LIGHTBOX

THE STATE OF DISTRESS

A SNAPSHOT REPORT - December 2021

DISTRESS IN COMMERCIAL REAL ESTATE: PAST, PRESENT & FUTURE

As we approach the two-year mark of the pandemic, the commercial real estate industry continues to rebound from a varied level of volatility across several sectors. One area that has been a surprise --and continues to be on the radar for many practitioners -- is the distressed property segment. Very early in the pandemic, some anticipated a tsunami of distressed properties of more than $1 trillion. Now, approximately 20 months later, the industry is still waiting for that shoe to drop.

Statistics from The Mortgage Brokers Association (MBA) show that over 95% of loans are current. Research by Trepp points to a level of CMBS distress that was 4.61% in October. Delinquencies recorded by the Federal Reserve remain below 1%. No one questions the presence of distress in the market—and the ongoing threat it poses. It just hasn't reached overwhelming levels, at least not yet. But there likely is trouble lurking in the shadows.

Commercial real estate (CRE) investment is occurring at unprecedented levels. According to statistics by Real Capital Analytics, the drive for higher yield pushed quarterly and year-to-date investment activity to record levels. Third Quarter 2021 sales totaled $193 billion, up 19% from 2019 and a level setting the tone for 2021. For the year activity has increased to $462.1 billion.

> *"Certain statistics and data points conjure the belief that the worst is over and the CRE market is back on solid footing. But experts we talk to contend that the inevitable has only been delayed; we've kicked the can down the road."*
>
> Tina Lichens, SVP, Broker Operations, LightBox

LightBox's Snapshot Report on the State of Distressed Real Estate provides perspectives on CRE distress and the opportunities it is creating and expected to create. Key findings of the report, based on a review of data from leading and trusted economic and sector sources as well as interviews with industry experts, include:

- The tsunami of distressed assets hasn't materialized, although distress among certain owner types and asset classes can't be downplayed.
- Shadow Distress - assets, businesses and investors that have been propped up by relief efforts and/or relaxed regulations—will intensify the pain in 2022. In short, we're far from "out of the woods".
- A LightBox analysis of special servicer activity points to increasing potential distress moving forward, with nearly half to occur into 2023 and later.
- Today's focus is on office assets as companies plot the potential land mines of the post-pandemic work environment; some hotel and retail properties remain tenuous because fundamental issues haven't been addressed.
- The marketing of loans/notes is heating up, especially for banks trying to clean up balance sheets but less for special services whose protocols are more rigid.
- Distressed/opportunistic funds are flush with record levels of cash, but short on ideal target opportunities.

BY THE NUMBERS - KICKING THE CAN DOWN THE ROAD?

LightBox's analysis of 3Q 2021 data from Morningstar reinforces the lingering threat of distress into 2023 and beyond. The study of special servicer notes and collateral for 385 delinquent tranches classified almost 1,300 properties on the probability of becoming REO and disposed of by the trust. Forty-nine percent of the properties—47.3% of the total value—are very early in the REO stage and may not be ready for disposition until late 2023 and beyond. Almost 24% of the properties are likely disposition candidates in 2022.

"There are some hidden risks lurking, waiting to rear their ugly heads," says Edward Weil, an attorney and partner in the Chicago office of the 400-lawyer national law firm Dykema.

Additionally, as one special servicer noted, based on experience during the great financial crisis, "it can take 10-12 quarters from the onset of a financial crisis until the true impact of distress is encountered."

