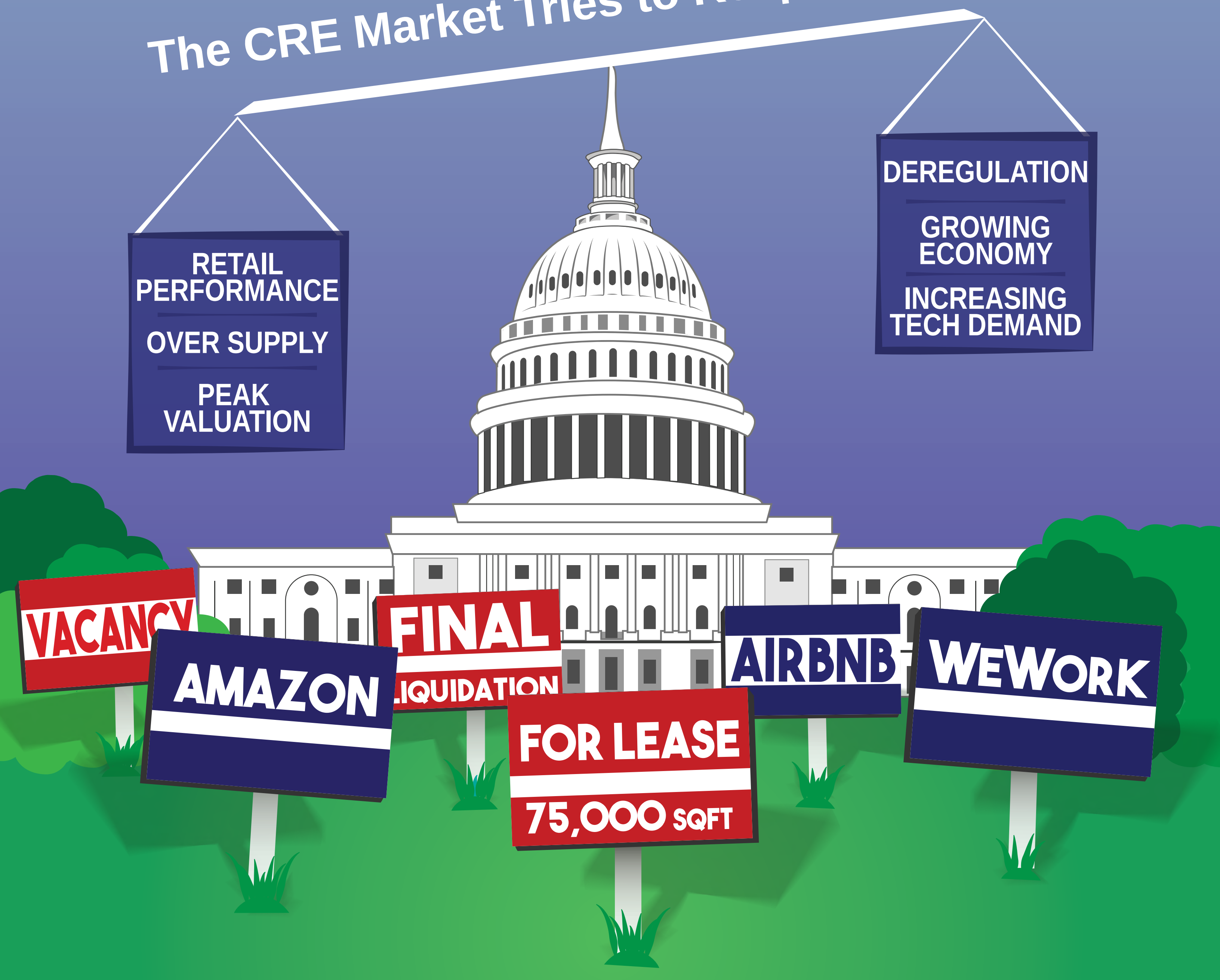
Commercial RealEstate Direct

THE MID-YEAR

2017

The CRE Market Tries to Keep its Balance



INSIDE THE MID-YEAR

Commercial Real Estate Direct

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LETTER FROM THE EDITOR

Orest Mandzy
Managing Editor

Players in the commercial real estate business are on pins and needles. As property prices have climbed to levels well above those reached before the Great Recession, investors have pulled the reins on new investment activity. That's had a dramatic impact on the lending business. If not for the wave of CMBS maturities that needs to be refinanced, lenders would be staring at walls.

Meanwhile, regulators are riding heavy on banks, the biggest providers of debt capital for commercial real estate. And retailers seem to be dropping like flies, which has had a profound impact on the retail-property sector.

All that makes for interesting times. Alternative lenders, which 15 years ago were considered niche players, at best, are now an integral part of the financing industry. They're trying to fill the void they say is being created by bank lenders lowering their profiles.

In the following pages, our team has outlined the major risks facing the commercial real estate sector. We've found that despite the risks, and there are plenty, the market is still chock-full of opportunities. Who, after all, would have thought that second-tier apartment properties could out-perform newly built, class-A properties?

As in previous editions of our twice-yearly magazine, we're including insight from a number of industry leaders. BuildFax, for instance, looked at building permits that get abandoned to determine whether they can be used as a leading economic indicator. The team there has found a correlation between the volume of permit abandonment and a sector's growth. Real Capital Analytics studies why, despite the substantial drop in property sales volumes, property prices have remained at elevated levels; and SiteCompli explains that even when you're buying a vacant parcel, you should be aware of what was on it and whether it was properly decommissioned.

It's very possible that the commercial real estate market is late in its cycle. But property fundamentals, with a couple of exceptions, remain healthy. That remains true despite the relatively tepid economic growth in recent years. Imagine what could happen with some real growth!

I hope you find our Mid-Year useful and informative. As always, we look forward to your feedback.

Best Regards,

Orest Mandzy

Alternative Lenders Move Into the Mainstream

By Orest Mandzy

Alternative, or non-bank lenders, a staple in the commercial real estate industry for decades, have come into their own.

They're filling in gaps in the mortgage world where they find them, whether it be the result of increasing capital requirements for banks, consolidation in the banking sector, or a pullback by CMBS lenders. And they're not going away any time soon, given the vast sums of capital they've raised.

Last year alone, the six largest players in the sector: Blackstone Group, Mesa West Capital, Starwood Capital Group, TPG Capital and Mack Real Estate Credit Strategies, collectively funded some $20 billion of interim loans. Each focuses on providing relatively big-ticket mortgages that generally have initial terms of two to three years to allow sponsors to complete upgrades or stabilization efforts.

Dozens of others play in the field just below them, providing loans against properties that could be classified as middle-market, in that they have total capitalizations of say $10 million to $100 million.

While alternative lenders are getting more attention, they're still relatively small players in the massive arena that's the commercial real estate lending world. Last year, for instance, they held 3.1 percent of the nearly $3 trillion of mortgages outstanding, according to a tally by the Mortgage Bankers Association. That compares with banks, which held a 40.4 percent share, up from 38.6 percent in 2015; the housing-finance agencies—Freddie Mac and Fannie Mae—with a 17.6 percent stake; CMBS, with a 15.5 percent share; and life insurance companies, with a 14.2 percent share.

Banks' relatively heavy exposure to commercial real estate has piqued regulators' concerns. As such, they're pulling back, creating an opening for alternative lenders.

According to the recent Federal Reserve's Senior Loan Officer Opinion Survey, banks reported that they had tightened their lending standards over the past year. They increased loan spreads for all commercial mortgages and a significant percentage of banks had reduced their required loan-to-value ratios on construction, land development and multifamily loans. In most cases, banks had cited the uncertain outlook for commercial real estate and increased concerns about the effects of regulatory changes.

Banks Are 'Rationing' Loans

"It's not that banks aren't lending," explained Stephen Theobald, chief financial officer of Walker & Dunlop. They're effectively rationing their credit by not providing too much financing to any one developer, sector or geographic area. That's prompted some developers to quickly pay off their construction loans, well before their projects reach stabilization, in order to be able to line up new financing for their subsequent projects. Often, as a result, developers will turn to alternative lenders for interim loans that would take a project from construction completion to stabilization.

"Once upon a time, banks were the real estate lenders," explained Joshua Stein, a New York attorney who has specialized in the sector for more than three decades. But

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Owners of Stabilized Properties Are Turning to Floating-Rate Loans

By Orest Mandzy

Some property owners are increasingly turning to short-term loans against stabilized properties, despite long-term interest rates remaining at near historic lows.

The odd trend is being driven by institutional investors and investment funds, in particular, that own fully stabilized properties but may only have a couple of years of life remaining.

Instead of locking in a 10-year loan with a coupon of say 4.75 percent, they're choosing a bridge loan that would provide prepayment flexibility. Property owners generally don't want an asset encumbered with long-term debt when it comes time to sell in order to attract the largest number of possible buyers. REITs, meanwhile, often can borrow on an unsecured basis, so they might be turned off by a property that is leveraged with long-term mortgage debt.

"The rationale for stabilized property owners seeking short-term facilities seems to be driven by a desire for optionality," explained Daniel Mee, executive director of Tremont Realty Capital, a Boston-area lender and mortgage bank. He said borrowers choosing a short-term loan "may want to consider a sale of the asset within the next 24 months and do not want to incur breakage fees on fixed-rate debt."

Long-term holders of properties, however, are generally sticking with long-term loans.

The phenomenon might have a salutary impact on loan origination volumes in the coming years. Given that relatively few loans, from all lender types, were written in 2008 and 2009, the thinking has been that refinance activity in 2018 and 2019 would be minimal. The short-term loans that are being written today might be refinance opportunities in those years.

"There's something going on in the psyche of borrowers that's …causing them to actually pay higher rates for shorter terms because they're viewing the prepayment option as much more valuable," noted Brian Harris, chief executive of Ladder Capital Corp.,

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which funds both fixed- and floating-rate loans. "We've seen an unusual amount of loans with financing for two years instead of five or 10 years," and their collateral properties are stabilized. "They're occupied. They're full," added Harris, who spoke recently on a conference call with analysts.

HFF, among the country's most-active mortgage intermediaries, is seeing much the same thing. While that typically would be an unusual phenomenon, given low current long-term rates, it's not surprising.

"Because there's a lot more institutional ownership of properties, there's a lot more need for flexible debt," explained Gerard Sansosti, executive managing director at HFF, who said 40 percent of the company's 2016 loan volume was comprised of floating-rate financing. While that volume included construction loans and mortgages against transitional properties, Sansosti said a "significant" volume was written against stabilized properties.

Long-term, fixed-rate loans generally include prepayment restrictions, so a borrower can't simply pay off a loan before it's due without facing a penalty. They also can be defeased, a complex and often costly process that involves replacing a loan's collateral with government securities.

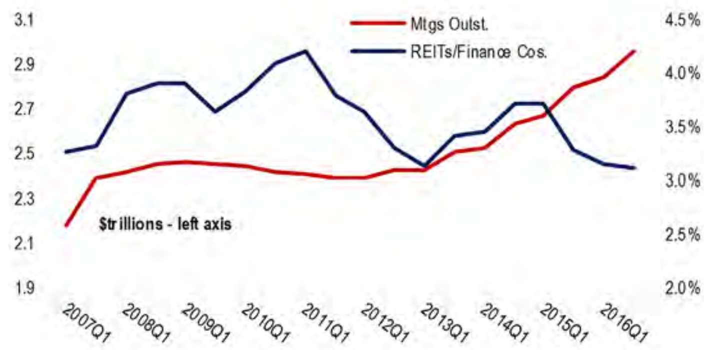
But yield-maintenance penalties can be extremely costly, particularly if Treasury rates are low relative to a loan's coupon. The penalties typically are calculated as the difference between a loan's coupon and the prevailing Treasury rate for the remainder of a loan's life, discounted to its net present value.

Borrowers sometimes can negotiate fixed prepayment penalties, as opposed to yield maintenance, providing them more certainty. But in exchange, lenders often will require a 10 to 20 basis-point increase in loan spread.

"A major concern for many borrowers now is the prepayment penalties," concurred Robert Slatt, a principal with Newmark Realty Capital Inc., a San Francisco mortgage bank that specializes in the middle market.

