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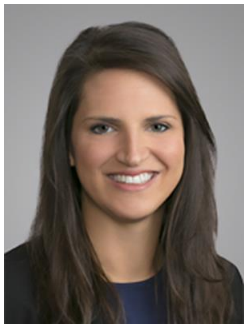
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Cadwalader Real Estate Leader Eyes A Possible CMBS Uptick

By **Andrew McIntyre**

Law360 (December 20, 2023, 1:38 PM EST) -- While issuance of commercial mortgage-backed securities over the past two years did not reach 2021 levels, the market could come back more quickly than traditional bank lending in 2024, one of Cadwalader's real estate leaders recently told Law360 in a wide-ranging interview.



Bonnie Neuman

Bonnie Neuman, co-chair of Cadwalader Wickersham & Taft LLP's finance group who also leads its real estate finance practice group, said investors like the prospect afforded by the CMBS market of being able to pool together assets, adding CMBS often rebounds more quickly than traditional bank lending following periods of economic uncertainty.

2021 saw $109 billion in CMBS origination, the highest mark since 2007, and in 2022, that figure fell to $70 billion, according to data from Trepp. The first half of 2023 saw only $16 billion of CMBS issuance.

Neuman, a New York-based partner, is also a member of the Cadwalader's management committee.

This interview has been edited for length and clarity.

What's your take on the real estate financing space right now?

So the real estate financing space over the last six months to a year has really been quite a roller coaster, as I think you're aware. ... There have been areas that have been very challenging, and there's been quite a bit of volatility within the market. … I think the prevailing thought that we're going to be at higher rates for longer … has really led to this mismatched expectation between investors and lenders in many instances, which resulted in fewer transactions even when there's capital to deploy. But I don't think it's all negative, either. I think it requires investors to be strategic.

You're seeing a divergence in the market of places where there are opportunities for certain types of assets, certain types of sponsors, certain types of lenders, and then you're seeing areas where there's a decent amount of distress.

You talked a little bit about underwriting, but I wanted to ask you more about that. What are you seeing in terms of changes in underwriting on the part of lenders?

I think that lenders are being cautious. I think there are assets that are easier to finance than others. I think loans need to have good structures. Borrowers need to work with their lenders to make sure they're providing structures where the lenders feel comfortable that they're going to be able to repay the debt.

We're seeing a lot more fixed-rate debt than floating at the moment, given the rising cost of interest rate caps, which is the general cost of interest rates. We have seen an increase in short-term, fixed-rate debt, whereas years ago, you might have seen a lot of 10-year, fixed-rate loans. We're not seeing a lot of that, but we're seeing three-year, fixed-rate loans in the market.

We're seeing significant reserves put up front. Debt yield, debt service coverage ratio tests that are tighter. And the market is favoring assets that are more reliable, whether that's data centers, high-quality industrial properties that finance at a low [loan-to-value ratio] — even at very high-quality, Class A office buildings. And hospitality assets, perhaps. But if you're not one of those categories of assets, you're going to have a hard time getting banks to lend.

On the flight-to-quality point that you made, sticking with office here … Class B, Class C buildings. What are you seeing regarding those buildings and the prospects for getting financing or refinancing for those buildings?

On the Class B, Class C office, it's really tough to get those buildings refinanced right now. We're seeing a lot of extensions on debt. … People are being asked to put in equity. … But at the same time, I think it depends on where you are a little bit.

So what the leasing profile looks like at your property. Not every Class B or Class C office is empty. So I think it really depends on where you are. Sometimes that's larger macro-geographic, and sometimes that's the difference between Century City and Downtown L.A. that are right next to each other but are absolutely different.

I also wanted to ask you about this question of lenders taking back buildings. Office and retail are on my mind. Traditionally, when a lender takes back a building, they try to resell it as the same use ... but I'm hearing more and more that lenders now are, when they take back office and retail buildings, actually thinking about trying to repurpose them because it's difficult to resell an office or retail building. What are you seeing on that front?

I think lenders are definitely exploring, as are developers, whether repurposing buildings or mixed-use buildings are a viable option for some of the office stock, particularly stock that is older and may not be as attractive to sell as is.

I think, again, it's going to depend a little bit on where you are and a little bit on what the building itself that you have is. I think there are certainly attractive options on the office side to being able to convert an office building to, say, a condo or something like that. But you also have challenges, whether that's regulatory challenges or zoning challenges or just floorplate challenges.

So while I think that is something many lenders and many developers are looking at, it's not as simple as just, 'let's convert it to another use,' right? I think there are a lot of things to look at out there. … If you are successful in converting to another use, that is certainly a way to revitalize quite a number of properties. I think there needs to be some partnership between both municipalities and lenders, developers, the industry at large to get some traction on some of that. Maybe see what happens over time.

For example, post-9/11, you saw this huge partnership with the government … to get people back into spaces and be able to convert spaces, and that really helped revitalize that area. I think on the retail side, what you see a lot is not necessarily completely repurposing space but sort of mixed-use, right? Whether it's adding an entertainment component or instead of just the traditional retail, you add Whole Foods. A grocery component along those lines. I think that tends to be a good way to get foot traffic to an area.

I want to ask you about the CMBS market too. There's been a lot of talk over the last several years of a wave of CMBS debt coming due. Some of that has come due already. Where are we right now in terms of this wave of CMBS debt? Has much of it already come due, or is a lot more still coming due soon?

I think some of it has started to come due. I think 10-year loans that were made in the 2011-2012 timeframe have certainly started to come due, and we're working through those. I think there's certainly more to come, and I think that that will put some stress on the market. … CMBS has declined by more than two-thirds just in the last year, from September 2022.

There's a lot of office and a lot of retail in CMBS. Those are very affected asset classes for CMBS, so that I think will be a challenge. … That said, it continues to be an attractive financing source, and I think it is also often one of the earlier sources to come back in the market. It provides liquidity in the market. I think you're going to have a harder time with some of the banks revving back up when the rate environment stabilizes a little bit.

And so I think CMBS will be a place people turn to for that financing and for that liquidity. I think it's going take a minute for people to get comfortable with the metrics. … I think already you're starting to see a little bit of loosening in that space, and I think there's more to come there.

Why is it that CMBS often comes back a little bit more quickly than other types of financing?

I think there's a lot of appetite for the market from a lot investors. It's an attractive asset class for people to invest in, and there's a lot of variety in there. And in the conduit space, the ability to kind of pull together assets is attractive for investors.

An asset class we haven't talked about yet are hotels. What's your take on the financing world for hotels right now?

It seems to actually be performing fairly well, all things considered. … We're seeing a lot of hotel loans come across our desk. Post-COVID, it was an asset class that's obviously gone through a really tough time with their highest level of occupancy historically going to nearly 0% occupancy quickly. And it's recovered well.

That's not to say there isn't distress. I think there's distress everywhere, and hotels tend to be a big consumer of floating-rate debt, and so that's a challenge. But I do think the hotel market seems to be performing fairly well at the moment.

What are the key trends in real estate finance that you'll be watching over the next several months?

Ideally, rates can stabilize, transaction value increases and everything goes back to business as usual, but

I don't think that's likely in the short term. I think that the market is going to adjust over time to the higher rates ... and quality assets and key markets are going to be financed.

I think distressed assets are going to continue to come up for modifications that in some cases require remedial action, and that presents opportunities in the market. I think the lowest-sale market hasn't really heated up yet. And so I think we're going to start to see some of that as well.

--Editing by Philip Shea.