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CRE Finance Council Miami 2024

Key Takeaways:

2024 CREFC Hot Topics

Authors: Teresa Long and Alicia Davis

There were a range of hot topics covered at the 30th Annual CREFC Conference in Miami on January 7-10, 2024. Here's what our team heard on interest rates, asset classes, property insurance, lending volume, distress/workouts and securitization.

Interest Rates:

- The pervasive topic at this year's conference was the impact and future of interest rates. The conference participants were cautiously optimistic, anticipating a shift away from the rate volatility of 2023 and a move toward interest rate stabilization with lower realized and implied rates in 2024. During an in-session live poll, the significant majority of audience members predicted that, by the end of 2024, the 10-year treasury note would be between 3.5% and 4%, and the one-month term SOFR rate would be between 4.0% and 4.5%.
- There was consensus throughout the conference that a series of between three and five interest rate cuts will occur in 2024, likely of 25 bps each, with many participants predicting that such cuts would commence in March, although some thought they could commence as late as June.
- Lenders are expected to have more liquidity in 2024 because the overnight rate is moving lower.
- The current trend for five-year fixed rate loans (representing 50% of CMBS loans in 2023, up from 10% in previous years) is expected to continue. Borrowers currently prefer these loans as the rate is predictable, and they also allow for flexibility in the near term. However, if projections of rate reduction and stabilization prove out in 2024, we should expect to see a return to floating rate loans in the second half of the year. Nevertheless, panelist consensus and in-session live poll results indicated that market demand for loans with five-year terms should remain strong.

Asset Classes:

Office:

- Office remains the asset class of greatest concern, dominating transfers to special servicing in 2023, a trend which is expected to continue in 2024. Panelists believe values in this sector have declined by 45% due to poor fundamentals and the fact that expectations for near-term improvement in this sector were extremely limited (especially in certain markets).
- Issuer panelists noted that no office SASB deals closed in 2023, and that office conduit exposure dropped from 34% in 2022 to 20% in 2023.
- Panelists in several forums noted that top-tier assets in this sector in stronger markets fare somewhat better, but that refinances in this sector will require patience and creativity among the parties in order to reach the finish line.
- The option of converting underutilized office space to multifamily housing was discussed. On the surface this appears to be an ideal method for simultaneously solving both the issues of an overabundance of office space and an inadequate supply of housing. Panelists discussed successful office-to-multifamily conversions in several markets. The timeline for completion of feasibility studies and cost-benefit analysis of proposed conversion projects vastly improved in 2023 using technology advances, reduced from a process that took several months to one that can be completed in a matter of hours. However, such conversions are often deemed not feasible either due to factors pertaining to the building itself or the market in which the property is located.

Multifamily Housing:

- There is still a significant housing supply shortage in the United States. As result, even though there has been an increase in troubled multi-family loans due to increasing interest rates and insurance costs, the multi-family asset class is generally expected to remain strong.
- Increases in rent-regulation programs were cited as one of the biggest risks to growth in the multifamily housing sector, reducing incentive for development in the applicable locales. That issue is compounded by increased construction, insurance and financing costs.
- The feasibility of office conversions to multifamily housing is heavily contingent on the market in which the property is located. Markets such as New York City, Washington, D.C. and Boston were viewed as more likely to contain feasible conversion candidates than markets in the Southeast and Southwest with, among other factors, their lower residential rents.

Retail:

This asset class has seen improvement and, unless a deep recession occurs causing a sharp drop in consumer spending, is expected to trend upward.

Data Centers:

This traditionally ABS asset class was flagged by panelists as evolving into a true CMBS asset class due to growing investor and lender interest in this sector.

Industrial and Self Storage:

Panelists were fairly optimistic with respect to these asset classes and described them as being among the most likely to experience growth in occupancy and rents.

Property Insurance:

- Increased insurance costs are having a chilling effect on the market, and panelists anticipated that this would be a key issue in 2024. The average cost of property insurance, which typically has increases of 2% to 3% annually, rose by over 15% in 2023 with the cost in certain markets rising by 200%.
- These increased insurance costs are largely attributable to a dramatic surge in the number of climate events, as well as inflation and its impact on property replacement and repair costs. As reported by the National Oceanic and Atmospheric Administration, there were 25 $1 billion climate events in 2023, as opposed to the typical eight or nine annual events. Further complicating matters, existing policies were not underwritten for current inflation and the actual cost to repair and replace damaged properties. Panelists estimated that a significant portion of existing loans are underinsured.
- Panelists anticipated that these increased insurance costs should moderate in 2024 because reinsurance renewals announced for January 1, 2024, have taken the 2023 increases into account and are expected to achieve an improved level of rate adequacy.
- In addition to standard Phase I and property condition reports, panelists anticipate that insurance diligence will evolve to include enhanced capital modeling going forward. These reports will analyze location-specific hazards, property-specific vulnerabilities and potential risk mitigants (for example, requiring hurricane tie-downs) including related costs.
- Insurance industry professionals on the panel stressed that borrowers and lenders need to begin insurance negotiations well before the policy placement date, suggesting that they do so at least six months before a renewal date and at least two weeks before a closing date.

Lending Volume:

- A recurring theme among panelists was that loan originations are often more difficult to accomplish than loan workouts in this market. As a corollary, there will likely be an increase in extensions and modification of maturing loans in cases where the fundamentals support such an option, impacting a large volume of maturing loans that would have typically been refinanced. Panelists reported observing an increase in preferred equity investment as a method of adding capital, demonstrating borrower commitment and facilitating modifications, extensions and workouts.
- The majority of panelists agreed that the leading drivers of increased deal volume projections for 2024 include reductions in interest rates, increased credit spread stability and an increase in acquisition volume.
- Increased volume is further contingent on borrowers becoming realistic about the current value of their property and being willing to accept stricter loan underwriting requirements in this changed environment. Panelists described additional structural requirements on loans including partial borrower recourse, higher DSCR triggers, and increased upfront reserves or economic holdbacks.

Distress/Workouts:

- There was agreement among panelists that the extent of current distress will not fully emerge until late 2024. Many panelists expressed concern regarding looming loan maturities, with at least one panel concurring that there's a "tsunami" coming.
- Currently, the majority of panelists expressed willingness to tailor each workout to fit the underlying loan, property and sponsor relationship, with the caveat that this bespoke approach may change if the volume of troubled loans significantly increases. However, workouts will generally require the borrower to contribute additional funds to partially pay down the loan and establish new reserves.
- Outside of the office asset class, at this time special service loans tend to occur either as a result of a term or maturity loan default, in which case a simple modification and extension is the market-favored approach to get these loans through the current interest rate environment.