SPECIAL SERVICER DATA

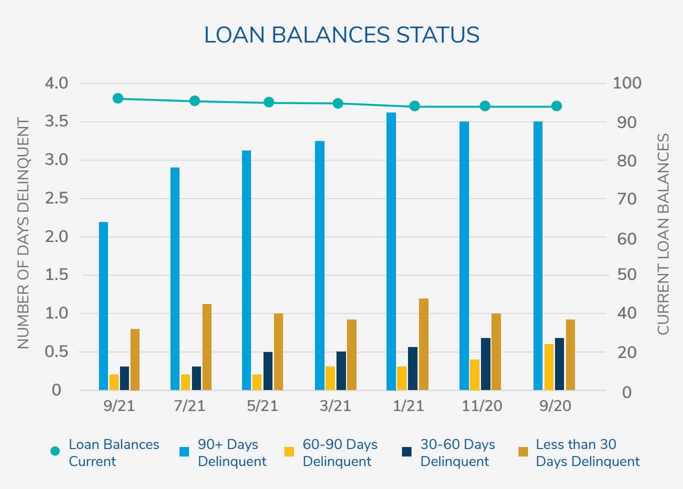
	Tier 1		Tier 2		Tier 3		Tier 4		Tier 5		Total	
Special Servicer	###	$$$*	###	$$$*	###	$$$*	###	$$$*	###	$$$*	###	$$$*
LNR	84	877	51	1,000	131	3,300	2	17	30	175	298	5,369
Rialto	55	792	63	595	219	3,000	-	-	-	-	337	4,387
CII/Greystone	24	400	10	445	12	362	2	200	1	52	49	1,459
CW	35	536	21	394	43	888	34	528	-	-	133	2,350
Midlands	91	1,750	92	1,950	112	2,550	-	-	-	-	295	6,250
Others (various)	16	175	45	1,770	113	380	-	-	-	-	174	2,325
Total	305	4,530	282	6,154	630	10,480	38	745	31	277	1,286	22,140
Total (%)	**23.7%**	**20.5%**	**21.9%**	**27.8%**	**49.0%**	**47.3%**	**3.0%**	**3.4%**	**2.4%**	**1.0%**		

** Dollar amounts are in millions*

Tier 1: Assets that are on track to become REO and/or disposed in 2022
Tier 2: Assets that are in the beginning stages of REO and/or disposed of in 22/23
Tier 3: Assets early in the REO stage and may be returned to Master Servicer. Disposed of in 2023 or beyond
Tier 4: Unable to determine with current reporting
Tier 5: Assets that already have gone to market or strategy already declined

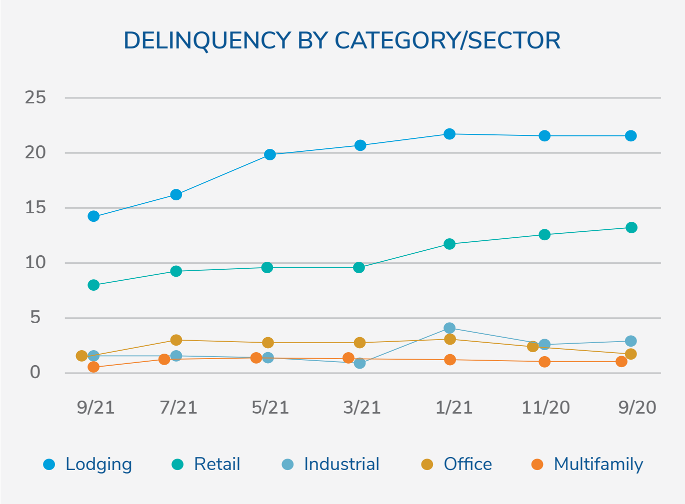
STATISTICS TELL A MIXED STORY

There are ample statistics available to present the state of the distressed real estate market. Yet these statistics only tell a portion of the story. At the end of the third quarter, for example, according to the Mortgage Bankers Association (MBA), 96.7% of loan balances are current; 2.2% being delinquent by 90+ days. Yet Jon Winick, President, Clark Street Capital, says pay history has never been more misleading than it is today.



"Whether it is CMBS, conventional banks or other sources, you see borrowers making payments," he says. "Drill down further and you see borrowers flush with stimulus cash, but underlying business operations are down."

On the surface it looks good. But in reality, Winick says there are lots of shadow workout assets and there is little understanding of the depth or darkness of the shadows.



