotel
  - Shortages of labor/supplies & higher costs/prices
  - Leisure travel up/business & group travel down
  - Challenges from postponed events/deposits
- Retail
  - Shift to online market
  - Conversions to residential or industrial
  - Pop-ups/short term leases
  - Malls repurposed/remodeled

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Post-COVID CRE Reactions

- Decision-makers now forced to reconsider real estate commitments/ expenses
  - “Our associates’ desire to work remotely and our ability to provide alternate work environments, in turn, requires less physical office space.” (Thor Thoradson, COO of Chicago-based AMITA Health).
  - “Hundreds of corporate executives tracked in earnings calls around the world in the past five months addressed the urgency to cut real-estate costs …Tactics include cutting office space, accelerating branch closures, renegotiating rents on warehouses and even shutting data centers.” (Sidders, Bloomberg, December 2020)
  - “Gone, at least for now, are leases that typically stretched to 10 and 15 years, according to Whitley Collins, global president for advisory and transaction services at CBRE.” (Ruiz, NY Times, April 2021)

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Post-COVID CRE Reactions

Companies reducing office footprint

- "More and more, the last 20 years, the spaces have been built more and more dense. That's going to stop. The days of the bullpen, the trading floors — that's over." (Whitley Collins of CBRE)
- The trend of reducing employee density in office spaces and increase in work-from-home policies "suggests that aggregate office demand will take a 15% hit in the future." (GlobeSt)
- "[R]emote work would 'significantly reduce our need for real estate.' For every 100 employees … [JPM] 'may need seats for only 60 on average.'" (NY Times quoting Jamie Dimon of JPMorgan)

1Q21 AICPA Business & Industry U.S. Economic Outlook Survey Executive Summary

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Post-COVID CRE Reactions

- Potential Impact of Continued WFH Policies:
  - According to Fitch Ratings, the change to a hybrid work-from-home model could cause a “permanent decline in demand for space and have a severe impact on property values.” A moderate stress scenario assumes employees work remotely 1.5 days per week, which “would result in a 20% decline in office workers and a 10% decline in office space demand.” Also assuming “rents decline at 1.25 times the reduction in space … increased vacancies magnify declines in rent levels.” (Shaver, GlobeSt, March 2021)
  - “A more severe stress assumes a 30% decline to the Fitch [office net cash flow] based on three days of remote working per week on average for office employees.” (Fitch, CRE Post-Pandemic: WFH Secular Shift Will Pressure U.S. Office Properties, March 2021)

Post-COVID CRE Reactions

- Retail recovering but distressed retail high risk
  - "Operating profit will grow a robust 10%-12% in 2021, and hard-hit sectors such as apparel, department stores, and off-price will see the most pronounced operating profit growth over the next 12 to 18 months." (Mickey Chadha, Moody's Vice-President and Senior Credit Officer)
  - Moody's projects that defaults among "US speculative-grade rated retailers this year will decline to 5.3% from the record high of 20% set during 2020." (Moody's Analytics, April 7, 2021).
  - Optimism for retail "thanks to big liquidity boosts from capital raises, broad balance sheet improvement and macroeconomic growth," however "the retail default rate remains historically high … Department stores and apparel are still confronting intense long-term pressures and highly levered retailers remain vulnerable."

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Post-COVID CRE Reactions

- New options for retail/mall spaces
  - 3 mall "models"
    - Traditional/old-school mall: *e.g.*, Paramus Mall
    - American Dream mall: mall as entertainment with rides and food for families and teens
    - Simon and Brookfield/Brookfield Place: one-stop for busy professionals with nearby offices
  - Conversion/Repurposing
    - Residential – similar to post-9/11; new residential neighborhood sparks retail opportunities
    - Industrial/warehousing – *e.g.*, Amazon seeking closed malls/retail locations to use as fulfillment and distribution centers

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Post-COVID CRE Reactions

- Real estate transaction volumes have decreased but CAP rates have stayed relatively constant. One explanation is that only the most stable, valuable properties have sold.
- After that, there's reportedly a large disconnect between the pricing expectations of buyers and sellers. When one or the other capitulates, transaction volumes will increase, as will market visibility into valuations.
- There is downward rental rate pressure given the increase in vacant and available office space. A lot of that pressure is not being reflected in rental rates as much as it is being reflected in increased concessions to tenants.
- Expectations for the "office apocalypse" equivalent to the retail apocalypse seem overblown. The past 30 days has seen an increase in NYC businesses planning to bring back workers sooner rather than later.
- Anecdotal market feedback suggests that rental activity picked up dramatically in May 2021.