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Get Real!

Real Estate Issues In Uncertain Economic Times

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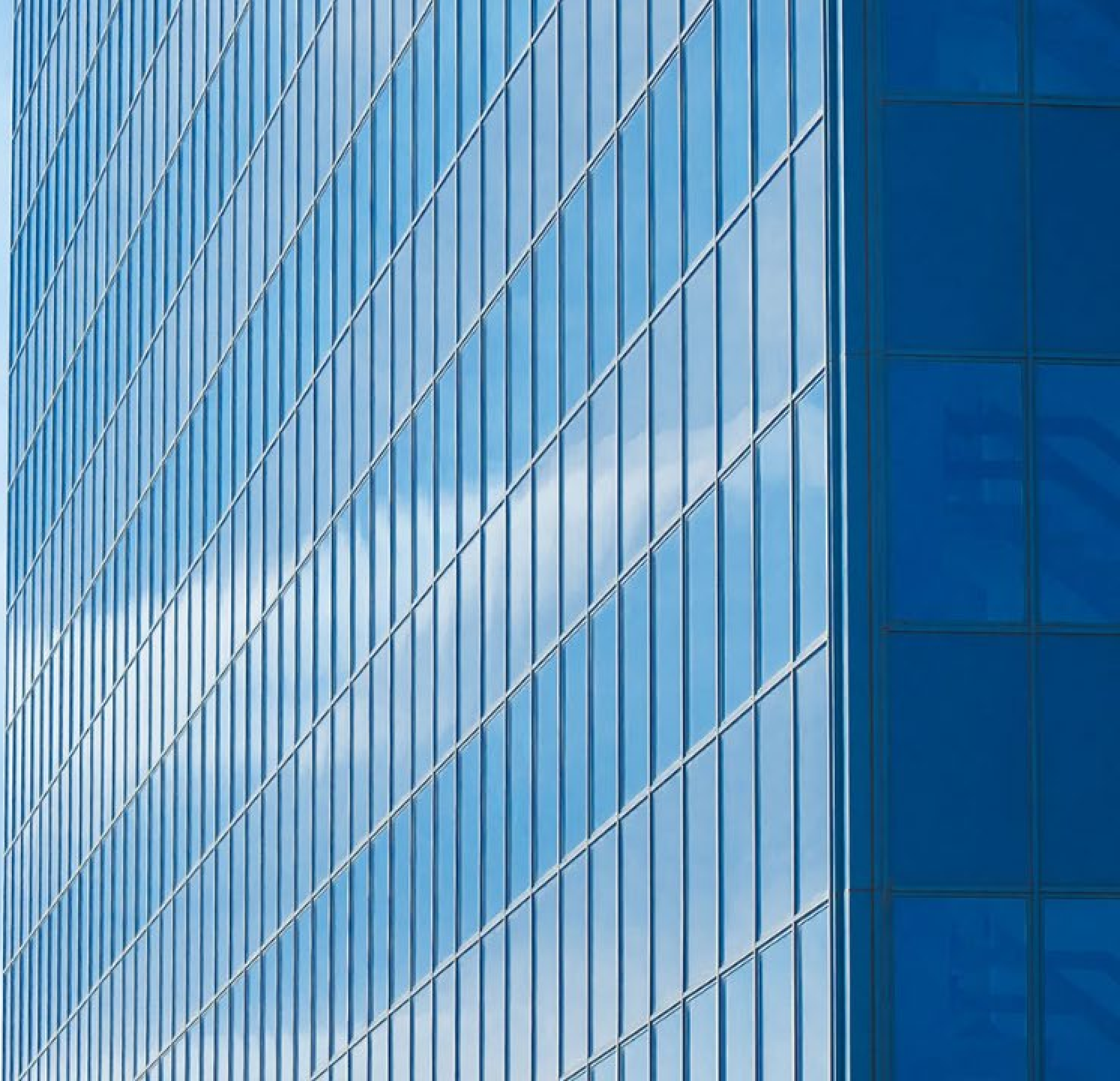
CLLA National Convention

May 18, 2023



COMMERCIAL LAW LEAGUE OF AMERICA
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Speakers:

Jack Rose, JR2G, LLC

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Hon. Thomas M. Lynch, US Bankruptcy Court, Northern District of Illinois

Moderator: Hon. Judith K. Fitzgerald (Ret'd), Tucker Arensberg, P.C.

