The Big Read Property sector

Pandemic exposes ‘severe stress’ in commercial property financing

Mortgage-backed securities fill a funding gap but as delinquencies rise investors are bracing for losses

Joe Rennison in London AUGUST 30, 2020

Over the course of 150 years, America’s oldest continuously running hotel has never been closed for this long.

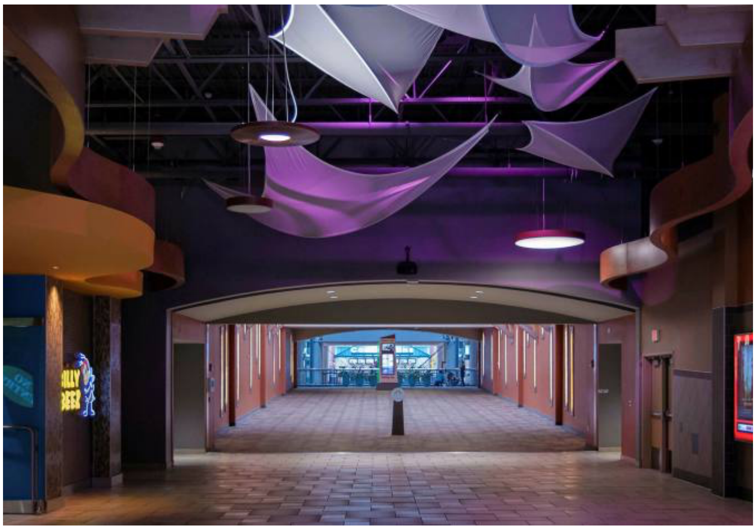
Yet, as stay-at-home orders took hold in March, all but one of the 1,641 rooms at the Palmer House Hilton in the centre of Chicago began to empty out, with the hotel eventually suspending operations on April 28 for all except a single long-term resident.

Its wide marble staircase now leads down to a near silent lobby after Hilton, which manages the property on behalf of the real estate investment firm Thor Equities, furloughed more than 90 per cent of the hotel’s 900 staff.

The fate of the property is not only emblematic of the severity of the crisis emerging for the hotel industry but also of the pressure building across the commercial real estate sector — from small-town malls to sky-high office blocks — hitting one of its primary sources of financing; the $1.4tn market for commercial mortgage-backed securities.

“I don’t think anyone foresaw the devastation that Covid would wreak on commercial real estate and the CMBS market,” says Lea Overby, an analyst at Wells Fargo who has covered the sector for almost two decades.

›ures on America’s malls, such as the Destiny in Syracuse, New York… © Alamy



…have been accelerated by the pandemic as properties empty and shoppers move online © Alamy

CMBS take either one, very large commercial mortgage — as is the case with the Palmer House deal — or bundle up a group of smaller property loans in what is known as a “conduit” deal. The mortgages are then used to underpin the sale of layers of fresh debt, with cascading exposure to the default of the underlying mortgages. The mortgage payments on the property, or properties, are then used to repay investors, such as fund managers and insurers.

Those investors are now bracing for losses, sitting at one end of a chain of turmoil that links millions of workers suddenly without jobs or furloughed after hotels, shops and offices closed their doors, to building owners in the middle, facing the prospect of handing the keys over to their lenders.

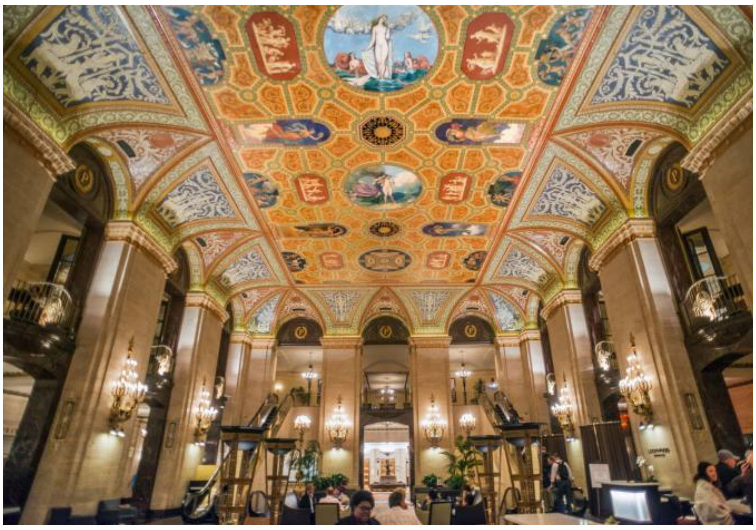
"This is severe economic stress," says Ms Overby.