Everyone knows the distress that has been felt in the lodging and retail sectors, and the improvements that have been made over time. But characterizing the improvement of certain sectors, or specific properties, as turnarounds is generous, Winick suggests. A more appropriate characterization could be turning the corner.

Improvement is trending in the right direction, but revenue streams could be down by 30 percent from 2020.

Most in the industry generally agree that the pre-covid issues that stressed the industry as a whole continue to exist. Many in the industry sing the familiar refrain, "COVID exacerbated or accelerated the situation."

Further addressing the risks that lie ahead, Weil says delinquencies are artificially lower in the office sector, particularly for B and C buildings that are 20-plus years old, lack the amenities and energy efficiencies, are farther away from mass transit, and have ownership entities that have been propping up the assets.

> *"The office sector's reckoning day is coming."*
>
> Edward Weil, Dykema

Weil doesn't rule out that distress could become more prevalent in newer, Class A buildings. Uncertainty among office space users is rampant as businesses work to define workplace strategies, including how they will address work from home philosophies. Increasingly, landlords are facing the long term outlook for decreasing tenant demand for space.

ON THE WATCH LIST

The concerns of those who are active in the distressed arena are really no different than for CRE as a whole. Weil says there are many potential threats, both domestically and on the world stage, with most linked to the competitiveness of the U.S. as a common thread. Consider:

- Labor/Employment - the ability to attract and retain employees is a universal concern. Its impact is more critical in some sectors more than others—like hotels, hospitality and retail where WFH options aren't an option.

- Inflation and Supply Chain - supply chain issues, among other factors, further impact distress situations for properties that require commodity construction materials to bring a hotel property in compliance with the corporate standards or keep an existing retail or office asset from losing its marketability. For owners already in distress, inflationary pressures can be daunting.

- Too Much/Lingering Stimulus - some experts contend that further stimulus measures will create opportunities to avoid confronting issues and trouble spots and, in some cases, create a false sense of security. Jon Winick, Clark Street Capital, hopes there are no further Covid relief programs, believing it's time for tough love.

- Robust Infrastructure Law Implementation - implementing an impactful infrastructure program is viewed as a measure that can more broadly impact the long-term importance and viability of central cities. The consensus is that improving central cities' transportation will bear fruit, enhance competitiveness and improve the performance of real estate and real estate loans.

"We have to be more competitive. Increased competitiveness, whether it's improving our transportation infrastructure or helping women get back and actively participating in the workforce at all levels puts us on a level playing field with the rest of the world," Weil said.

> *"If you don't allow properties, borrowers or loans to fail, there will be consequences."*
>
> Jon Winick, Clark Street Capital

BRIGHT SPOTS & OPPORTUNITIES

Profitability among the largest banks represents a positive business story. Still, many banks are closely scrutinizing loan portfolios to assess strengths and weaknesses, threats and opportunities to their balance sheet.

According to Winick, this creates opportunities for loan sales. Some of these represent a preemptive strike, to sell off what may be deemed to be future problems. "We're seeing positive momentum in terms of loan sales and new loans being brought to market."

Weil offered a differing opinion. "Note sales are always a tool in the tool kit, but largely depend on the role you play in the ecosystem," Weil says. "Special servicers typically are looking to create greater value more commonly associated with a workout reinstatement or negotiated buyout. That makes loan sales unlikely as a first or second option."

In spite of the differing opinions, the number of notes being brought to market through LightBox has been steadily increasing. Through the end of October, the number of notes brought to market had exceeded the totals for 2020 by 25.5% and 2019 by 88.2%.

BRIGHT SPOTS & OPPORTUNITIES *(cont'd.)*

Special servicers also report seeing life, and profitability, on the other side of distress. This is already playing out across the country, especially where certain dynamics—an attractive buyer pool and a lack of product—exist. The results have been somewhat surprising by the level of participation and interest by prospective buyers. This in turn has some special servicers taking a more proactive route to stabilize the asset and create value.