He noted that a number of lenders—A10 Capital and LStar Capital, to name two—have developed programs that provide greater prepayment flexibility on their fixed-rate offerings. In addition, certain credit unions will offer flexible prepayment options, but they'll usually limit their loans to $10 million or less. And some life insurance companies could be willing to structure certain prepayment flexibilities in their loans. They can, for instance, include a yield-maintenance penalty for the first few years of a loan, then fix that penalty as a percentage of the loan's balance that would decline as the loan ages.

The expectation is that demand for loans with greater prepayment flexibility should remain healthy, as institutional investors and funds have accounted for just more than 25 percent of all property transactions over the past three years, according to Real Capital Analytics. In 2007, they accounted for 42 percent of that year's $571.2 billion of transactions. ■



Source: Mortgage Bankers Association

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growing regulatory oversight "has made it difficult for them to do business. They've become very conservative."

Thorofare Capital, a Los Angeles lender that focuses squarely on the middle market, pointed to that pullback, particularly by community banks, which were the meat-and-potatoes lenders to relatively small and mid-sized development projects throughout the country. They also were the traditional lenders to properties undergoing redevelopment or renovations.

"Before the downturn, they were doing deals for the real estate, not for the banking relationships," explained Felix Gutnikov, executive vice president of originations for Thorofare. Now, he said, they're typically reluctant to lend, unless they're able to generate additional business from their clients. That's created pockets of opportunity for Thorofare, which last year originated $345 million of loans and expects volume to increase substantially this year, given the 70 percent increase in volume it saw during the first quarter.

Meanwhile, outside of the Trump Administration's efforts to reduce regulations there's no move, among developers and others, to push for a reduction in regulations on banks. So, "the space is wide open" for alternative lenders, according to Boyd Fellows, who two years ago led a team that formed ACORE Capital after developing and running the conduit-lending operation for Starwood Property Trust.

Dozens of other investment managers have raised capital to lend on a relatively short-term basis. Some have been in the debt space for years, while others traditionally invested in properties. Arden Group, a Philadelphia opportunistic investment manager, recently launched an effort to raise a fund that it would use to provide bridge and mezzanine loans against properties undergoing renovations.

It's found that banks are no longer willing to provide more than say 65 percent leverage against properties, after their repositioning. That often puts a crimp in developers' plans, so Arden hopes that they'll turn to companies like itself for alternative financing. The company, meanwhile, continues to make opportunistic investments and finds itself borrowing from other alternative lenders.

That makes sense since many alternative lenders got their chops in the industry by investing in properties themselves. So they're familiar with how redevelopments work and the challenges investors might face.

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Alternative Lenders Easier to Work with Than Banks

Arden, for instance, turned to Apollo Commercial Real Estate Finance Inc. for a loan against a hotel it bought in Atlanta and is planning to revamp. It called the borrowing experience the smoothest loan closing it's had in the 29 years it's been in business. Explained Craig A. Spencer, the company's founder and chief executive: "They knew why we were asking for stuff. They started out as an equity shop" so they understand how value-add and opportunistic investors operate.

"In this market, the primary driver" for borrowers "is certainty of execution," noted David Blatt, founder and chief executive of CapStack Partners, a boutique investment bank in New York. "They're able to get that comfort more from an alternative lender than from a traditional bank."

"Alternative lenders started to come into play when the CMBS market faltered" in late 2015 and early 2016, explained Gerard Sansosti, executive managing director of HFF. Historically, he said, alternative lenders were typically credit or finance companies that provided non-recourse financing against properties in transition.

The best known of the bunch probably was GE Capital, which two years ago quit the business, partly in an effort to lose its systemically important financial institution tag, and sold off its commercial mortgage assets, mostly to Blackstone Group and Wells Fargo Bank. Now, Sansosti said, "We get a call a week from a new debt fund."

GE Capital really pioneered the alternative-lending space. Developers before-hand would turn to banks for cookie-cutter loans. But if they needed any sort of customization of terms, and didn't want recourse, they had few alternatives. GE Capital took advantage of that, structuring loans specifically to meet the needs of its borrower clients.

In those days, buy-and-hold investors held most of the real estate. That started changing following the savings and loan crisis in the early 1990s, when growing numbers of pension funds started investing in opportunistic investment vehicles, whose strategy was to buy, fix and sell properties. In other words, they no longer were solely buy-and-hold players. That strategy necessitated short-term financing, and most couldn't deal with recourse. GE Capital and other similar lenders were the big beneficiaries.

"Our borrowers are value-add or opportunistic funds partnered with operators," explained Mark Zytko, a GE Capital alumnus, who in 2004 co-founded Mesa West with Jeff Friedman, a former principal of Maguire Partners.

"They want customized loans on the front end, and they want their lender to be there on the back end," he said. He explained that alternative lenders today provide financing for "today's borrowers." Forty years ago, for instance, every region in the country was dominated by one or a small number of developers, which had their regional funding sources. As those developers' activities became more national in scope, the need for institutional capital increased.

Meanwhile, the challenge for alternative lenders as recently as 15 years ago was educating the investment community, from which those lenders would generate funds to lend. Most lenders at the time funded their originations through the public capital markets. Those included iStar Financial and Capital Trust, both of which were publicly traded.

Blackstone Group was among the pioneers to tap into the pension-fund world for capital to finance against real estate. The New York investment manager, as well as other early players that tapped institutional capital, had to convince their investor clients that investing in commercial real estate loans would result in returns as good, if not better, than their traditional fixed-income investments, yet provide them with downside protection. After all, most loans being made were senior, so they had a cushion of equity beneath them.

Capital-Raising May Have Peaked

Capital-raising appears to have reached a crescendo. That's due to the idea that as the commercial real estate market has become long in the tooth, it might be wise to move up the capital stack and invest in lower-risk mortgage products. What was a $5 billion-capitalization business during the early 2000s now is at least 10 times as large.

But it's not without risks.

Most lenders rely on warehouse facilities, repurchase agreements or use other leveraging strategies to increase their yields to the low teens from the mid-single digits. That, according to Jay Rollins, founder and head of JCR Capital, a middle-market lender based in Denver, could be an issue.

"There's a false prophecy that investors (in debt-investment vehicles) are taking on less risk," he said. But lenders that rely on repo agreements or warehouse lines could in most cases be subject to margin calls in the event interest rates climb or the value of the loans used as collateral declines. "The biggest risk would be a systemic issue that freezes ... or locks up the capital system," he said. "If you look back over the last 25 years, the leveraged bridge lenders that are no longer in business failed due to their leverage, not the asset underwriting."

His lending vehicles do not rely on leverage. Instead, JCR funds its loans through a relationship with StanCorp Financial Group, a Portland, Ore., insurance company. It's also in talks with other insurance companies with which it hopes to structure similar relationships. Few other investor types would accept the unleveraged yields—typically Libor plus as little as 400 basis points—that bridge loans would provide.

"People aren't raising money to meet borrower demand," Rollins explained. "They're raising money because they can," and limited partner investors are pouring capital in because of the promise of double-digit returns from what they view as low-risk debt investments.

"You can already see competition in the space," he noted. That, he added, could lead leveraged bridge lenders to lower their rates and stretch underwriting, which would have the potential of disappointing investors.

Those investors, he pointed out, "thought this was safe and easy." ■

Do Not Fear the Fall in Deal Volume

By Jim Costello

The amount of capital invested in commercial property fell by 18 percent, on a year-over-year basis in the first quarter, with sales of $94.8 billion. This decline marks the second year in a row in which first-quarter volume declined by such sharp double-digit rates. The trend has industry participants on pins and needles.

The fear is that we are due for a correction and that the pain felt in 2008 and 2009, with falling prices and massive mortgage defaults, is just around the corner. Is the market doomed to see price swings and mortgage defaults on the scale of that seen in the Global Financial Crisis (GFC)?

I feel a little bad raising that question. It feels like I'm setting up a straw man argument, but that's exactly the concern I have heard expressed by a number of clients. I tell them that it is a mistake to read the recent declines in deal volume as a precursor to the sort of mayhem seen in the last market cycle.

Every market cycle is different. While there will always be some similarities on the surface, the forces driving up prices and the market imbalances bringing prices back down will always be different. The current decline in sales volume is not a sign of impending doom. Rather, it is a reaction to growing uncertainty and the investment opportunities in the market today.

Explaining the Drop in Deal Volume

Industry professionals note that the pullback in deal volume is due to a pullback of willing sellers bringing assets to market. In one sense, that seems like too convenient of an excuse. If lack of willing sellers is the issue, then perhaps prices do not need to correct all that much. Proving this type of relationship in the data can be challenging. But using some basic relationships in the data, the only way to get the combination of climbing prices and falling deal volume seen in the first quarter is from sellers bringing fewer assets to market.

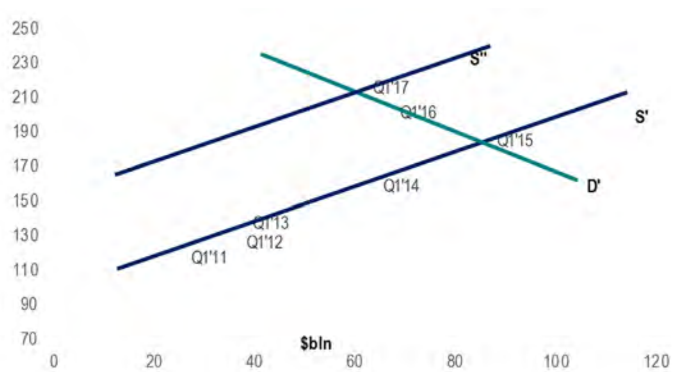
Think back to college and that microeconomics 101 course. Yes, I know that's difficult. But if you remember one thing from that class, it should be that prices never exist in a vacuum.

If there is a certain amount of demand for a product and if the supply of that product goes up, prices will need to fall for the market to clear. Correspondingly, if demand for that product is growing and supply declines, prices will need to increase for the market to clear. One can think of the commercial property investment market in the same sort of framework.

Back in that microeconomics 101 course, the professor or teaching assistant would have described all these interactions, drawing some supply and demand curves on the chalkboard—remember those? The typical framework is highlighted in the chart below, with the demand curve, D', downward sloping. The rationale here is that with the quantity supplied on the x-axis, as prices on the y-axis drop, more of the good is consumed. The supply of goods is said to be upward sloping, in that as prices increase, there is an incentive to deliver more of a good to market to sell.

OK, I hope that brief return to school was not traumatic. Don't worry, there is no test involved here, and I hope it doesn't make you wake up in cold sweat tonight worrying that your midterm is tomorrow. Here's the thing: those curves, they're somewhat imaginary. We do not really know what they look like. Nor do we know their slope.

CPPI



Source: Moody's/RCA Commercial Property Indices.

What we do know is what transacts each quarter and at what prices. Essentially, we know the intersection points of all those imaginary supply and demand curves each period. Using the quarterly deal volume for commercial property sales on the x-axis and the level of the Moody's/RCA Commercial Property Price Indices, or CPPI, on the y-axis, the recent trends from 2011 to 2017 are highlighted.

From the first quarter of 2011 through the first quarter of 2015, there's a steady upward creep in the interaction of prices and the amount of property transacted. Even without the visual aid of the S' line, you can see that price levels and deal volume had a somewhat linear relationship. One can think of each of those quarterly points highlighted along the S' line as an upward move of the D' line, as buyers were willing to pay more for a given level of investment each year.

Into 2016 and 2017 though, deal activity fell back. If buyers were the primary source of the falling deal volume, it would mean that the D' line would have shifted down and to the left, with prices falling back to levels from the first quarter of 2014. That sort of price decline did not happen. While deal volume fell 30 percent in total from the first quarter of 2015 to the first quarter of 2017, prices increased by 17 percent.

The only way to get that price increase with falling deal volume is for sellers to move more than buyers. Think of

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the situation in the last two years as buyer demand, D', remaining fairly constant, but sellers pulled back and moved to the position S". Essentially, for any given sell/hold decision, they want much more than in the past to be induced to bring that asset to market.