'Zero to 60 in two seconds'

When Potter Palmer first built Palmer House in 1871, the hotel lasted just two weeks before it burnt to the ground in the great Chicago fire. Palmer, a local businessman, immediately began work rebuilding the property, financing it with $1.7m in unsecured debt — believed to be the largest ever individual loan at the time.

A century and a half later, the financing for the property has evolved. Thor Equities bought the property from Hilton in 2005 for $230m. Following a $170m renovation, Thor negotiated a new $330m mortgage on the property with JPMorgan, which was subsequently sliced up and used by the bank to underpin a CMBS deal sold to investors in 2018.

er House Hilton in Chicago, one of America's longest running hotels, suspended operations on April 28… © Alamy



…its fate is emblematic of the severity of the crisis emerging for the hospitality industry © Alamy

As coronavirus spread in the US, revenues at the Palmer House fell. Thor has not made its monthly mortgage payment since April. Instead, it requested a six-month forbearance on its loan due to "Covid-19 concerns", according to servicing notes in a document from Wells Fargo, the deals' trustee. The Wells Fargo document dated August 17 lists the property as being in foreclosure. "Default notices were sent to the borrower," it notes.

"The entire hospitality industry has been devastated by the pandemic," said Thor Equities, in a statement to the Financial Times.

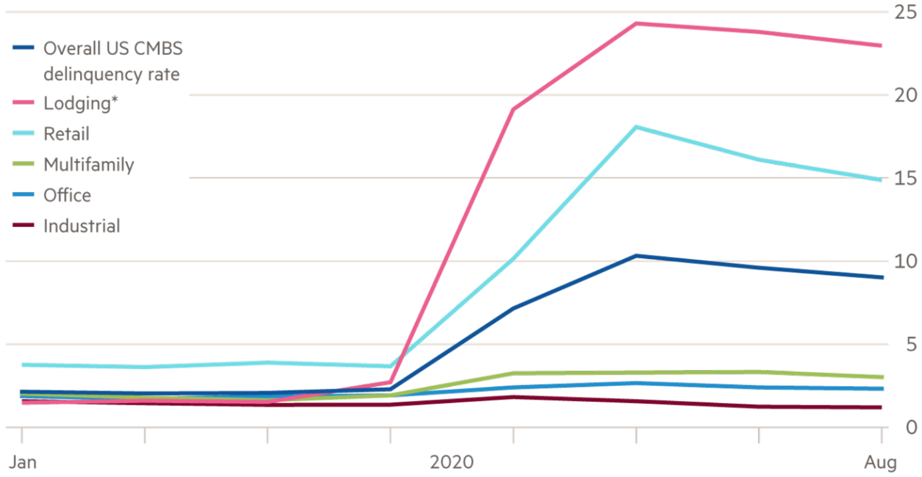
The impact of the pandemic is being felt across other property types too. Malls remain empty as shoppers' shift online. Office blocks face an uncertain future as the effects of working from home begin to alter companies' requirements for desk space. Renters in apartment blocks face challenges as government programmes to support consumers dwindle.

Approaching the end of August, almost a quarter of all hotel loans bundled into CMBS had failed to pay their mortgage for at least 30 days — classified as delinquent — followed by 15 per cent of retail loans, according to data from Trepp.