Get Real! Real Estate Issues in Uncertain Economic Times.

- How should we approach issues in bankruptcy involving real estate and the impact of uncertainty in the markets?
- As interest rates and inflation continue their rise and economists struggle to predict what comes next, practitioners must deal with the reverberations in the bankruptcy world and determine how best to resolve valuation fights, cash collateral and adequate protection disputes, and other issues related to leasehold interests, executory contracts, plan confirmation, and § 363 sales.
- What valuation methodologies do the courts use? Battle of the experts?
- Financing options available to distressed companies inside and outside of bankruptcy, the advantages of bankruptcy over other reorganization alternatives.

Uncertain Economic Times

- PWC “Emerging Trends in Real Estate 2023©” states:

…it’s not just home sales that are slowing. Virtually all aspects of the housing market—both for-sale and rental—have been decelerating. New home prices peaked in April 2022, while prices of existing homes likely peaked in June after appreciation started to slow with the rise in mortgage rates. Meanwhile, apartment rents have continued to push ever higher, but the pace has been moderating in recent months. Construction starts also have slowed. The National Association of Home Builders housing market index has fallen for eight straight months through August 2022 to its lowest level since May 2020.

…The white-hot industrial market also seems set to cool after several years of unprecedented demand growth and rent gains that have pushed rents far above prior records. Growth in e-commerce is slowing and giving back some of the market share it captured from physical retailers during the pandemic. The largest warehouse user in the United States has delayed occupying numerous completed projects, trying to sublet many, as it slows its physical growth. Other major retailers also have been cutting back their distribution expansion plans.

…Property investment returns are primed for a reset. Earnings have been unusually robust during the two years since COVID19 hit, driven by strong property fundamentals and intense investor demand—as well as ultra-cheap debt and the federal government’s three rounds of stimulus spending. Total returns soared to over 20 percent in the four quarters through mid-2022, almost three times the 20-year average. But returns will be coming down. The 43 economists and analysts surveyed in October 2022 by ULI’s Center for Real Estate Economics and Capital Markets expect total returns to drop to 3.8 percent in 2023….

…After a robust first half of 2022, real estate property transactions began declining, primarily because buyers and sellers cannot agree on pricing due to heightened market uncertainty.

…Rising debt costs and restrictive underwriting standards are also limiting transaction volumes.

Commercial Real Estate Defaults – Surprise!

- Brookfield, the largest office owner in Downtown Los Angeles, defaulted in mid-February on two major properties worth a combined $784 million.
- Early March well-capitalized and respected Blackstone Properties defaults on a 531 million € bond backed by a portfolio of retail and office space following the denial of a request for an extension to repay the debt
- Columbia Property Trust (controlled by PIMCO) defaulted on a $1.7 billion in loans for 7 commercial properties across the country including office buildings in NYC and Boston. ($2.27 valuation in 2021)
- M&T Bank in January 2023 reported that about 20% of its office loans were at risk of defaulting (including certain New York City office buildings loans).

Commercial Real Estate Defaults – Surprise!

- New Jersey's Valley National Bancorp recently stopped issuing loans for small and midsize urban office buildings.
- In March 2023, the Wall Street Journal quoted the CEO of Boston Properties ""Commercial real-estate markets are currently in a recession". https://www.wsj.com/articles/office-landlord-defaults-are-escalating-as-lenders-brace-for-more-distress-894938c0 (last visited 4/10/2023)
- The Fed plans to issue stress tests in spring to evaluate banks' ability to handle a commercial real-related economic slowdown. However, some banks heavily invested in the sector already show signs of stress.