This chart-derived approach to thinking about the market matches what I picked up in conversations with acquisition professionals at the Urban Land Institute Conference in Seattle last month. These professionals noted that during the first quarter, they simply did not see as many high-quality packages as in the past. Why should sellers pull back? Part of the issue is structural and some of it broader uncertainty. Timing factors are at play as well.

On a **structural basis**, why bother selling? Many of the highest quality assets already have transacted in the cyclic expansion since the GFC. Prices have been bid up to record levels in many cases, with potential returns on new investments at such low levels that unless one is forced to sell, there are few better alternatives out there for the capital that is currently deployed.

Make no mistake, even in the best of times, there is always somebody that needs to sell, whether in an arms-length transaction due to the scheduled closing date of a fund, or in more of a non-economic distressed situation such as a tenant leaving. But if the owner of an asset does not need to sell and financing is still accessible, assets will be less likely to transact.

On **uncertainty**, everything changed last November. Investors are more hesitant to get involved in transactions if they don't know the rules of the game. Measuring the uncertainty around monetary, fiscal and regulatory policy—the rules of the game for investors—is a tricky business. The team at Economic Policy Uncertainty have assembled an index of the uncertainty around these issues using new data techniques that "read" news stories online.

Over time, when the rules of the game are known and policy uncertainty is low, growth in commercial real estate deal volume is relatively high. Conversely, high uncertainty leads to lower growth in deal volume.

Economic Uncertainty Index

Source: Real Capital Analytics, PolicyUncertainty.com, National Bureau of Economic Research

Policy uncertainty has spiked since the U.S. presidential election. Owners of existing assets face an unsure future. If they sell now, will tax treatment for their gains be better in the future? Will stimulus spending and/or tax cuts generate higher levels of economic growth that boost income? Should they sell now or reap those gains in income and sell properties in the future at potentially higher prices even if capitalization rates remain the same? Faced with this sort of uncertainty, it's little wonder that sellers are sitting on their best assets and only willing to move for the most lucrative offers.

On **timing**, sellers set their expectations on a backward-looking basis. As prices climb higher and higher, their expectations for pricing that they could achieve in a sale will be set, in part, by recent pricing trends. The behavioral aspect of this is that people seeing prices move in one direction for a bit will assume that this growth will continue for a while at least and ask for higher prices even as buyers are not willing to go that far. In such a case, prices may eventually fall somewhat as buyers and sellers come back together.

Prices may well fall in the near term. In fact, our first-quarter data show price corrections underway for certain geography/property type combinations. Apartment properties in the six major metropolitan markets of the United States, in particular, posted declines in the CPPI. This price decline was on the order of 1 percent from the previous quarter. Certainly not enough of a movement to generate a massive wave of loan defaults as seen during the GFC. Clients, though, come back and ask if this slight decline is not the start of something big.

Price Drivers are Different in this Cycle

I know what you're thinking, and you're right. Whenever somebody says that "this time it's different," you should put your hand on your wallet. Such caution is advisable. But caution should not inspire people to inaction. The market is not a roller coaster with the same massive climbs and dips in each cycle. This cycle is differentiated from the last by the behavior of lenders.

Aggressive lending was part of the equation driving high property prices during the last economic cycle. Lenders aren't as aggressive today, and so far they're not changing their standards to win business.

As shown in the chart on the following page, into the end of the last property cycle, the average debt-service coverage ratio for commercial mortgages hit a low of 1.3x as cap rates hit their minimum. During that cycle, as cap rates for commercial properties fell, lenders cut their required DSCRs to win business. Loans completed at the end of the cycle were particularly challenged. With a 1.3x DSCR, if cash flow fell 30 percent, an investor would have only enough for ongoing loan payments. Such an investor would be incentivized to walk from their investment.

The average DSCR today comes in closer to 1.7x. And while cap rates have fallen, lenders haven't chased deals by lowering their required DSCRs, leaving far more cushion in the event cash flows decline.

New regulations such as the stress tests of the "Too Big to Fail" financial institutions and the CMBS risk-retention rules—while painfully challenging and heavy handed for many lenders—may well have helped to restrain some of the more aggressive activity one might have expected this far

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into an expansion.

In the current cycle, there is simply much more equity chasing fewer transactions. Deep pocketed cross-border investors, in particular, have been a signature feature of this cyclical expansion, with their purchases accounting for 20 percent of all deal volume in the country's six major markets during the first quarter. These investors compete for deals with much more equity behind them. They are not the only ones, however. Generally speaking, LTVs are lower today than in the peak periods of activity into the GFC.

Commercial Loan Performance Metrics

Source: Real Capital Analystics

Again, this is not to say that price declines will not happen. We're already seeing some declines for the priciest assets. But recent declines in deal volume aren't a signal of price drops on the scale seen during the GFC in the near term.

Implications for Lenders

Our best advice for lenders at this stage of the cycle is simple "don't do anything stupid." Prudent lending has been the rule in this cyclic expansion, and with prices at peak levels in most markets, now is not the time to give in to pressures to loosen standards to win business.

At the same time, there are no major imbalances in the economy to be worked out in the near term. We are not, for instance, building two million housing units per year when the economy only needs one million units (the spark that caused the fire of the GFC). Growth for both jobs and overall activity for the economy is slow but steady. There are no clear known items that will upset the apple cart here.

Prices fell so sharply in the last cycle because of the use of high octane debt. With high leverage levels, even a small change in prices mandated asset sales at liquidation prices. Remember the term, "catch a falling knife?" If there is some unknown, outside shock that does upset the apple cart (war with North Korea?), we'll likely hear that term a lot less in the recession that follows.

Owners of existing assets, having used more equity in their acquisitions, will be less likely to default and walk away from properties than in the previous cycle. As long as lending standards do not change, this sort of environment suggests lending will remain relatively safe in the near term, even as volume falls. ■

Jim Costello, CRE, is senior vice president of Real Capital Analytics, a New York data and analytics company.

The Multifamily Sector: A Tale of Two Classes

By Jen Loukedis

Luxury apartments have been the darlings of the multifamily sector's building boom since the Great Recession. However, a number of shifting dynamics are putting pressure on the asset class, while mid-range class-B properties remain underserved by developers and investors, despite strong fundamentals. Workforce housing, often categorized as class-C, is facing even tighter supply issues.

New apartment supply is expected to peak this year with some 320,000 units scheduled for delivery, up 5.3 percent from last year, according to Marcus & Millichap. Most of the supply is in the luxury urban class, and for good reason. Construction costs across the board have steadily increased, by 37 percent during the 10 years since 2006, according to the IHS PEG Engineering and Construction Index. The higher cost needs to be offset by high rental income in order to make housing construction profitable.

Meanwhile, lesser-quality properties, those that might be considered class-B or -C, have seen little in the way of new construction.

Tenants in class-B and -C units are generally renters by necessity... A lack of accumulated wealth may prohibit home ownership.

Last year, class-B/C units outnumbered class-A units by about 1 million. That's despite just about zero growth in volume over the past seven years. During that time, the country's class-A inventory has grown by some 17 percent.

"Of the approximately 320,000 units that are expected to be built this year, the class-B/C component is projected to be approximately 50,000 units," said Scott Lawlor of Waypoint Residential, a real estate investment firm with more than

Inventory of Apartment Units

Source: PWCMoneytree.com

22,000 multifamily and student-housing units across the South, Southeast and Midwest markets. "However, with a similar number of units of older mid-range stock likely to be renovated to class-A status, the net result would be only a negligible increase in overall affordable-housing supply," he explains.

Class-A properties typically are less than 10 years old, offer a slew of luxury amenities, like fitness centers, swimming pools and pet spas, and feature the finest interior finishes. They are usually professionally managed and in prime locations.

Tenants of class-A properties are renters by choice. They have the wealth or income to be discretionary about their housing choices. Millennials—people born between the early 1980s and 2004—and Baby Boomers—people born between 1946 and 1964—are the biggest targets for these newer communities. Many are attracted to the flexibility that renting affords.

Class-B/C Properties Are Aging, Offer Opportunity

Class-B properties, meanwhile, are between 10 and 20 years old, offer some amenities and have little deferred maintenance. For investors, they are typically value-add opportunities because unit and common-area improvements can result in higher rents. Class-C properties are between 20 and 30 years old and often come with original building systems and finishes. As a result, they typically have substantial amounts of deferred maintenance.

Tenants in class-B and -C units are generally renters by necessity. They tend to be grey-or-blue collar professionals, such as teachers and policemen, with steady, but moderate income. A lack of accumulated wealth may prohibit home ownership.

While there is no standard definition of workforce housing, it usually is considered housing for tenants who make too much money to qualify for traditional housing subsidies, but not enough to afford local market-rate homes.

The Urban Land Institute describes workforce housing as properties that target households making between 60 and 120 percent of an area's median income (AMI). Affordable housing, meanwhile, is targeted to tenants that make 60

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2016 Apartment Inventory by Region

	Total Households (mln)	Class-A Inventory	% of Households	Class-B/C Inventory	% of Households
Northeast	14.15	503,914	3.56	694,174	4.91
South Atlantic	18.29	1,304,592	7.13	1,286,839	7.04
South West	8.00	914,690	11.43	829,218	10.36
West	18.58	1,374,743	7.40	1,785,790	9.61
Midwest	13.21	703,625	5.33	1,095,353	8.29

Source: Reis Inc.

percent of AMI or less. There are a number of federal and local programs to subsidize rent and building costs for those projects.

"Very little (new workforce projects are being developed) and in many markets, none at all," explained Greg Campbell, senior managing director of acquisitions and dispositions at TruAmerica Multifamily. The Los Angeles company was founded in 2013 with a focus on affordable high-quality rental homes that it could reposition and renovate. Workforce housing projects "don't pencil out well for developers, and unless we see costs decrease, or municipalities offer stronger incentives, we aren't likely to see this change," he explained.

National apartment rents across all asset classes grew by 0.1 percent on a trailing three-month basis in March compared with February, according to Yardi Matrix. Gains were led solely by the renter-by-necessity asset class, which grew 0.2 percent during that time period, while 'lifestyle' rent growth was flat. Trailing 12-month rents show an even wider gap between the two groups, with rents at renter-by-necessity properties growing by 4.9 percent over the prior year and those at lifestyle properties rising by only 3.1 percent.

The number of renter households increased by 9.3 million in the 10 years through 2015... while the number of owner-occupied households dropped by 2.1 million.

"Suburban class-B markets are underserved, with occupancy rates in the 97-99 percent range," Campbell noted.

That begs the question, is the class-A multifamily market overbuilt? Not necessarily.

There Is a Need for More Apartments

While there are pockets of what arguably could be viewed as over-development, "household formation in the U.S. is increasing so quickly, that it's creating a housing shortage," Campbell said.

The number of renter households increased by 9.3 million in the 10 years through 2015, according to the Census Bureau, while the number of owner-occupied households decreased by 2.1 million.

The top markets for new supply are Dallas, with 25,093 units; Houston, with 15,450; Washington, D.C., with 13,686; Seattle, with 12,351; and Denver, with 12,080, according to Yardi Matrix. Nonetheless, each of the markets, except for Houston, is expected to see at least nominal growth in rents this year.

Rent growth nationally has slowed and that trend is expected to continue. Last year, for instance, asking rents grew by only 3.7 percent, according to Reis Inc. That's in contrast to the 5.8 percent growth rate in 2015. The New York research company expects a further softening this year, with rents growing by 2.7 percent.

"Gone are the projections of 5, 6 and 7 percent annual growth," Campbell said.

Millennials, Baby Boomers Want to Rent

Demand for all apartment asset classes is expected to remain strong through 2024, primarily because the number of millennials between 20 and 34 years old, the prime renter ages, will reach nearly 70 million, or 20 percent of the country's total population.

Baby Boomers are getting in on the rental action, too. The number of renters 65 years or older will more than double by 2030, to 12.2 million, according to research by the Urban Institute.

Freddie Mac, meanwhile, last year found that 71 percent of people aged 55 and older planned to rent their next homes.

Unfortunately, nearly a quarter of Baby Boomers have no retirement savings, according to the Insured Retirement Institute, and about half of retirees are living off of their Social Security benefits. The average social security payment in January 2017, according to the Social Security Administration, was about $1,317, while the national median rent was $1,234/month, according to GOBankingRates.