Bond investors have responded accordingly. In the CMBS deal backed by the Palmer House Hilton, the original triple-B-rated tranche — a rating that signalled it was a reasonably safe "investment-grade" asset — has slumped to below 80 cents on the dollar. Moody's has cut the debt to a junk rating.

Commercial mortgage-backed securities delinquencies

Delinquency rate, 2020 (%)



* The lodging category is largely made up of hotels
Source: Trepp

"In 2009 it took some time before we saw significant commercial real estate delinquencies," says Alan Kronovet, head of commercial mortgage servicing at Wells Fargo, declining to comment on the Palmer House loan specifically. "In this pandemic we went from zero to 60 in two seconds."

Filling a funding vacuum

In February 1994, shortly after he had struck one of the first CMBS deals, Ethan Penner threw a weekend event for the emerging industry at the Boca Raton Resort & Club in Florida.

For the previous three years he had worked to bring together commercial real estate owners and bond investors that up until then had no cause to have any dealings with one another. That night, Elton John played for two and half hours to 500 guests, says Mr Penner, who is widely credited as the architect of the CMBS industry. "Grown men were crying," he adds.

bustling buildings around the Westin Bonaventure Hotel and Suites, Los Angeles, now stand empty © David McNew/Getty

The CMBS market grew out of the decade-long savings and loans crisis that began in the mid-1980s, and which saw the demise of over 1,000 savings and loans institutions crucial to financing commercial real estate. It left a vacuum in funding for the industry. "All the capital providers abandoned the business at the same time," says Mr Penner. "The real estate industry found itself without a lender."

While leading real estate figures like Sam Zell turned to public equity markets, Mr Penner thought CMBS could provide a solution. He joined Nomura in 1993 with the intention of developing the market.

The basic mechanics of CMBS remain much the same as they were in those early deals. Lenders — often banks — originate loans that are then sold to a trust. The trustee effectively acts on behalf of investors that buy bonds backed by the payments on the loans. A master servicer is appointed to collect the payments and deliver them to the trust.

y lobby at International Place in Boston's financial district is a sight echoed across the country © David L Ryan/Boston Globe/Getty

There are three main master servicers in the US — Wells Fargo, KeyBank and Midland Loan Services. If borrowers fail to pay, the servicer will advance the funds up to the value of the property collateralising the loan.

Most of the debt is rated triple-A, with agencies comfortable giving such high-quality ratings to those tranches because of the protection provided by the lower-rated tranches, which absorb losses first.

The market grew rapidly into a $900bn industry — responsible for over 50 per cent of commercial real estate funding before the 2008 financial crisis — according to data from Bank of America and the Commercial Real Estate Finance Council. Much as it was for residential mortgage bonds that fuelled the economic downturn, the next few years proved a reckoning for the loose underwriting and weak protections that had taken hold in the boom years.

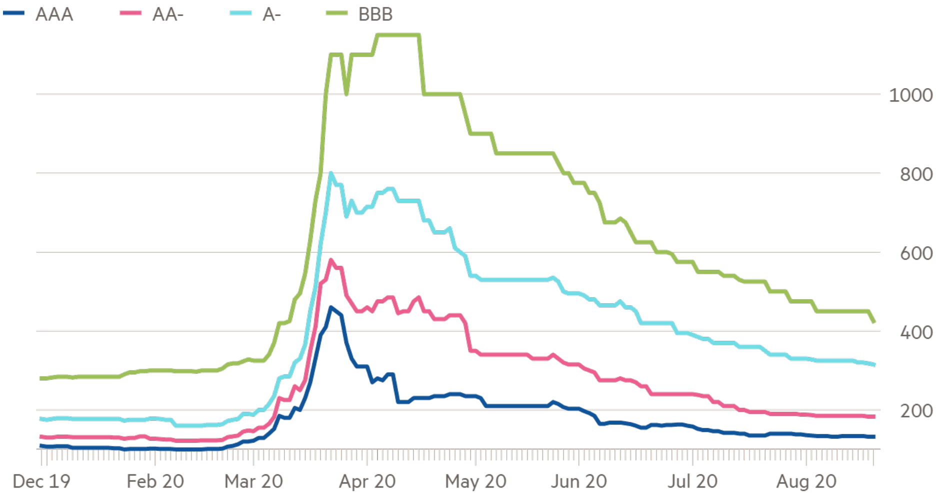
“Over time the standards in the market reduced and reduced,” says Joel Ross, a veteran of the hotel CMBS industry. “By 2006 the standards were almost non-existent. By 2007 if you were breathing you could get a loan.”