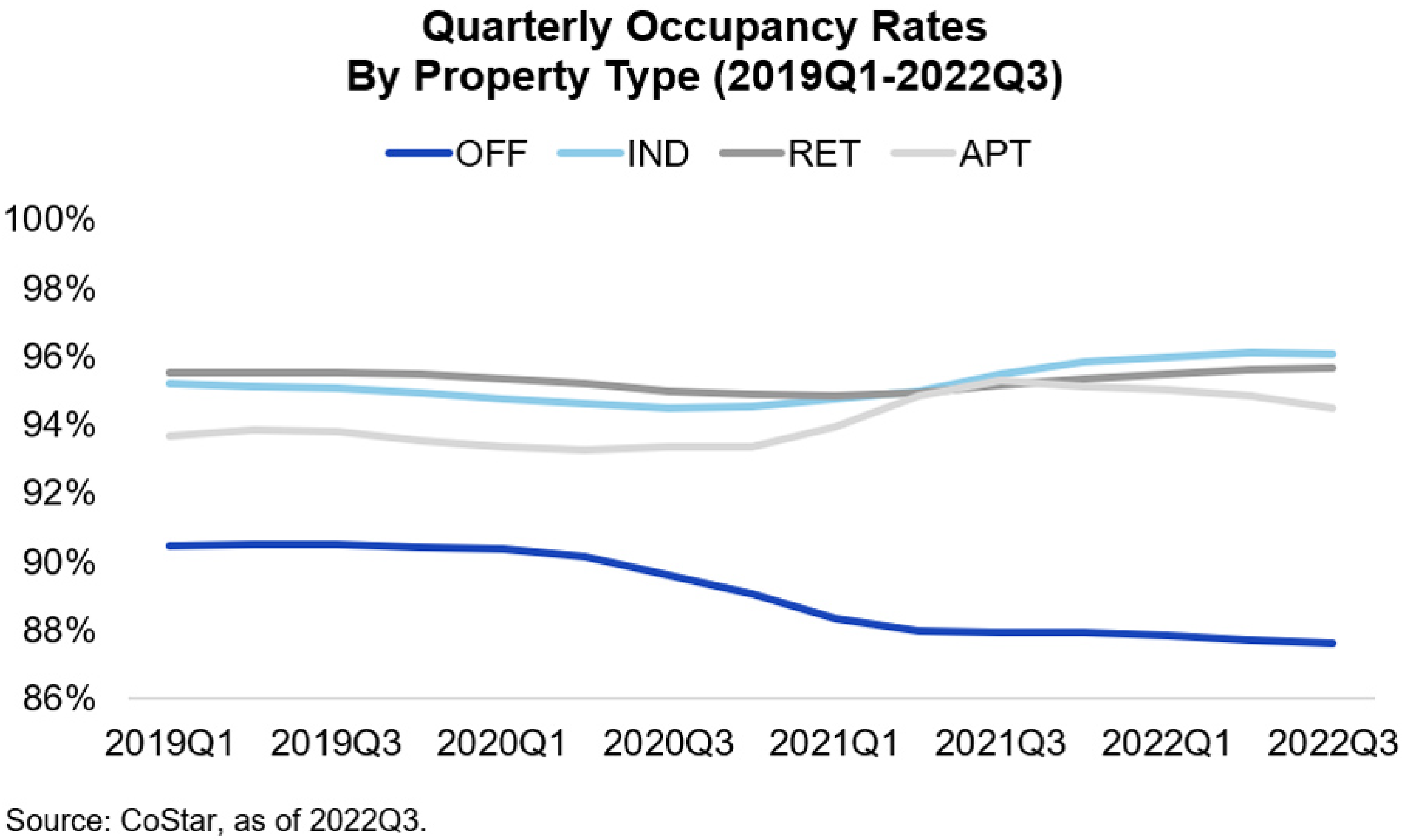
Real Estate Trends

- CBRE predicts "High interest rates and a recession will make 2023 a challenging year for commercial real estate." See https://www.cbre.com/insights/books/us-real-estate-market-outlook-2023
- CBRE forecasts a 15% year-over-year drop in U.S. commercial real estate investment volume in 2023, although it will exceed the pre-pandemic record annual total in 2019. Investment activity likely will bottom out in the first quarter and then gradually improve. This timing assumes a moderate recession, lower inflation, a drop in long-term U.S. Treasury yields and the end of rapid-fire interest rate hikes. All of this will result in a less-uncertain environment, bolstering investor sentiment and facilitating sound underwriting. See https://www.cbre.com/insights/books/us-real-estate-market-outlook-2023/capital-markets