Perhaps that's all working to pour cool water on the sector. In March, prices paid for apartment properties actually declined, by 0.48 percent, marking only the second time that had happened since 2009. They're still 52.2 percent higher than they were during their previous peak, in 2007, according to the Moody's/RCA Commercial Property Price Indices. ■

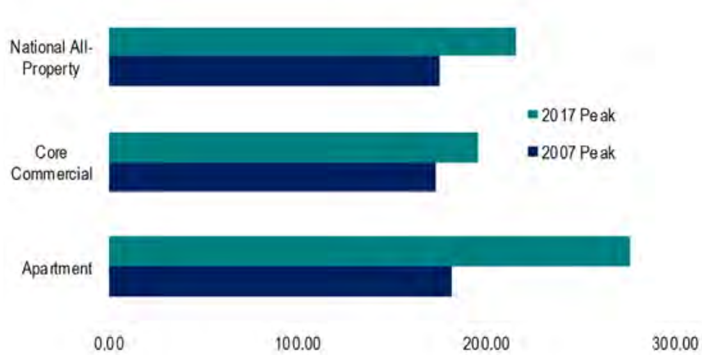
Record Commercial Real Estate Prices Crimp Investment-Sales Activity

By Josh Mrozinski

Record commercial real estate prices helped to crimp investment-sales activity during the first quarter.

Despite a recent softening, property prices remain 22.9 percent higher than they were during their previous peak in 2007, according to the Moody's/RCA Commercial Property Price Indices, or CPPI. But pricing hasn't been even across all property types. Apartment prices are up 52.2 percent, while core-commercial properties were up 13.1 percent. Retail and suburban office properties, meanwhile, remain below their pre-recession peaks.

Commercial Property Prices

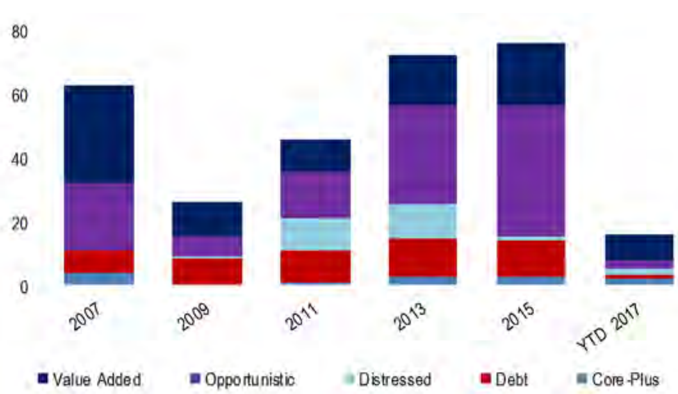


Source: Moody's/RCA Commercial Property Indices.

With prices at what many would argue are lofty levels, buyers have become extremely cautious. Adding to their trepidation: the expectation that interest rates will increase and property performance levels have stabilized.

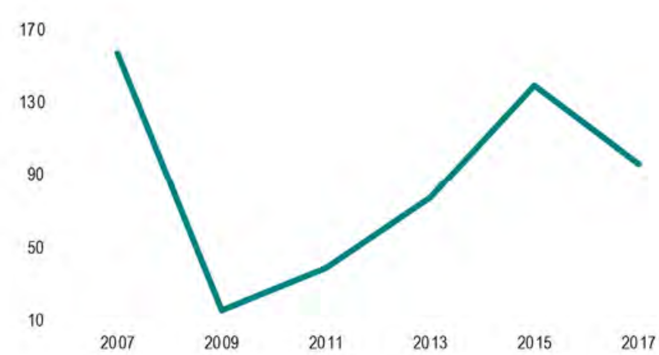
As a result, the volume of sales dropped 18 percent to $94.8 billion in the first quarter, from about $116 billion a year ago, according to Real Capital Analytics.

Capital Raised for U.S. Commercial Real Estate ($Blns)



Source: Preqin

Historical 1st Qtr. Sales Volumes



Source: Real Capital Analytics

Apartment properties, which have led sales volumes since 2015, saw the largest decline—perhaps a sign that investors are pushing back against the pricing being sought. In addition, some are concerned about what could be an overbuilt sector in certain areas. Sales fell by 35 percent to $26 billion in the latest period. Office property sales, meanwhile, declined to $27.7 billion from $31.4 billion a year earlier.

Most property owners looking to sell their assets remain stubborn, however. They point to the vast sums of capital raised by investment managers specifically for real estate.

Fund managers raised $76.5 billion of capital specifically for real estate investments last year, according to Preqin. While that was down from the $83.6 billion raised in 2015, it's still the second highest amount raised in any given year since the recession. Managers now have $250 billion of dry powder, or capital waiting to be deployed in commercial real estate.

"There is a lot of money out there," said Andrew Moylan, head of real estate products at the London research firm.

That might be prompting some prospective buyers to consider capitulating. Nearly half of the 180 fund managers interviewed by Preqin said they have lowered their return expectations, in light of the higher pricing. That means that those fund managers are willing to pay more.

Of course, fund managers aren't the only buyers. REITs, another set of substantial players, are effectively sitting on the sidelines, as they face challenges finding assets that would be accretive to their earnings.

Despite fewer transactions taking place in the first quarter when compared with last year, pricing remains at nosebleed levels in large part because of the feeding frenzy for trophy properties in major markets. Indeed, properties in major markets are now trading at levels that are nearly 40 percent higher than they were during their previous peak 10 years ago. But those in non-major markets are up only 8.8 percent.

That's led some investors to hunt in secondary markets for relative bargains.

"When you get into record (pricing) territory, you start to see a pullback in those (major) markets and a shift into the

Continued on page 18

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Growth in Commercial Real Estate Lending by Banks Shows Signs of Slowing

By Manus Clancy

One of the concerns making its way on the cocktail circuit during the second half of last year was whether or not the combination of the new risk-retention rules with a renewed focus on commercial real estate, or CRE, lending by commercial banks could trigger a squeeze on borrowers in 2017.

The prevailing wisdom was that risk-retention would certainly result in a reduction in CMBS lending. Fortunately for borrowers, that has not come to pass. Issuance through May had topped $20 billion and was expected to near $30 billion for the first half.

But the second part of the equation—the tail off in CRE lending among banks—has been more noticeable over the last 12 months.

Anecdotal evidence from Trepp's banking clients and conversations with banking industry experts have suggested that banks with high CRE concentrations are coming under more scrutiny than at any time since the financial crisis.

The greater attention from regulators is not entirely surprising. With commercial real estate values surpassing their 2007 peaks in many locations and across most property types, and the fact that banks have been aggressively growing their CRE books for several years, it's no surprise that CRE has become a sector of growing concern for regulators. Banks looking to aggressively grow their exposures would be doing so at potentially the worst possible time.

The heightened focus on CRE seems to have had some impact on banks over the past year.

If we look at CRE growth in total among banks and thrifts over the last four years, there was steady growth for the first 36 months, but a gradual (albeit bumpy) pull back over the last four quarters.

From the third quarter of 2015 through the second quarter of 2016, CRE holdings grew at a better than 10 percent year-over-year rate. During the last three quarters, however, those values have registered 9.46 percent, 8.36 percent and 8.8 percent. Certainly these are not "race for the exits" numbers, but they do show there has been a tapping of the

Continued on next page

Above 300% Regulatory Guidance on CRE Loans

	Number of Banks			
	1Q 2017	4Q 2016	3Q 2016	2Q 2016
All Banks	**461**	**445**	**448**	**439**
States				
AL	2	2	3	3
AR	4	4	6	6
AZ	3	3	3	2
CA	63	58	63	62
CO	7	9	10	12
CT	5	4	4	3
DE	0	0	1	1
FL	29	25	27	30
GA	20	22	20	22
HI	0	0	1	0
IA	10	10	10	8
IL	27	26	25	22
IN	3	3	3	2
KS	6	5	5	7
KY	4	4	3	3
LA	3	2	4	4
MA	18	18	16	16
MD	8	10	8	10
ME	1	0	0	0
MI	6	7	8	7
MN	11	10	8	5
MO	17	18	21	19
MS	2	2	0	0
MT	0	0	0	0
NC	4	5	6	5
ND	1	1	0	2
NE	8	7	7	7
NH	1	1	1	2
NJ	23	24	21	24
NM	1	2	2	2
NV	3	3	4	4
NY	41	39	37	34
OH	7	4	3	3
OK	14	11	13	10
OR	2	4	4	3
PA	16	14	13	11
RI	2	2	2	2
SC	2	1	1	2
TN	14	15	13	13
TX	35	33	31	29
UT	0	1	0	1
VA	8	9	11	10
WA	10	10	8	10
WI	18	16	20	19
WV	1	0	1	1
WY	1	1	1	1

Above 100% Regulatory Guidance on CRE Loans

	Number of Banks			
	1Q 2017	4Q 2016	3Q 2016	2Q 2016
All Banks	**331**	**325**	**330**	**318**
States				
AL	6	5	5	6
AR	8	8	9	7
AZ	1	2	2	2
CA	2	3	6	6
CO	9	11	11	7
CT	1	1	1	0
DC	0	1	0	0
FL	8	7	6	6
GA	28	27	29	29
IA	11	9	8	6
ID	2	2	1	2
IL	9	9	9	11
IN	1	0	0	0
KS	9	7	9	6
KY	3	1	2	1
LA	17	17	14	17
MA	6	5	4	5
MD	5	4	4	4
MI	1	1	1	1
MN	10	11	8	6
MO	16	12	13	11
MS	6	4	5	5
MT	2	3	3	3
NC	12	10	13	13
ND	1	1	1	1
NE	7	5	6	7
NH	1	1	1	1
NJ	7	10	8	7
NM	1	2	2	2
NV	1	1	1	0
NY	2	2	4	3
OH	2	2	2	2
OK	20	22	22	19
OR	0	0	0	1
PA	2	3	3	2
SC	5	4	3	5
SD	0	0	1	0
TN	23	23	23	22
TX	67	68	71	73
UT	7	8	7	7
VA	5	5	6	7
WA	4	5	1	2
WI	1	1	3	1
WV	1	1	1	1
WY	1	1	1	1

Source: Trepp Bank Navigator™

Continued from previous page

brakes over the last year.

Looking at the individual categories that make up CRE, the fall off has been well distributed.

Construction growth saw a post-crisis peak in the third quarter of 2015, when year-over-year loan growth hit 15.39 percent. Since then, the growth rate has subsided—somewhat unevenly—to 12.97 percent as of the first quarter. The chart in the middle is an illustration of quarterly growth rates for construction loans over the last three years.

% Quarterly Multifamily Loan Growth

June 30, 2014	3.61
Sept. 30, 2014	2.71
Dec. 31, 2014	2.92
Mar. 31, 2015	2.75
June 30, 2015	3.73
Sept. 30, 2015	4.28
Dec. 31, 2015	4.15
Mar. 31, 2016	1.70
June 30, 2016	4.14
Sept. 30, 2016	2.47
Dec. 31, 2016	2.32
Mar. 31, 2017	1.90

Source: Trepp LLC

The volume of multifamily loans on bank balance sheets grew by a post-crisis peak of 15.76 percent in the fourth quarter of 2015, when compared with the year before. Since then, however, the growth rate has subsided to 11.27 percent, as of the first quarter.

Meanwhile, the volume of loans that banks held against traditional owner-occupied or income-producing properties grew by a post-crisis peak of 8.65 percent in the second quarter of 2016. That growth rate was tempered, to 7.86 percent in the first quarter.

From our conversations with banks subject to the Comprehensive Capital Analysis and Review framework and the Dodd-Frank Wall Street Reform and Consumer Protection Act, they already have high CRE concentrations and are facing the most scrutiny. In particular, regulators have two gauges of concentration for banks.