In the decade since, analysts say underwriting in the industry has improved and rating agencies have begun requiring more protection for investors in the highest rated tranches. What's more, the dominoes of derivatives and financial alchemy that toppled the housing market in 2008 and knocked through the broader economy are less pronounced for commercial mortgages.

But vulnerabilities remain.

The changing spreads for CMBS tranches

Basis points, by rating



Source: Wells Fargo

Need for greater protection

Moody's warned last year that the protection from defaults for higher-rated tranches of conduit CMBS deals was too low, saying the market had stopped soliciting their ratings as they became more stringent.

Ahead of the last downturn, this default protection for the average triple B-rated bond sat at just above 3 per cent of the loan balance. That means that 3 per cent of the total owed by borrowers underpinning a CMBS deal could remain unpaid and triple-B tranche investors would still get their money back

Analysts and investors say that has now risen to around 7 per cent. Wells Fargo analysts anticipate overall losses rising to between 6.5 per cent and 8.7 per cent over the lifetime of a typical CMBS deal. "When we are talking to investors we are very upfront that a lot of triple Bs will take a loss," says Ms Overby, "and some will take a big loss".

Kevin Fagan, a senior credit officer at Moodys, says that such widespread losses is exactly what the rating agency had tried to warn against. "We did not think the enhancement going into this crisis, for years before, had been sufficient."

has hit one of the primary sources of real estate financing; the $1.4tn market for commercial mortgage-backed securities © Alexi Rosenfeld/Getty

For bonds backed by a single, large mortgage, the story is a little different. Credit enhancement is more varied, depending on the specifics of the deal, but it is normally much higher due to the greater risk of being dependent on the performance of just one property. In the case of the Palmer House Hilton, investors in the triple-B-rated bond are protected from almost 33 per cent of losses, according to the trustee report.

Edward Shugrue, who runs a $300m CMBS fund at RiverPark, the Kansas City-based fund manager, is "exceedingly comfortable" holding the Palmer House backed debt. He does not expect Thor to recover and repay the mortgage. Instead he anticipates the storied property will be sold and that he will get his money back.

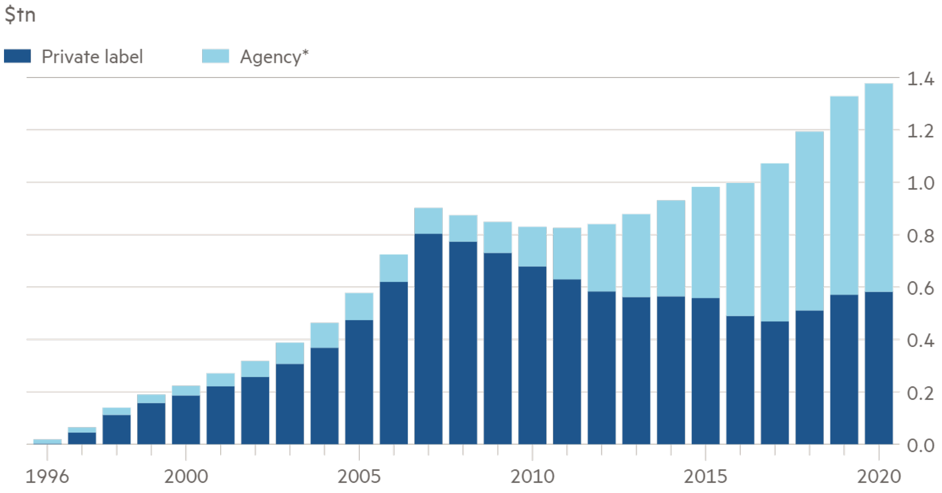
"This hotel has lived through the Spanish flu and guess what, it is still standing," says Mr Shugrue. "Palmer House is always going to exist."