Real Estate Trends

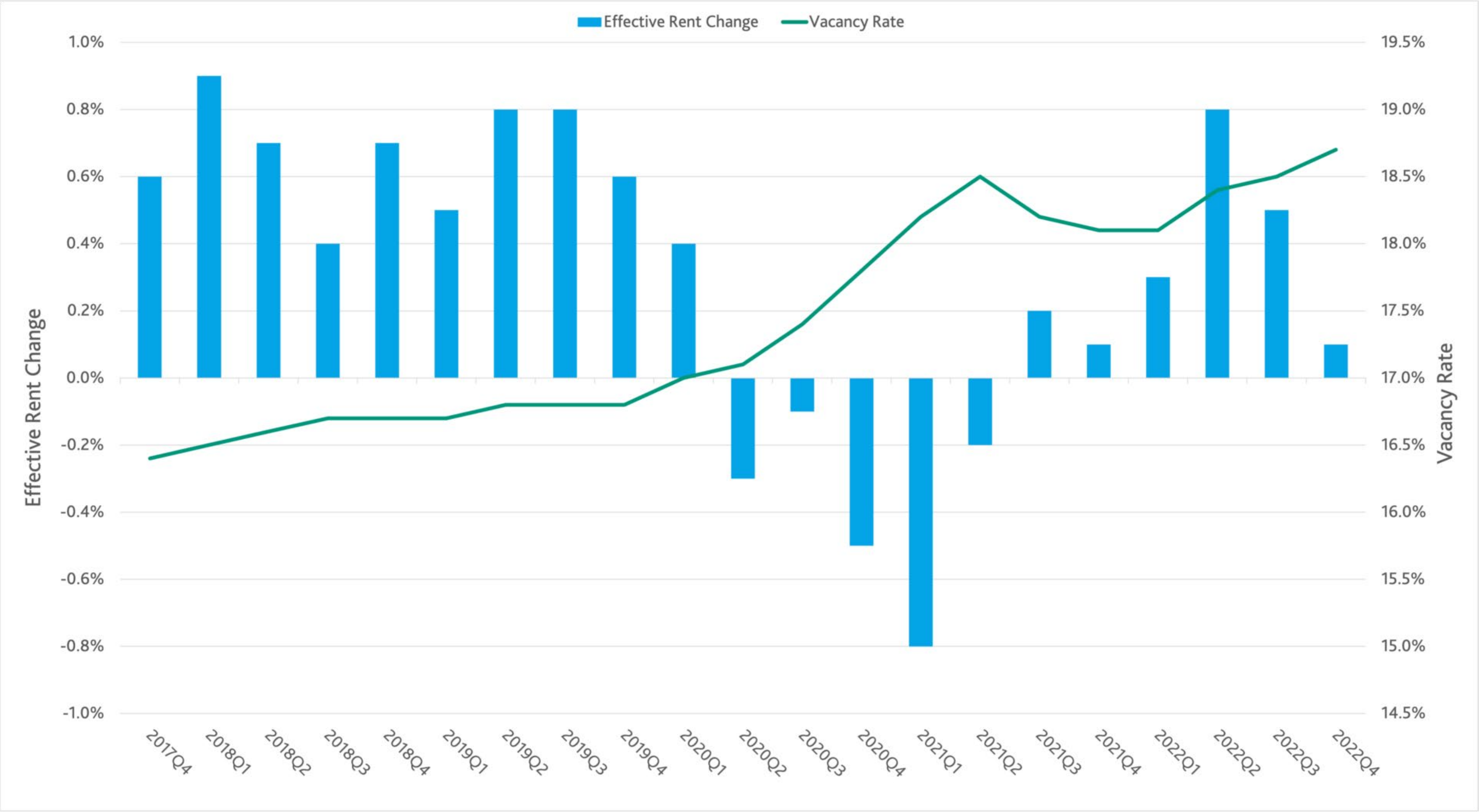
- Colliers reports that "The U.S. office market cooled in Q3 2022. Vacancy ticked up, while sublease space hit a new record high. Is a market correction on the horizon? It will likely take another 18 to 24 months for economic and business concerns to play out. Concurrently, occupiers are reviewing their working practices and office space needs. The U.S. office vacancy rate stands at 15.4%, an increase of 30 basis points in the third quarter and 50 basis points year-over year. However, vacancy is still below the peak of 16.3%, seen at the height of the Global Financial Crisis (GFC)." See Colliers_Q3_2022_Office_Outlook_Report.pdf
- The Deloitte 2023 commercial real estate outlook reports that "The real estate industry also faces an unknown trajectory" and that "Concerns about the economy are top of mind for most global real estate leaders…." Consequentially the forecast revenues respondents in North America anticipated a 43% drop in revenues for 2023 compared to the anticipated drop of 11% for 2022. See Deloitte 2023 Commercial Outlook.