% Quarterly Construction Loan Growth

June 30, 2014	4.13
Sept. 30, 2014	3.33
Dec. 31, 2014	3.47
Mar. 31, 2015	3.11
June 30, 2015	3.97
Sept. 30, 2015	4.03
Dec. 31, 2015	3.32
Mar. 31, 2016	2.51
June 30, 2016	4.37
Sept. 30, 2016	3.03
Dec. 31, 2016	3.35
Mar. 31, 2017	1.66

Source: Trepp LLC

First, regulators measure to see if a bank's CRE exposure exceeds 300 percent of risk-based capital. A total of 461 of a universe of some 6,000 banks meet that threshold. Second, the regulators measure to see if a bank's construction exposure exceeds 100 percent of risk-based capital—331 institutions fall into that category.

The table on the previous page shows the number of banks in total and the number by state that have exposures that exceed these levels.

The state-by-state data are critical in understanding the role CMBS has played in providing liquidity for commercial properties in secondary and tertiary markets. While CMBS has had a healthy start in the post risk-retention world, if that were to change, those secondary and tertiary areas would lose a source of capital. If those markets included a large number of banks with high concentration levels, property owners could lose another important source of capital. ■

% Quarterly Commercial Loan Growth

June 30, 2014	0.72
Sept. 30, 2014	0.62
Dec. 31, 2014	1.56
Mar. 31, 2015	1.15
June 30, 2015	1.22
Sept. 30, 2015	2.05
Dec. 31, 2015	2.68
Mar. 31, 2016	0.77
June 30, 2016	2.90
Sept. 30, 2016	1.69
Dec. 31, 2016	1.73
Mar. 31, 2017	1.31

Source: Trepp LLC

Confusion Over HVCRE Rule Gets Attention from Legislators

By Orest Mandzy

The high-volatility commercial real estate, or HVCRE, loan classification, introduced by the Basel III regulatory framework, has been a source of confusion for construction lenders since it went into effect two years ago.

The rule increases by 50 percent the risk weighting of a loan held on a bank's balance sheet. As such, banks have to hold capital totaling 12 percent against such loans, up from 8 percent for most commercial mortgages. But bank managers remain confused about what exactly should be classified as an HVCRE loan.

A loan, typically an acquisition, development and construction, or ADC loan, is classified as an HVCRE loan if it has a loan-to-value ratio of more than 80 percent and if its sponsor, or borrower, has put up less than 15 percent of the collateral's equity, based on the project's completed value. It also gets the classification if the sponsor is able to recover any excess cash flow from the collateral, typically a construction project, during the loan's life.

Meanwhile, the rule dictates that only the amount paid for a land parcel, if it's being used as part of a sponsor's equity—and not its value at contribution, which was the norm—could be used in calculating whether a sponsor has met the 15 percent equity contribution standard.

That's resulted in a mish-mash of interpretations by lenders, and thrown a monkey wrench into the loan syndication business simply because one bank might interpret the rule differently than another.

Help might be on its way.

In April, Reps. Robert Pittenger (R-N.C.), and David Scott (D-Ga.) introduced H.R. 2148, the Clarifying High-Volatility Commercial Real Estate Loans bill in an effort to ease the pain that the HVCRE rule has caused.

The rule would amend the Federal Deposit Insurance Act and spell out, for instance, exactly what an HVCRE ADC loan is.

Loans used to finance the purchase of "existing income-producing real estate" would not be considered HVCRE. Nor would loans made to fund improvements to properties that generate enough cash flow to service their indebtedness. Neither would those that meet certain leverage thresholds, or those in which the borrower has invested at least 15 percent of the equity, based on the collateral property's value when it's completed.

In addition, the bill specifies that once construction of a loan's collateral project is completed and its cash flow can support its indebtedness, it could be reclassified as a non-HVCRE loan, reducing the amount of capital needed to be set aside for it.

While the bill still has a long road ahead of it, every major trade organization representing lenders has applauded it. It has been referred to the House Committee on Financial Services. ■

Why Operational Risk Should Be First Thing on Your Due Diligence List

By Kristen Hariton

You're set to purchase a commercial real estate asset, and you think you know everything there is to know about the building.

You've got the square footage, the transaction history and the associated loan balance. But do you know the property's ongoing operational risks? Do you know how the compliance history of the third passenger elevator can impact the building financially going forward? You should.

Looking Beyond the Basics and Into the Details of a New Asset is Critical to Minimize Compliance Risk and Prevent Ongoing Infractions

Take that elevator—would it affect your investment if you knew the car suffered from years of maintenance and operational issues, and carried several city-issued violations to show for it? How would the operational, repair or regulatory costs of this piece of equipment impact your bottom line? What if you found out all of this after the closing?

It's imperative to understand the operational details of your future asset. Knowing what you'll be responsible for gives you a more complete idea of your investment. In fact, the earlier you know operational and risk-associated costs, the more informed your final investment decision will be.

Failure to uncover ongoing areas of risk can lead to severe financial penalties. A recent example we saw in New York City involved the purchase of a vacant lot for development. While the property was entirely cleared and there was no existing structure or accompanying equipment, a boiler that had been in the structure before it was razed was never officially decommissioned with the city's Department of Buildings. Violations for failure to submit regular boiler inspections piled up for years and were only found after the property purchase was completed. The new owner was on the hook for tens of thousands of dollars in non-negotiable fines and had to undergo a long and tedious process to "remove" the boiler from the DOB's records.

Similar stories involving permitted equipment produced similar results; not knowing about the existing item or accompanying violations wasn't a sufficient excuse for city agencies—existing compliance penalties followed building ownership, no matter who was actually responsible for the infraction.

The best way to prevent this scenario is to bake operational risk into your due diligence. Here are the three factors you'll need to consider when measuring operational risk at an individual asset:

- **Equipment and Associated Costs/Requirements**
  - Getting a full roster of equipment plus any requirements (permits, inspection and filing frequencies, ongoing maintenance costs, compliance history) can help prevent any unwanted financial or regulatory surprises from popping up.
- **Ongoing Regulatory Requirements**
  - In addition to requirements for equipment, the building itself may also have to submit regular filings. Facade and exterior reviews, consumption benchmarking and registration may all be requirements from your local enforcement agencies. Know how to complete these requirements, and what their costs are.
- **Current Property Infractions**
  - This may seem obvious, but open infractions are discovered post-closing at an alarming rate. Being aware of open violations (especially ones with accompanying fines) will save you from having to eat the costs. Obtaining proof of payment and correction for all infractions (ongoing and recently corrected) is a standard best practice, pre-closing. The last thing you want is to be stuck with the risk (and the bill) for any outstanding issues.

Prevent your organization from tripping over financial potholes in your new investment—make operational risk an essential part of your due diligence. ■

Kristen Hariton is senior manager, product marketing at SiteCompli, a New York company that gathers and analyzes data on regulations with which property owners, managers and developers must comply.

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secondary markets," explained Revathi Greenwood, head of investment research for the Americas at CBRE. In addition, she said, "Investors are being more selective."

Major markets accounted for $38.7 billion of the first-quarter sales volume, down 22 percent from the $49.6 billion of deals posted a year earlier—underperforming the overall market. Secondary markets accounted for $41.9 billion of the volume in the first quarter, down only 19 percent.

So the best-performing properties in certain secondary markets generally get solid investor attention. For example, Denver's Triangle Building, a 227,000-square-foot office property that was completed two years ago and is just about fully leased, was purchased by German investment manager Union Investment for $154 million, or $678/sf—among the highest prices paid for an office asset in that market. The property is anchored by Liberty Global, which uses 70,000 sf as its headquarters. ■


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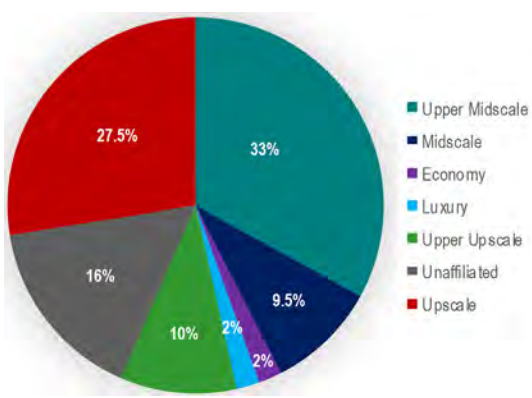
Hotel Sector Slowing Down: Bumps in the Road Ahead?

By Jenny Robinson

So far, healthy demand has pushed hotel metrics to record levels, but the pace of growth in those metrics is slowing, amid the robust development pipeline.

In the first quarter, hotel occupancy rates increased by 90 basis points to 61.1 percent when compared with a year earlier. And average daily room rates rose by 2.5 percent, to $124.27, according to STR, a Hendersonville, Tenn., research company. As a result, revenue per available room, or RevPAR, jumped 3.4 percent, to $75.92. It was a record-setting performance in all three metrics, despite a 1.9 percent increase in supply during the quarter, the biggest supply increase in nearly seven years.

U.S. Hotel Construction Pipeline (By Chain Scale)



% by Rooms

As of Q1 2017		
	Projects	**Rooms**
Unaffiliated	521	90,788
Full Service		
Luxury	55	13,127
Upper Upscale	266	57,948
Select Service		
Upscale	1,208	156,869
Upper Midscale	1,882	187,991
Limited Service		
Midscale	648	54,041
Economy	141	10,547
TOTALS	**4,721**	**571,311**

Source: STR

The lengthy current cycle began during the post-recession recovery in 2010, when travel started picking up again, pushing hotel occupancy and room rates higher. RevPAR grew by as much as 8.1 percent annually, a figure recorded both in 2011 and 2014.

The hotel construction pipeline took a while to catch up, increasing by less than 1 percent annually until 2015, when the inventory of rooms grew by 1.4 percent.

During the 12 months through March, 106,450 rooms were opened, a 1.5 percent increase in supply—the biggest increase since 2010, when hotel supply increased by 1.7 percent.

While demand has remained robust and has outgrown supply for seven consecutive years, that trend is projected to change course. STR expects demand for rooms to grow by 1.7 percent this year. New supply, however, will outpace that, at 2 percent.

"When we get to this part of the cycle and we see the supply move up and continue to ramp and demand soften, that's when we get more and more concerned," explained Mike Barnello, president and chief executive of LaSalle Hotel Properties.

The supply/demand imbalance will lead to a 30-bp drop in occupancy this year, to 65.5 percent, predicts Jan Freitag, senior vice president, Lodging Insights at STR. That would be the first time occupancy would drop since 2010. But average daily rates, or ADRs, are still expected to improve, by 2.8 percent, to $127.44. RevPAR, as a result, will increase by 2.5 percent to $83.47. Both RevPAR and ADR data are projected to set new records.

The bulk of the supply—more than 60 percent—coming online is in the upscale or upper-midscale segments, both dominated by limited-service brands such as Courtyard, Hilton Garden Inn, Clarion, Fairfield Inn and Holiday Inn Express.

"From a lending perspective, there's a comfort level for a lender," explained J.P. Ford, senior vice president and director of business development at Lodging Econometrics. "Those brands have very strong reservation systems, and are relatively easy to run. They are more manageable. The development loans are typically more reasonable."

Freitag called the sectors "the sweet spot of development." Many such properties are developed by public companies, giving lenders an extra level of comfort to provide them construction financing.

Meanwhile, developers prefer them because of the relatively healthy profit margins they generate and their relatively efficient operations, when compared with full-service properties.

The New York market accounts for nearly half—46 percent—of all rooms under construction in STR's top-25 markets. As of the end of March, it had 15,911 rooms in various stages of construction, which would represent a roughly 14 percent potential increase in the city's supply.

Demand has kept pace, but could have been the result of a 2.2 percent drop in ADR in the first quarter, to $197.01. While the number of rooms in the city increased by 5.2 percent during the period, that was outpaced by a 6.2 percent increase in the number of rooms sold. So, STR reported an improvement in occupancy during the first quarter, to 77.9

Continued on next page

Washington Update: CHOICE Act 2.0 Debuts with Little Change; Durbin Amendment Stunner

By Martin Schuh and Christina Zausner

Republicans in 2016 campaigned on the call to "repeal and replace" many of the signature legislative accomplishments by the Obama administration, such as the Affordable Care Act, better known as Obamacare, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Rep. Jeb Hensarling (R-Texas), chairman of the House Financial Services Committee, vowed to take care of the latter.

