More challenges than ever before

Guest comment by **Kevin Tatro**

Investors should avoid a 'wait-and-see' approach to the unfolding financial turmoil, says Trimont's managing director of special servicing

I recently heard someone say: "This can't be as bad as in 2008." Without speculating on exactly how long and deep this cycle will be, we do know that commercial real estate is now facing more challenges than were obvious in 2008. These stressors include changing demands, inflation, evolving lending vehicles, interest rate corrections, short-term floating rate debt and a looming recession.

Like it or not, work from home is real, and office buildings are emptying out at a frightening rate. Older, badly designed, poorly located and inadequately maintained buildings may never be occupied again. Pair this with changes in shopping preferences and we have two large asset classes experiencing significant collapse.

Inflation is no surprise, as the markets were flooded with cash after the covid crisis; and while that spending spree was fun, we are now paying the price with higher operating expenses. The Federal Reserve has reacted, attempting to tame inflation with rate hikes, which are now impacting rates and pushing the US into a long-anticipated economic slowdown.

This brings us to the scary simple math. After 14 years of LIBOR averaging less than 0.5 percent, short-term rates have widened by 450 basis points, and we can expect similar increases in cap rates will follow. The typical deal originated at a LTV of 65 percent and a 1.5x DSCR now looks more like a LTV of 120 percent, with DSCR well below 1.0x, regardless of asset class.

While 2008 saw rate increases, nobody should expect the current picture to be the same short-lived spike. The past decade of interest rate stimulus was never sustainable, and current rates are more in line with historical precedence and Fed rate targets. Longer term fixed-rate deals might avoid immediate pain, but for everyone else, the reality of equity evaporation and higher rates is likely to persist well past the expiration of rate caps and short-term maturity dates.

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Less experienced teams

Yet there is more bad news. With the popularity of outsourcing, most lenders have few distressed asset managers in-house, and most have primary servicing agreements that fail to address distressed situations.

Yes, some people worked on the short-term mods of 2020, but that was a very different problem than we are now facing. This crisis is much more like the 1990s, and it's unfortunate that most of those workout experts have retired, while anyone younger than 36 has never really even seen a downturn.

The good news is there is significant liquidity on the sidelines that was not available in 2008. Additionally, special servicers know how to help, they know how to build teams and they are familiar with empty buildings and highly distressed complex capital stacks.

In the last cycle, people were rewarded for waiting, while in this cycle, the best move may be to realize the situation, rip off the band-aid, and look for the best investment opportunities while avoiding the falling knife. ■