2023 occupancy rates



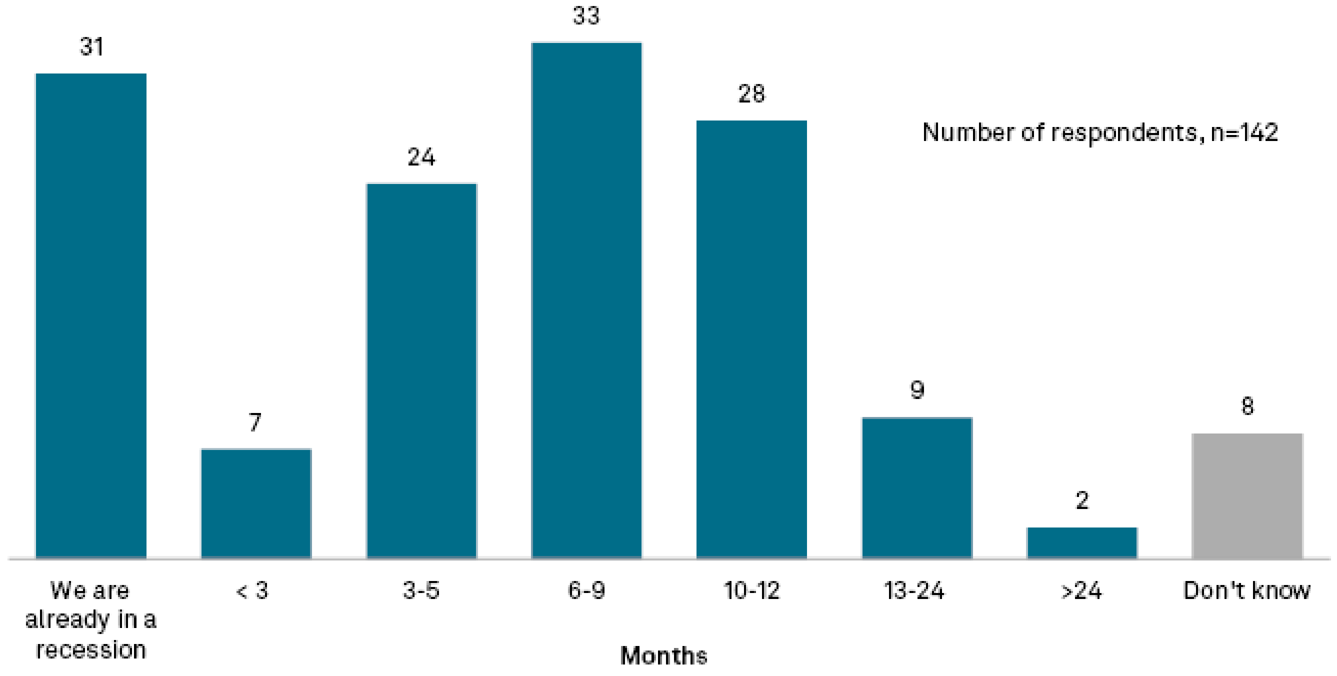
Office vacancy and rent costs are up
See Moody's Analytics

[Office-Q42022-final.png (1920×1055) (moodysanalytics.com)] last visited 1-30-2023



A recession would be bad for CRE? Is recession a self fulfilling prophecy?