When he introduced the Financial CHOICE Act, or FCA, last July, it was considered more a "messaging bill" than an earnest attempt to curtail Dodd-Frank. While perhaps a bit more tempered than expected, FCA 2.0, released on April 19, was constructed in a way that antagonized Democrats rather than enticed them.

Though the bill has grown longer with additional regulatory relief provisions, the original construct and goals are intact. Most notably, FCA 2.0 still calls for regulatory relief for banks (especially if they meet certain conditions), a boost to traded markets through the repeal of risk retention and the Volcker rules, as well as a pushback on rulemaking, especially those generated through international authorities such as the Basel Committee on Banking Supervision. Within that context, there are some notables for the commercial real estate finance sector.

"Repeal and Replace" of Regulatory Provisions Probably Not Juicy Enough to Entice Volunteers

Hensarling sweetened the pot since the last round, but the bar is likely still too high. FCA 2.0 retains a provision allowing banks that maintain 10 percent leverage ratios to escape risk-based capital and stress-testing requirements. A 10 percent leverage ratio, however, is generally thought to be a non-starter for large banks. As a comparison, current risk-based capital requirements stand at 5 percent for banks and 6 percent for bank holding companies. Banks say even the current, lower levels constrain activities.

While stress-testing exemptions for qualifying banks take away a bit of the sting, the bill sponsors focus on the complexity of capital requirements and regulation as the primary constraint on business activity. However, the heightened capital requirements are the higher order challenge to much of the industry.

Alternatively, Banks Can Take a Lesser Gain and Feel No Pain

Where FCA 2.0 gets friendly to banks is not in the headline repeal-replace section, but in the basket of offerings it attempts to pass out more freely to all banks. Regardless of whether or not they choose the "regulatory off-ramp," banks would still have to comply with the risk-based capital regime and some stress-testing requirements in FCA 2.0, but all banks would benefit from:

• Stress tests that would be run by the banks themselves, as opposed to the Federal Reserve;

• Various forms of relief related to the Comprehensive Capital Analysis and Review, the qualitative complement to the stress test;

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percent from 77.1 percent a year earlier. RevPAR declined by 1.3 percent to $153.46.

Freitag warned that "the supply will be with us for a long time. But demand might not."

While New York has the heaviest construction pipeline in the country, Miami during the first quarter saw the steepest decline in RevPAR. It's been challenged by a number of factors. The Zika virus scare impacted travel to the area, hitting hotels hard. Also affecting the market were weak economic conditions in Brazil and Russia, both of which normally are strong tourism sources.

Hotel occupancy in Miami remained very healthy at 82 percent, but dropped by nearly one percentage point during the first quarter. Average room rates declined by 7.5 percent, to $227.37, resulting in an industry-leading 8.5 percent drop in RevPAR, to $186.36. Meanwhile, 3,707 rooms are in the area's construction pipeline, essentially unchanged from a year ago.

Houston, meanwhile, had the biggest drop in occupancy during the latest quarter. The city, which has been hard hit by the turmoil in the energy market caused by low prices, witnessed a 3.2 percent drop in occupancy to 63.7 percent. RevPAR, meanwhile, dropped by 4.5 percent to $77.16.

But those metrics haven't stopped developers from breaking ground on new projects, as 4,784 rooms are in the pipeline. If they're all completed, they would increase the city's existing supply of rooms by 5.5 percent. ■

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• Exclusion of prior operational risks from a bank's calculation and application of the framework to prospective risks only;
• Repeal of the Volcker rule; and
• Repeal of the risk-retention rule, except for residential mortgage-backed securities.

The above is only a partial list of the provisions that could apply to all banks, but it includes the most impactful.

Increased oversight and control of independent agencies is a highly contentious issue, especially since it would allow Congress and the President greater influence on a host of regulatory issues.

NRSROs Provide Additional Safe Harbors

FCA 2.0 provides several new measures that could benefit nationally recognized statistical rating organizations, or NRSRO businesses, with mitigations of both compliance and modeling prerequisites currently required under Dodd-Frank:
• Makes SEC examinations purely risk-based instead of strictly annual;
• Eliminates the requirement for corporate board approval of ratings methodologies;
• Eliminates attestations from chief executives for internal controls and conflict-management policies and procedures (Regulation AB II would be unaffected);
• Requires the SEC to improve and tailor the rules that govern the NRSRO "look-back" requirement that reaches those that do not have a conflict of interest; and
• Streamlines the content of information provided to the SEC.

Crowdfunding Allowed Greater Latitude

With respect to debt products, FCA 2.0 would allow crowdfunding entities to market a greater number of transactions to a wider range of investors.

Attempts at Oversight of Regulatory Agencies Extensive, But Possibly Non-Starters

As in the first version, FCA 2.0 interjects greater discipline on the regulatory agencies, as well as their rulemaking and enforcement authorities, while also still seeking to curtail the independence of certain bodies such as the Consumer Financial Protection Bureau and the Financial Stability Oversight Council.

Increased oversight and control of independent agencies is a highly contentious issue, especially since it would allow Congress and the President greater influence on a host of regulatory issues. Moreover, FCA 2.0 would repeal the Chevron Doctrine (a principle in administrative law that requires a court to give deference to agency interpretations of unclear statutes), which could further constrain an agency's discretion in the rulemaking process. FCA 2.0 also seeks to enforce greater cost-benefit discipline over rulemaking. However, the process would be subject to the vagaries of assumptions and model construction, and it begs the question of who is in control of those studies.

After a Lengthy Markup, CHOICE Act Approved by House Committee

During the same week that the House of Representatives slogged through a continuing resolution to avert a government shutdown and narrowly passed the American Healthcare Act to repeal and replace Obamacare, the committee conducted a marathon markup of FCA 2.0. In the end, the bill passed out of committee, intact, on a straight party-line vote of 34-26.

Although passage by the committee was almost a certainty from the beginning, Democrats did their best to delay and dilute the bill (e.g., they required the 600-page bill to be read in its entirety by committee staff). Many Democrats also repeatedly called for the legislation to be broken up into smaller bills in order to move forward on specific issues where there would be bipartisan support. In addition, they offered various amendments that would have stripped provisions from the bill, including the repeal of the Volcker rule. In total, 19 amendments were introduced by Democrats. All were defeated on party-line votes. Notably, none of the introduced amendments referenced FCA 2.0's repeal of Dodd-Frank's debit-card interchange fee limits (known as the Durbin Amendment). The Durbin Amendment repeal likely will be a flash-point going forward as retailers vigorously oppose the rollback and the provision has bipartisan friends and foes, with many in Congress loathe to revisit the issue.

The next step on the path for FCA 2.0 is consideration by the full House, though timing is uncertain. Passage in the House could be trickier with the Durbin Amendment debate—we expect a floor fight over the Durbin issue at the least.

Even if FCA 2.0 is passed by the House, its prospects are dim in the Senate, where it must win 60 votes to survive a filibuster. With only 52 Senate Republicans, FCA 2.0 would face the daunting task of flipping eight Democrats to advance the bill.

Stay tuned! ■

Martin Schuh is senior director and head of government relations for the CRE Finance Council. Christina Zausner is CREFC's senior director and head of industry and policy analysis.

The Brick-and-Mortar Retail Sector Faces a Revolution

By Catherine Liu

Since 2015, more than $72.6 billion of CMBS loans backed by retail properties have been successfully paid off or refinanced. They accounted for 28.19 percent of all private-label loans that were liquidated during the "wall of maturities" period.

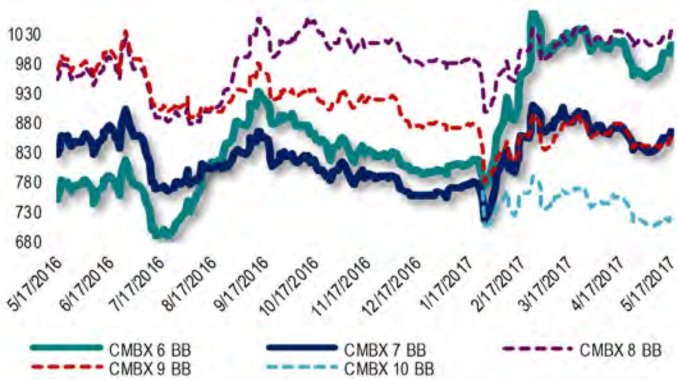
Stable commercial real estate fundamentals and abundant capital in a low interest-rate environment have helped more than 90 percent of the loans get resolved without any losses.

Loans against retail properties comprise the largest share of securitized debt scheduled to mature in the next few years: $25.3 billion is up for maturity this year, while an additional $42.5 billion will come due between 2018 and 2022. That's nearly one-third of the total volume of maturing CMBS loans for the time frame.

That's happening while the retail sector continues to be in the news. And mostly, not in a positive light. Well-established retail giants, such as Macy's and JCPenney, which in the past might have been viewed as being "too big to fail," have been ramping up plans to downsize their physical footprints. These conventional brick-and-mortar retailers, which often anchor shopping malls, are struggling to stay relevant. Malls are facing a period of changing consumer shopping habits, thanks mostly to the rise of e-commerce.

Securitized retail loans have a greater delinquency rate than loans against other property types, as loans originated during the market's peak years approach their maturity, and face difficulties getting refinanced. In April, the delinquency rate

CMBX 6/7/8/9/10 BB Spreads



Source: Trepp LLC

for retail loans was 6.28 percent, up roughly 75 basis points from the national average and up 128 bps from a year ago.

Meanwhile, lenders, aware that investors aren't keen on retail loans, have reduced their interest in them. The share of retail loans in CMBS deals that were issued in the first quarter was down 10 percent from the previous quarter.

While overall origination volumes in the CMBS world were down by 53 percent in the first quarter, retail originations were down by 76 percent.

In light of the retail malaise plaguing CMBS, more and more investors have been setting their eyes on a new "big short" opportunity that involves buying credit default swaps against a CMBS derivative index known as CMBX.

CMBX 6 and 7 Mall and Retail Center Overview

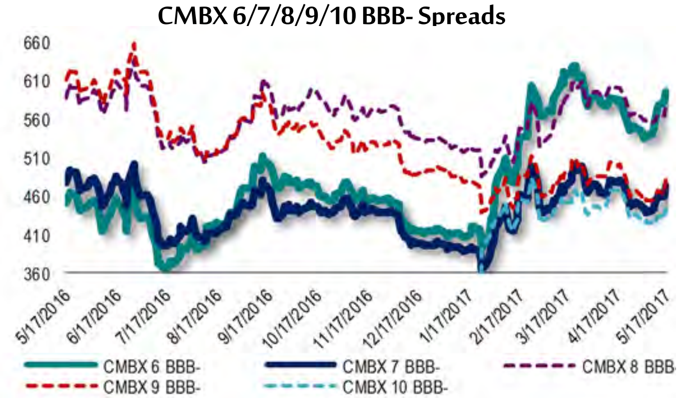
Total Current Balance: $9.54 Billion	
Watchlist	5.48%
WA LTV	61.26%
WA DSCR	2.19x
WA Occupancy	94.07%

Source: Trepp LLC

The indexes are tied to baskets of CMBS transactions from varying vintages, and is used by traders to measure the market's performance and enables them to take corresponding short or long positions. Earlier this year, several hedge funds and market participants, like investment firm Alder Hill Management and Deutsche Bank, discussed selling short the BBB- and BB bond components of the CMBX 6 and 7 series, which track conduit deals issued in 2012 and 2013 and are thought to have a greater exposure to lower-producing malls.

The argument was that class-B and -C malls in demographically weaker areas that rely heavily on anchors such as Sears, JCPenney and Macy's would suffer as each retailer has announced plans to shutter stores. Most inline stores

CMBX 6/7/8/9/10 BBB- Spreads



Source: Trepp LLC

at malls sign leases that include co-tenancy clauses, which generally give them leeway to either renegotiate lease terms or vacate if an anchor leaves. As tenants would vacate, loan defaults would spike, impacting CMBX values.

The general oversupply of malls in the U.S., along with market speculation of softening property values has further exacerbated the problem. Trepp LLC's internal database indicates that retail centers serve as collateral for over $9.5 billion in CMBS debt across 47 deals in CMBX 6 and 7.