Investors in other properties are more sceptical. The Destiny Mall in Syracuse, New York, is one of the largest regional shopping centres in America. The triple-B-rated tranche of the CMBS backed by the property has been downgraded by Kroll to triple C, implying a high likelihood that it will default. Even the double-A-rated tranche — awarded the stellar rating by both Kroll and S&P — has slipped to a junk rating of double B. Investors say they have seen the tranche traded in the market for as little as 50 cents on the dollar.

The pressure on America's malls has been accelerated by Covid-19 as more shoppers move online. The properties are also harder to repurpose, say analysts, impinging on the possible recovery value to investors in the bonds if the malls are sold. It's a similar story for some hotels. The trustee documents note that Palmer House has had an appraisal of its value that came in at almost $30m less than the value of the mortgage.

"Why would you want to own these properties?" asks Mr Ross, the industry veteran, "what are you going to do with them?"

Outstanding US commercial mortgage-backed securities



* Agency backed CMBS encompass deals structured by government agencies such as Fannie Mae and Freddie Mac
2020 figures as at Jul 1 while all other years as of Dec 1
Source: Bank of America

Call for more protection

The pain in the market has led to calls for assistance from Washington. Other industries have received help, so too should commercial real estate, argue industry groups.

Thor Equities said that Palmer House had so far been ineligible for government support, like many other properties. "We are hopeful the government stimulus plan will help these places of employment for so many individuals and numerous adversely affected communities," the company added.

The Federal Reserve has stepped in to purchase some of the senior most, triple A rated securities of deals but proposals for a more substantial intervention pose problems.

Critics, both inside and outside the CMBS industry argue that a bailout would simply protect institutional property owners — like private equity firms and real estate companies — from losses, while putting taxpayer money at risk and leaving those laid off as businesses have closed their doors still unemployed.

"The real estate industry wants to bail out borrowers who knew exactly what they were getting into with these loans," says Marty Leary, research director at Unite Here, a union for hospitality workers. "Don't say this is about employment. This [support for CMBS] will not bring back a single job."

There are more structural issues as well. CMBS tend to prohibit mortgage borrowers taking on more debt, which has been the government's proposed solution in other areas of the economy.

Instead, lobbyists are pursuing a riskier alternative, calling on the government to lend money at a fixed interest rate through what is known as preferred equity. The Helping Open Properties Endeavor bill has been introduced in the House of Representatives but has yet to be enacted. Essentially, it is asking the US government to lend money to ailing properties and then to take losses ahead of bondholders should things turn sour.

"The question is whether this is a bridge or a crutch," says Lisa Pendergast at the Commercial Real Estate Finance Council. "We see it as a bridge to Covid's end."

ıe best-case scenario the US commercial real estate sector may have fundamentally changed, leaving CMBS bondholders carrying the bag © David McNew/Getty

Even without additional government aid, there are glimmers of hope. The price of debt in the CMBS markets has rebounded from its nadir in March, with the recovery most pronounced in the higher-rated tranches. New deals — mostly avoiding sectors worst hit by coronavirus — have also managed to be sold, breathing new life into the CMBS market.

The industry is far from being on a firm footing, however. Even in the best-case scenario, with a broad economic recovery in the US, office properties will struggle to repay rent if businesses scale back on floor space. Hotels catering to conferences will struggle if companies stop spending money on business trips. That means bondholders in CMBS may still be left holding the bag.

"We could simply have less demand for commercial real estate," says Ms Overby. "My biggest fear is that the sharp rebound we are hoping for doesn't materialise. If it doesn't come there will certainly be another leg down within commercial real estate."

This article was updated on August 30 to make clear Thor Equities bought Palmer House from Hilton Hotels