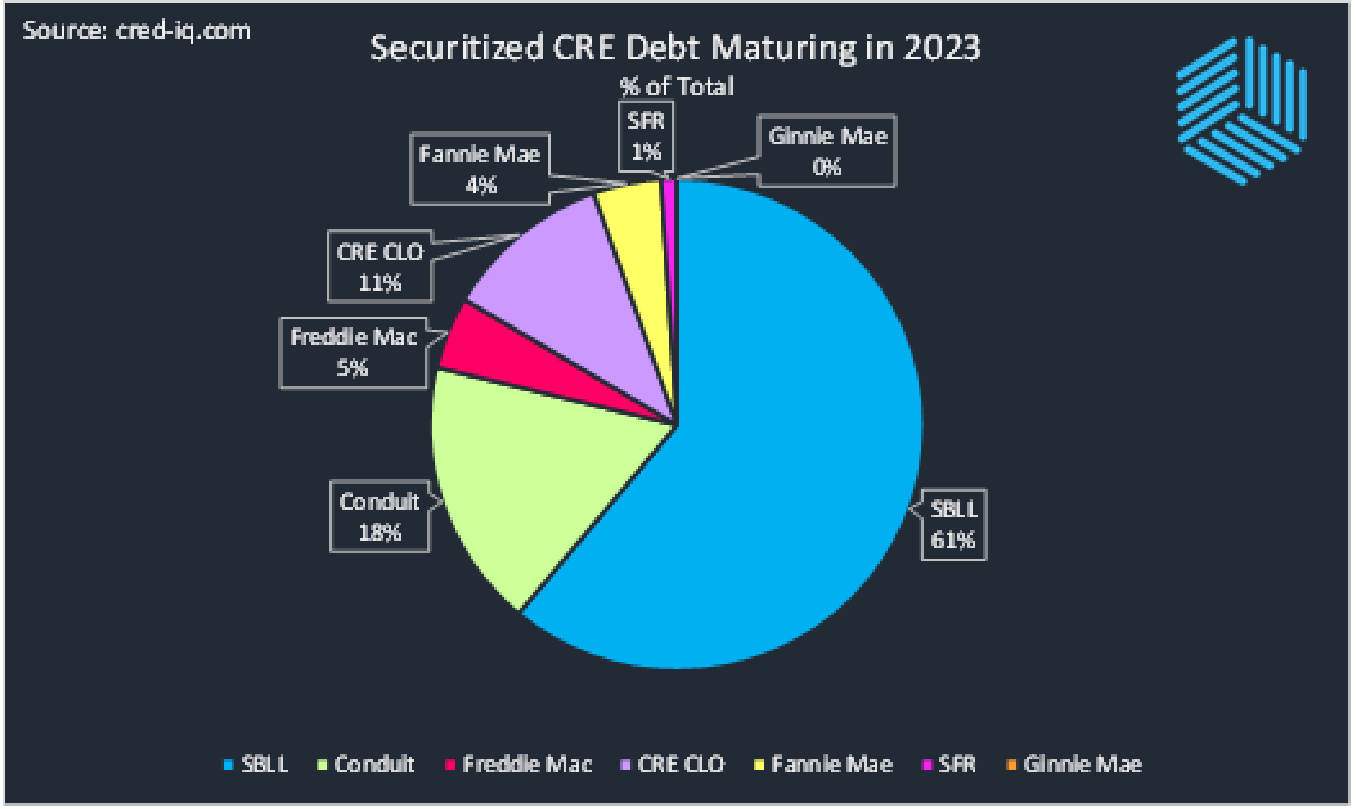
Do you think a recession is likely to occur, and if so, when?



Data compiled Jan. 10, 2023.
The online survey of 142 U.S. financial institutions was conducted Nov. 16, 2022, to Dec. 14, 2022.
Source: S&P Global Market Intelligence.

Real Estate Financing / Refinancing

Source: [2023 CRE Maturity Outlook: The Year Ahead | CRED iQ Blog (cred-iq.com)]
by Cred IQ 12/1/2022



- Based upon CRED iQ's data base with $162 billion in commercial mortgages scheduled to mature in 2023including loans securitized in CMBS conduit trusts, single-borrower large-loan securitizations (SBLL) and CRE CLOs, as well as multifamily mortgages securitized through government-sponsored entities like Freddie Mac, Fannie Mae and Ginnie Mae.

Rising Interest Rates mean adjustments in deals

- Per the PWC Emerging Trends Report:
  - Says the regional leader of one global firm, “Cap rates have gapped out as interest rates went up. And suddenly, things didn’t pencil, and that generated broken deals. The cost of financing for real estate and everything else went up dramatically. And so everything has to be repriced, everything has to be reset.”
- Issues for investment in real estate:
  - Inflation
  - Labor shortages
  - Supply chain issues (still a problem)
  - The Fed raising interest rates

Interest Rates 2022 vs 2023*

(source: https:// Fred.stlouisfed.org last visited 4/10/2023)

	January 2022	June 2022	January 2023	April 2023
Federal Funds Rate	0% - 0.25%	1.5% - 1.75%	4.25% - 4.50%	4.65%
10 Year Treasury	Rate 1.63%	2.94%	3.80%	3.41% - 3.95%
SOFR	0.05%	0.80%	4.30%	4.67%

Will property valuations be a problem in 2023?

Reports indicate that acquisition appraisals are down and that "the downturn in transaction activity has limited the data points traditionally used to value assets, presenting challenges for appraisers who must now look beyond sales data to place a value on assets".