The largest exposure is in WFRBS Commercial Mortgage Trust, 2012-C7, while the top loan to keep an eye on is the

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Building a Better Mousetrap: Harnessing New Technologies to Drive Site Selection Decisions

By C-J. Ford

For decades, the mantra used when selecting a site for office and retail users has been "location, location, location." In densified markets such as New York City, office tenants typically wanted to be near their clients and competitors, while retailers always desired to be in an area that catered to their target demographic.

That said, with the "flattening" of the geography in these markets, tenants are more concerned with the spaces that fit their business needs: drive times are being replaced with walk, transit and biking scores; traffic counts are being replaced with office user studies; and in place of general demographics, tenants are now closely examining location analytic tools.

So how does it all work, and why is this changing the way we look at site selection?

It's actually quite simple. To attract the best talent, tenants need to have the best spaces. Whether it's an open floor plan in new construction that's part of a trophy development or a destination retailer surrounded by diverse tenants that also complement the area, tenants are now having to think outside the box when choosing where to set up shop. While this initially could be a daunting task, there fortunately are a multitude of new technologies helping to ameliorate these tough decisions.

One way to tackle this task is through the integration of data and technologies through an Open API (Application Programming Interface). Since the early 2000s, Open API sources have changed the way clients look at space decisions, as the ability to merge technologies within an existing infrastructure has enabled users to quickly access multiple data sources in a singular interface. While this technology is well established, it's only come into practice in the commercial real estate space in recent years.

When Xceligent last year launched a web-based application for the creation of digital tour books, Xceligent Spaceful, one component of the application focused on integrating these APIs within the database. By allowing Spaceful users to view Walk and Transit Scores alongside building-level data, multiple data sources work together to facilitate efficient and informed decisions outside of typical decision-making factors, such as amount of light, total rentable square footage, etc.

The above example only scratches the surface of what is driving the industry. It seems like every other day, another company enters the marketplace with the promise of having the true solution to build a better mousetrap.

When thinking about retail site selection, the solutions space is even more convoluted. LocationGenius of Toronto provides crowd-sourced scoring and analytics to help retailers in the selection process. This is done using cellular network data, presence sensors and beacons to measure actual foot traffic near the location under consideration, and social media data. Foot traffic analysis is especially key, as it allows a service-oriented space user, such as a hair salon or coffee shop, to access real-time data to compare against multiple locations in their space search.

So the million dollar question is: where do we go from here? As this space becomes more and more crowded, the true champions will be the organizations who are able to truly combine location data with technology in a user-friendly format. This is already being demonstrated in the way companies are harnessing the power of new technologies and Open API and in the way technology is evolving to both partner with and guide the end user: the decision makers. ■

C-J. Ford is senior director of Analytics at Xceligent, a New York City company that tracks leasing and sales data for commercial real estate.

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$580 million mortgage against Miracle Mile Shops, a luxury mall complex in the heart of the Las Vegas Strip.

Perceived downside risk in the retail sector has caused subordinate CMBX spreads to go on a widening spree throughout the year. At the peak of the blowout in late March, BBB- spreads in CMBX 6 and 7 were 261 and 136 bps wider than their respective low points in late January. For BB bonds, spreads were 293 and 192 bps wider than their tights. Spreads have since recouped some of their losses, but for the 6 series, they're still 143 bps higher than levels reached a year ago.

Despite all the worries over the retail sector and the potential impact on retail loans, it's unlikely that a full-fledged collapse is on the horizon. Many have pegged the short as largely speculative, since U.S. real estate is still widely considered stable.

Meanwhile, there is concern that too many players have been crowding the same trade. Other skeptics doubt that a retail default crisis on the scale of the subprime mortgage crisis would ever occur and reason that the bet against retail wouldn't pay off for quite some time.

But uncertainty surrounding the retail sector has had a contagion effect on spreads at the lower end of the credit stack for the less seasoned CMBX 8 through 10 series, which point to deals issued in 2014 through 2016. Those deals typically have collateral loans that were somewhat conservatively underwritten and don't have much of an exposure to higher-risk malls.

Meanwhile, mall operators and retail tenants are aggressively pursuing new strategies to engage consumers. There are many success stories where developers have transformed "dead" malls by repurposing existing space, diversifying their tenant rosters and incorporating more advanced technology. By this account, the dynamic of the retail landscape is merely shifting, not dying. ■

Employment Growth in Major and Secondary Markets Reflected in CMBS Volumes

By Karina Estrella

As property investors increasingly focus on fast-growing "18-hour" cities, both major and secondary markets are experiencing accelerated growth rates. As a result, CMBS deals are seeing a growing volume of loans against properties in those markets.

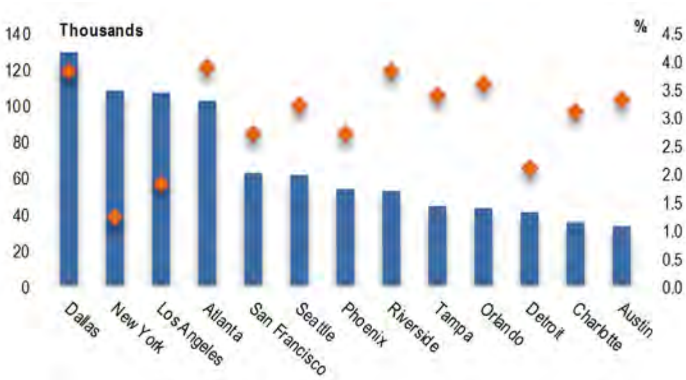
Top-tier markets—New York, Los Angeles, Chicago, Washington, D.C., San Francisco and Boston—are still showing consistent absolute economic growth. But property prices are reaching peak levels in the "big six" 24-hour cities, especially for office and retail properties.

The higher costs of living and higher cost of business in those markets are driving investors to expand into other markets, including up-and-coming secondary areas that have above-average urban populations. Those areas include Austin, Texas, Tampa, Fla., Orlando, Fla., Dallas, and Charlotte, N.C.

Employment

Major markets, such as Dallas, Houston, Philadelphia, Atlanta, Miami, Phoenix, Detroit, Seattle and Minneapolis, posted the highest absolute and relative growth in employment during the 12 months through March, netting 580,000 new jobs, for a 2.61 percent growth rate. Secondary markets, meaning those with employment bases of 900,000 to 1.5 million, followed, with a 2.39 percent growth rate in jobs. Both alternative market categories are now outperforming the gateway cities in job creation, as the top-tier markets gained a total of 430,000 jobs, for a 1.48 percent growth rate, during the period.

Metro-Area Nonfarm Job Growth (March 2015-2016)



Source: Trepp LLC

Dallas, New York, Los Angeles and Atlanta lead absolute job growth over the past year with more than 100,000 new jobs each. On the relative scale, Dallas, Atlanta, Riverside-San Bernardino, Calif., and Orlando outperformed, as each experienced greater than 3.5 percent employment growth.

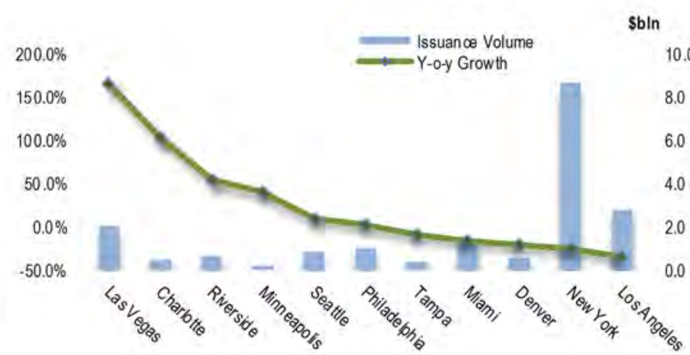
Employment ($million)

Market Type	March 2016	March 2017	Absolute Change	% Change
Top-Tier	29.13	29.56	0.43	1.48%
Major	22.23	22.81	0.58	2.61%
Secondary	22.87	23.41	0.55	2.39%
All U.S.	145.80	143.70	-2.10	-1.44%

Source: Bureau of Labor Statistics

Employers are flocking to major and secondary cities where it is less expensive to expand and do business, which in turn attracts job seekers and boosts population. The millennial demographic is a large driving factor drawing investors to 18-hour cities, which offer not only affordability, but also a vibrant "live, work and play" culture where entertainment and recreational opportunities are as abundant and accessible as career opportunities. Rising alternative cities have several characteristics in common: moderately priced housing, contemporary urban developments with amenities and strong transit-oriented infrastructure.

CMBS Issuance Growth (Last 12 Months)



Source: Trepp LLC

CMBS Originations

Meanwhile, a compression in property capitalization rates coupled with heavy competition from foreign investors in core markets is driving many investors, both foreign and domestic, to alternative U.S. markets, particularly for retail investments. These second-tier cities boast higher yielding property investment opportunities. Data from Trepp LLC reflect this shift, as the markets displaying high private-label CMBS issuance growth are no longer dominated by the 24-hour cities, but rather an assortment of secondary, major and top-tier metropolitan areas.

Leading Markets

Seattle, Las Vegas, Atlanta and Orlando top Trepp's CMBS market rankings. These markets boast robust population growth, employment growth and solid CMBS loan performance. Seattle, Las Vegas and Orlando are each in states that don't have an income tax, and Georgia has a

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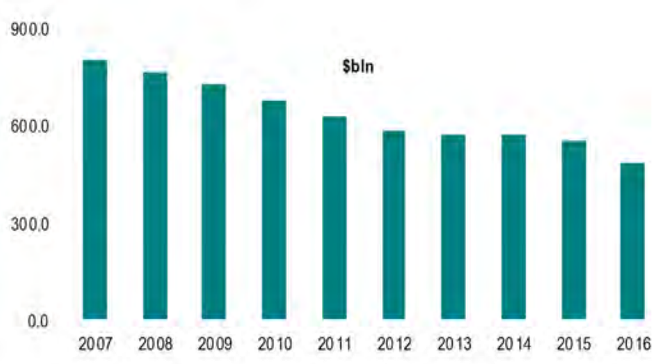
CMBS Universe Shrinks As Major Index Grows

By Orest Mandzy

The size of the CMBS universe has shrunk by roughly 40 percent over the past nine years, to $484.5 billion, as new originations have failed to keep pace with pay-offs.

Things don't bode well going forward as issuance has remained anemic. First-quarter issuance, for instance, was $12.6 billion—down 27 percent from a year earlier.

CMBS Outstanding



Source: Trepp LLC

Meanwhile, $34.2 billion of CMBS loans were paid off during the period.

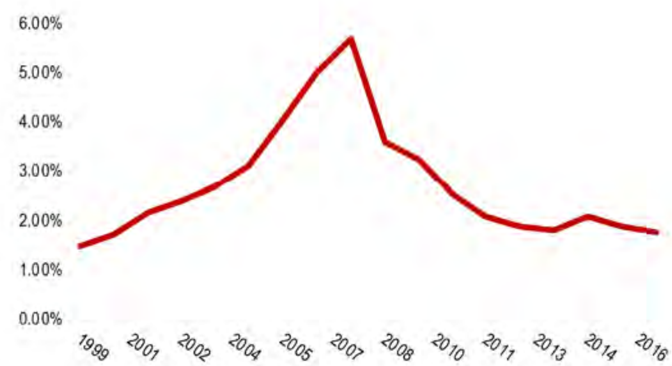
While issuance has picked up in recent weeks, the volume of loans that are coming due is increasing as well. A total of $24.7 billion of loans comes due during the third quarter and $15.6 billion in the fourth, which if they are repaid would bring payoffs for the year to just more than $103 billion. Issuance is unlikely to reach anywhere near that level. So the CMBS universe will continue to shrink.

That might may not be a good thing for the sector's long-term prospects. CMBS makes up 1.69 percent of the Bloomberg Barclays U.S. Aggregate Bond Index, a widely followed benchmark. The smaller CMBS becomes, the less relevant it is. At that point, investors who track the index could simply ignore CMBS if they choose.

The proportion of CMBS in the index has declined sharply from its peak in 2007, when it amounted to 5.66 percent of the index. Of course, the index itself has grown since then, but at the same time, the size of the eligible CMBS component has shrunk.