THE INSATIABLE APPETITE FOR RISK

Earlier this year, CBRE's Annual Investor Intentions Survey reported that as investors aim for higher returns, they have a greater tolerance for risk. Accordingly, nearly 30% of participants—the highest in the survey's seven year history—are targeting distressed/opportunistic asset investments. In 2021, 10% specifically cited distressed assets versus 0% in 2020. The survey analysis cautioned that deal sourcing could be challenging as the level of distress has been mitigated by stimulus and relief measures.

Various investment firms have raised considerable amounts of cash targeting the distressed property market. By mid-October, according to a Wall Street Journal story citing Preqin statistics, more than $90 billion had been raised by 179 U.S. real estate funds for investing in distressed assets. Many funds far exceeded fundraising goals.

Earlier this fall, for example, Starwood announced the closing of a $10 billion fund. Some of the firms/funds have the ability to invest not only in distressed real estate assets, but in the companies that control those assets. Earlier this year, for example, Blackstone and Starwood acquired Extended Stay America for approximately $6 billion.

Jay Olshonsky, President and CEO of NAI Global in New York City said, "With the amount of funds that have been raised because of investors' appetite for distressed and opportunistic situations, fund sponsors will have to move into other types of investments due to lack of distressed product to buy."

TRENDS TO WATCH

- The Sunset - when the CARES Act and other pandemic support measures (i.e., the re-interpretation of FASB regarding Troubled Debt Restructurings) sunset early next year, the market is expected to see more foreclosures. It won't happen immediately, but over time, with activity expected to build through mid-year and beyond.

- Deployment of Dry Powder - can and will significant capital—especially for distressed funds—hold out for the likely building wave of distressed assets, or will pre-emptive investments be more prevalent? Experts are debating this topic and agree that only time will tell.

- The Dynamics of the Office Market - owners, lenders and investors anxiously await greater clarity on how companies adapt their workplace solutions and requirements, and how this will impact the office market long-term. As Olshonsky noted, he's concerned with the impact work from anywhere will have on further accelerating the movement of office buildings to a position of greater distress.

- Key Economic Benchmarks - barometers such as bank profitability and bankruptcy levels help further define the economic landscape. Profitable banks may be more forgiving of loans. Business and personal bankruptcies showcase the difficulties that entrepreneurs, business owners and corporations face and are a predictor of future issues.

"In the absence of any significant black swan type of event, a greater occurrence of distress in the CRE market is expected to build gradually throughout 2022, as previous measures to stave off a crisis burn off or are eliminated. Property owners, lenders and special services will be forced to get creative and/or rely on familiar tactics to cure their distress."

Steve Shanahan, General Manager, Broker Solutions, LightBox

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- **Trepp**
- **RCA**

About LightBox

LightBox is a leading provider of CRE data and workflow solutions for marketing, prospecting, due diligence, risk management, and location intelligence that enable decision making for 50,000 CRE brokers, 1,100 banks and lenders, 2,000 appraisal firms, and 5,000 environmental consulting and engineering firms. By combining proven brands with innovative technology and data capabilities, the company is creating new solutions to facilitate transparency, efficiency and insight for real estate.

Through RCM, LightBox offers a global marketplace for buying and selling CRE and increases the speed, exposure, and security of CRE sales through a streamlined online platform. Solutions include integrated property marketing, transaction management, and business intelligence tools to unify broker-level and firm-level data and workflows. The company has executed over 72,000 assignments with total consideration in excess of $2.4 trillion. Approximately 50% of all U.S. commercial assets sold, over $10 million, are brought to market using the company's online marketplace annually. LightBox was established in 2018 and backed by Silver Lake and Battery Ventures. Learn more and follow LightBox at www.lightboxre.com, on Twitter at @LightBoxRE, or on LinkedIn.

For More Information Please Contact: info@lightboxre.com | 888-440-7261 | www.lightboxre.com