See https://www.wealthmanagement.com/investment/lacking-property-sales-data-appraisers-look-other-marketplace-drivers-value-assets

Bankruptcy Issues – Valuations

- Adequate Protection: Bankruptcy Code Section 362, 363 and 364
- Disclosure Statements and Plans
- Section 363 Sale of Assets
- Section 506 valuations
- Avoidance Actions – Solvency based on valuations

How does a bankruptcy court value property?

- Bankruptcy courts have flexibility in determining the appropriate valuation method, given the particular facts of the case at hand. *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav. (In re Winthrop Old Farm Nurseries, Inc.), 50 F.3d 72, 73 (1st Cir. 1995);* In re McWilliams, 2016 WL 4991502 (Bankr. N.D. Ala. 2016) (citing In re Grind Coffee & Nosh, LLC, 2011 Bankr. LEXIS 1335, 2011 WL 1301357 (Bankr. S.D. Miss. 2011)).
- Property valuation is not an exact science, courts analyze conflicting testimony and afford it the weight deemed appropriate under the circumstances. *In re Dickerson*, 222 F. 3d 924 (11th Cir. 2000)
- A Court is not bound to accept the value in an appraisal but may form its own opinion of the value of the subject property. *In re Wright,* No. 20-12021-JCO, 2021 Bankr. LEXIS 2626, at *7 (Bankr. S.D. Ala. Sep. 24, 2021)

Valuation Methods

- Sales comparison approach: values a property using data from recent sales and/or listings of comparable properties in the same market area of the subject property to develop a ‘fair market value’.
- Income capitalization approach or Discounted Cash Flow valuation: values a property using data to capitalize anticipated future income from the subject property. The data can come from the property itself or comparing it to similar properties in the market area.
- Cost approach (replacement value) values a property based on the sum of current depreciated replacement or reproduction cost of the property, together with land value and an appropriate incentive or profit figure, where applicable. Used when comparables are not readily available.

Valuation Methods: CRE

- Value Per Gross Rent Multiplier (GRM) . A CRE valuation formula id's properties with low price relative to potential income. (*see e.g. OMP v. Sec. Pac. Bus. Fin., Inc.*, 716 F. Supp. 251, 257 (N.D. Miss. 1989)(finding appraisals deriving a gross rent multiplier (GRM) to enable a meaningful comparative sales approach).
- Value per Door: valuation which multiplies a per unit average value by the number of units to come up with the property value. (see e.g., *Word Invs., Inc. v. Bruinsma* (In re TML, Inc.), 291 B.R. 400, 421 (Bankr. W.D. Mich. 2003)(this methodology rejected by court as too simplistic a methodology to adequately form a valid opinion of the value of a truck terminal.
- Cost per rentable square foot: combine the occupiable square footage with common areas for a rentable square foot and compare to average lease cost per square foot to come up with valuation. (Usually incorporated into an appraisal using a cost and income approach).

Court decisions regarding valuation in bankruptcy

- Bankruptcy Code § 506(a) requires that bankruptcy courts apply the replacement value standard when a debtor proposes to retain and continue to use the property to be valued [but] it leaves to the discretion of bankruptcy courts "as triers of fact [the] identification of the best way of ascertaining replacement value on the basis of the evidence presented.“ The "proposed disposition or use" of the collateral is of paramount importance to the valuation question. *Assocs. Commer. Corp. v. Rash*, 520 U.S. 953, 962, 117 S. Ct. 1879, 1885 (1997). *Accord, Museum of Am. Jewish History v. UMB Bank, N.A.* No. 20-6341, 2021 U.S. Dist. LEXIS 66178, at *15 (E.D. Pa. Apr. 6, 2021)
- At least as important as the methodology employed at arriving at market value is the "quality and reasonableness of the assumptions which are plugged into either methodology”. See e.g., *In re Vanderveer Estates Holding, LLC*, 293 B.R. 560, 564 (Bankr. E.D.N.Y. 2003)(valuing a multifamily low income housing project as part of plan confirmation process and determination of feasibility and accepting appraisal based upon discounted cash flow method).
- Issues of highest and best use will impact valuation. *See e.g., In re 785 Partners, LLC*, *No.* 11-13702 (SMB), 2012 Bankr. LEXIS 1182, at *1 (Bankr. S.D.N.Y. Mar. 20, 2012)(Based on an analysis of the opinions of the parties' experts, the court concluded that the highest and best use for the building was as a rental and not a condominium)