As recently as 2014, the index tracked $354.1 billion of CMBS, which amounted to 2.01 percent of the $17.6 trillion of bonds tracked. As of the end of last year, $321.9 billion of CMBS was in the index, which had grown to $19.1 trillion. ■

CMBS as % of BBG, Barc Agg Index



Source: Bloomberg Barclays US Aggregate Index

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reputable low tax burden and business-friendly climate. Some of the top markets are performing better than others in terms of private-label CMBS origination growth, which may signify different types of lenders are actively providing financing.

Markets in the Middle

Places like Phoenix, Dallas, Tampa, Boston, Charlotte, Denver and Riverside, Calif., have healthy job growth, and each (with the exception of Boston) posted employment growth rates of more than 2 percent for the year. These markets experienced varying degrees of CMBS loan performance. Some outperformed while others struggled with rising delinquency rates, below-average debt-service coverage ratios or sluggish growth in net operating incomes. Nevertheless, these middle-ranking markets could still provide interesting opportunities for CMBS lenders, as some of the lackluster CMBS growth rates may be attributed to lower-credit quality loans that were written before the Great Recession.

Slower Growth Markets

The markets at the bottom of Trepp's ranking are characterized by slower growth rates overall, and varying levels of improvement for loan performance. San Jose, Calif., Philadelphia, Columbus, Ohio, and New York City are within this group. These markets posted lower relative employment growth rates, and less active population growth. With the exception of Philadelphia, average occupancy decreased in each of the markets for the five major property types. These metros offer steady—although relatively slower—growth with less risk, compared to some of the faster growing areas.

Methodology

This analysis is intended to be a current snapshot ranking of the markets with the largest exposures in CMBS collateral, by balance. Only top-tier, major, and secondary markets were included. Trepp used nine factors, designed to measure not just absolute growth, but relative growth as well, during the period from March 2016 through March 2017. Each factor was given equal weighting.

- Absolute employment growth
- Percentage change in employment
- Unemployment rate
- Population growth (July 2015 - July 2016)
- Growth in net operating income
- Weighted average debt-service coverage ratio
- Growth in average occupancy rates
- Change in delinquency rate
- Year-over-year CMBS issuance growth ■

Is Abandoned Construction an Early Signal of Economic Change?

BuildFax specializes in translating construction data from building permits into property condition and history. But what about the building permits that never make it? Those projects that get started, but never completed?

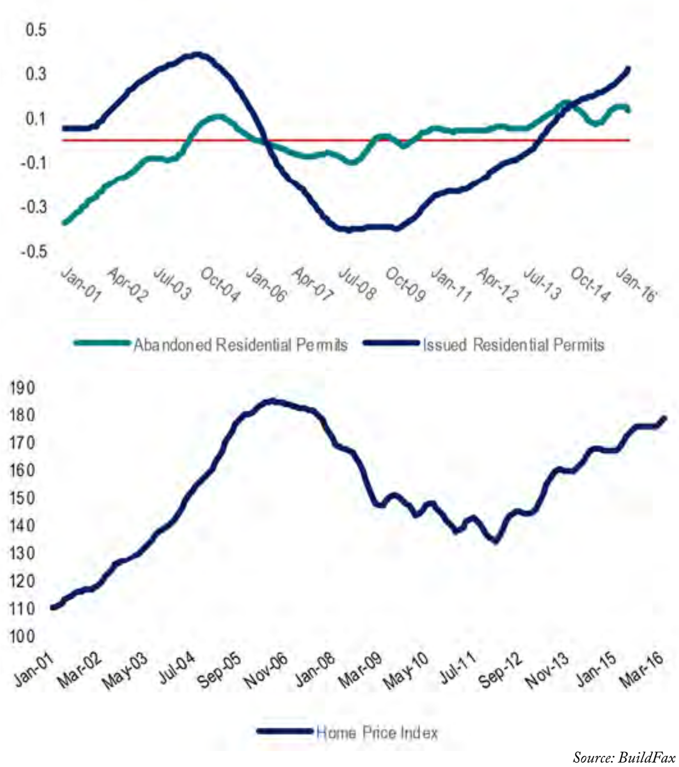
Could examining abandonment trends over the course of an economic downturn uncover a possible connection to the housing crisis, or even reveal a new leading indicator? And what about the rise in construction we are seeing now—is there a recurrence of abandoned projects in the current economy (or on the horizon)?

These construction records might have some pretty interesting stories to tell. (Spoiler alert: they do!)

A Tale of Two Trend Lines

It turns out that the trend lines for abandoned and issued residential building permits show signs indicating housing-market shifts.

Residential Issued Permits Vs. Abandoned



Source: BuildFax

When viewed together, residential permit issuance and abandonment followed similar trajectories in the early 2000s. Both climbed rapidly until they plummeted, with issuance peaking in September 2004 and abandonment peaking just five months later, in March 2005 (a whopping 15 months before the Home Price Index, or HPI, crashed). As a reference point, the HPI peaked in July 2006, marking the beginning of the economic downturn.

Considering the events of 2004 and 2005 (changes in financial regulations, excessive borrowing and swelling consumer indebtedness), it makes sense that people may have bitten off more than they could chew with construction projects. Perhaps many factors formed a perfect storm that left too many investors unable to complete their projects, and forced them to abandon ship.

Combined with a rapid rise in project abandonment, the sharp swing between construction starts appears to indicate an unstable pattern of growth. The pattern hasn't appeared again beyond the economic crisis, which may signal a more sustainable outlook. In fact, such a slow increase of project abandonment during the last 10 years may be a good sign for our economic future.

Abandoned residential construction projects have significant impact on the industries that serve the residential market.

- **Insurance Carriers**: Carriers should keep an eye on residential construction abandonment, especially as it relates to the properties on their books of business. Is it worth flagging properties that have had abandoned construction projects for possible review?
- **Building Product Manufacturers**: How might abandoned permits affect construction material sales and forecasting? Should a high frequency of abandoned construction projects in a certain area raise a red flag for manufacturers?
- **Equity Traders**: Might these trends reveal an untapped resource for trading signals?

More Smooth Sailing Ahead for CRE Sectors

With compelling findings for residential issuance and abandonment, commercial real estate could reveal some insights as well.

This study looked at three sectors: lodging-resort, healthcare and retail. Interestingly, construction activity in the three sectors took on distinct trends.

Retail permit issuance and abandonment were the most volatile over the 15-year period from 2001 through 2016, which may indicate greater churn than in the lodging-resort and healthcare industries. This is in line with the skyrocketing growth of online shopping over the last decade, which has disrupted sales at brick-and-mortar stores.

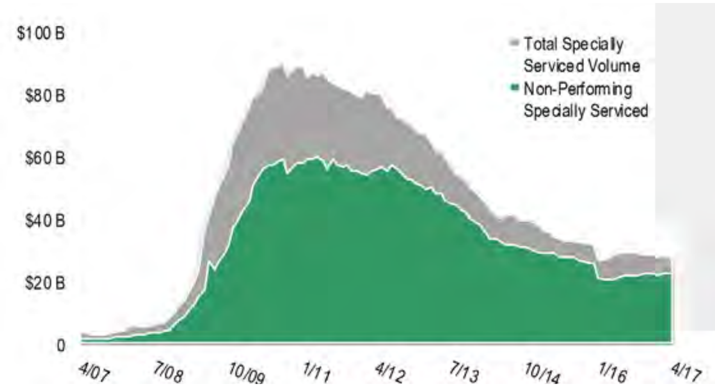
The smoother trends of lodging-resort and healthcare also make sense. Overall, the economy has been on an upswing: people are still vacationing. And they're still getting sick. Of the three sectors, healthcare is (understandably) most immune from macroeconomic business cycles.

Overall, abandonment is down, while permit issuance is up for each sector over the period. As expected, permit activity mimics trends in the larger economy, showing clear fluctuations during times of crisis and recovery, and long-horizon trends consistent with a growing economy. ■

BuildFax is an Austin, Texas, maintains a national database of construction permits.

The Data Digest

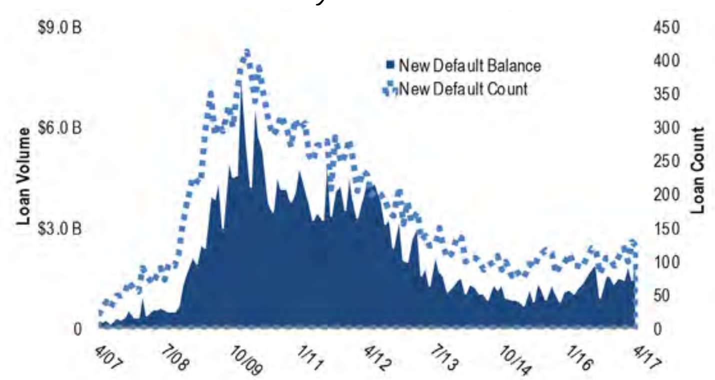
Special Servicer Volume



Source: Trepp LLC

The volume of CMBS loans in special servicing was $27.17 billion as of April, down 3.69 percent from the same time a year earlier. Volumes have not surpassed the $30 billion-mark since December 2015, when a total of $31.34 billion of loans was in the hands of special servicers.

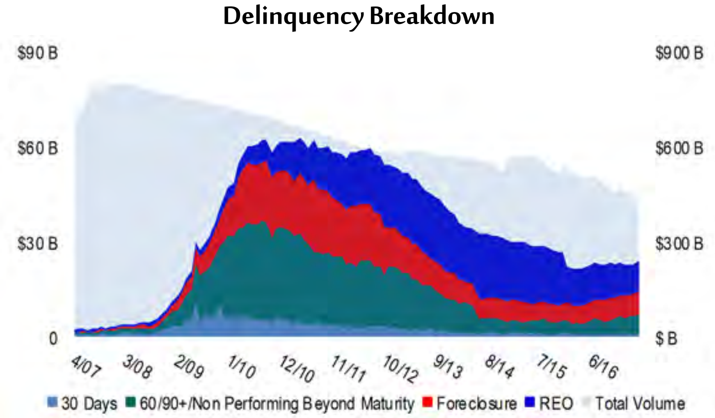
Monthly New Defaults



Source: Trepp LLC

A total of $2.44 billion of fresh debt went into default in April. That's the highest monthly volume of delinquent CMBS loans since March 2013, when $3.03 billion of securitized debt was past due. Through the first four months of the year, the average monthly balance of new defaults totaled $1.80 billion, up from $1.13 billion for the same four-month period a year earlier.

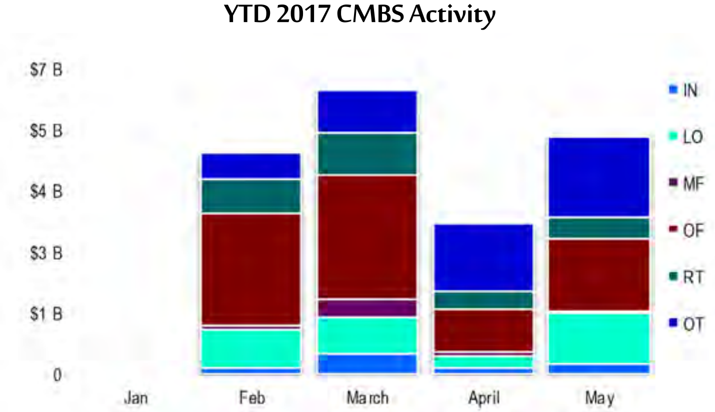
Delinquency Breakdown



Source: Trepp LLC

The delinquency rate for securitized loans was 5.54 percent as of the end of April, up from 4.22 percent a year earlier. But that's been exacerbated by a shrinking denominator. The size of the CMBS universe has declined to $425.7 billion from $503.3 billion over that time. Delinquency volumes, meanwhile, have increased to $23.6 billion from $21.3 billion.

YTD 2017 CMBS Activity



Source: Trepp LLC

This year's CMBS issuance has had an 18.1 percent concentration of retail loans. That's down from last year's 19.2 percent concentration. Meanwhile, the sector is steadily increasing its taste for office collateral, which is up to 33.7 percent so far this year, from last year's 26 percent.

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