Court decisions regarding valuation (cont'd)

- *Issues of character / use of the property:* the appropriate standard for valuing collateral must depend upon what is to be done with the property — whether it is to be liquidated, surrendered, or retained by the debtor. *In re Heritage Highgate, Inc.*, 679 F.3d 132 (3d Cir. 2012) (dispute on valuation and timing. "Like the appropriate measure of fair market value, the appropriate time as of which to value collateral may differ depending on the facts presented.") *See also In re Sunnyslope Hous. Ltd. P'ship*, 859 F.3d 637, 644 (9th Cir. 2017), as amended (June 23, 2017) (citing Rash, 520 U.S. at 962) (even though a low income housing property had a foreclosure value that was higher than market value, the proper valuation was the intended use of the property as affordable housing pursuant to debtor's chapter 11 plan.)
- *Issues of Timing:* The choice of a measuring date can be significant where a claim has increased and value of collateral has decreased over the course of case. *Prudential Ins. Co. of Am. v. SW Bos. Hotel Venture, LLC* (In re SW Bos. Hotel Venture, LLC), 748 F.3d 393, 409 (1st Cir. 2014)(upholding lower courts' determination that a flexible approach on timing of valuation is appropriate and a sale closing date and sale price were the correct measuring times and values.)

Tax Implications – Yes!! Talk to your tax lawyer!

- Debts canceled, forgiven or discharged for taxpayers who've filed for bankruptcy are not considered taxable income. The Internal Revenue Code broadly defines gross income to encompass "all income from whatever source derived," including income from the discharge of indebtedness. 26 U.S.C. § 61(a)(11). Thus, cancelled debt outside of bankruptcy is treated as taxable income.
- But a narrow statutory exception permits taxpayers to exclude debt from discharged income, so long as the discharge occurs at a time when the taxpayer is insolvent. 26 U.S.C. § 108(a)(1)(B).
- This exception acknowledges the reality that insolvent taxpayers will realize no income from discharge because—as a practical matter—no assets become available to the taxpayer. *See United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131, 72 Ct. Cl. 739 (1931). For this reason, the Code also limits the exclusion of discharge-of-indebtedness income to the amount by which the taxpayer's liabilities exceed his assets. *See* 26 U.S.C. § 108(a)(3); *see also Carlson v. Comm'r*, 116 T.C. 87, 91 (2001) ("[T]he term 'insolvent' means the excess of liabilities over the fair market value of assets.") (quoting 26 U.S.C. § 108(d)(3)).

Tax Implications – Yes!!

The Bankruptcy Code provides for special tax treatment when indebtedness is discharged or forgiven through a bankruptcy case.

11 U.S.C. § 346(j) Special tax provisions provides that

1) For purposes of any State or local law imposing a tax on or measured by income, income is not realized by the estate, the debtor, or a successor to the debtor by reason of discharge of indebtedness in a case under this title, except to the extent, if any, that such income is subject to tax under the Internal Revenue Code of 1986 [26 USCS §§ 1 et seq.].

- Partnerships and LLC's which are "disregarded entities" for tax purposes have their own rules.
- Working with a tax lawyer or accountant is a must!

Tax Implications – Yes!!

In addition to § 346, the Internal Revenue Code § 108 addresses income generated from the discharge of indebtedness:

§ 108. Income from discharge of indebtedness

(a) Exclusion from gross income.

(1) In general. Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case, . . .

(2) Coordination of exclusions.

(A)Title 11 exclusion takes precedence. Subparagraphs (B), (C), and (D) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case. . . .

- But the IRC requires that a debtor reduce its tax attributes – including NOLs that are available - to the extent of discharge of indebtedness. That can have significant impact on income tax obligations in the future.

Pop Intensity Factor

	Population	Sq. Miles	Pop Intensity Factor
New York	8,468,000	302.0	**28,039.74**
Los Angeles	3,849,000	502.0	**7,667.33**
Chicago	2,697,000	234.5	**11,501.07**
Houston	2,288,000	665.0	**3,440.60**
Phoenix	1,625,000	517.0	**3,143.13**
Philadelphia	1,576,000	141.0	**11,177.30**
San Antonio	1,452,000	505.0	**2,875.25**
San Diego	1,382,000	372.4	**3,711.06**
Dallas	1,288,000	385.8	**3,338.52**
San Jose	983,489	181.4	**5,421.66**

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