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As uncertainty looms, retail investors seek to lock more than just interest rate

We've entered this year's second half, and 2020 is right around the corner. As a fresh decade approaches and we reflect on the former, two major themes stand out. First, the current economic expansion, which our industry continues to enjoy, has now lasted over a decade. Second, retail is far from dead, but it has undergone substantial change.

Despite the fact that the word "apocalypse" has been used so many times to describe the retail sector, there are notable bright spots in the retail space. There are a wide variety of retailers posting healthy growth and the same online retailers and direct-to-consumer brands that were supposed to be a threat to our industry are now opening brick-and-mortar stores. Amazon, Warby Parker, Casper Mattress, Untuckit, Mizzen & Main, Ministry of Supply, Bonobos, Allbirds, Everlane, Away and Indochino are just of a few of the successful companies that have opened physical stores and now make up the growing "clicks-to-bricks" category. Another bright spot within the retail sector has been the success of infill neighborhood retail centers, many of which have proven that with a strong lineup of service-based tenants, a grocery store is not necessarily needed to drive traffic.

Michael Salzman
Principal, Essex Financial Group

Despite all of the aforementioned "good news" in the retail sector, retail real estate investors are presented with two significant challenges as we embark on a new decade. First, the retail space will continue to evolve in ways we cannot predict. Second, the economic environment is uncertain, and while interest-rate movements are a significant wild card, they are only one of many economic factors that we cannot predict.

With this confluence of industry-specific uncertainty and overall economic uncertainty, we're noticing that our borrowers who intend to hold retail assets long-term are often opting to secure long-term financing for reasons besides locking a long-term fixed interest-rate. Many of our borrowers are focused on securing a long-term loan amount with no structuring (leasing capital reserves or cash flow sweeps) that lenders would not be allowed to modify during an economic downturn. Further, these borrowers also are careful to secure a term that matches up with their lease expiration schedule and with enough term to get past the next economic downturn. In many cases, this decision has meant pivoting away from bank financing, and toward nonrecourse permanent lending sources, like life insurance companies and commercial mortgage-backed securities lenders. While these capital sources usually don't offer the same level of prepayment flexibility as banks, their loan documents also don't typically contain "negative covenants" often required by banks, whereby banks reserve the right to order a new appraisal of loan collateral at any time during a loan term and can demand loan pay-downs ("re-margining") in the event that a property's value has decreased.

Peter Keepper
Principal, Essex Financial Group

As borrowers have shifted toward lending sources that do not require "negative covenants" in their loan documents, they have found a variety of capital sources attractive for distinct reasons:

- **Life insurance companies.** Aside from offering the lowest interest rates available in the market, life insurance companies continue to offer the longest-term fixed-rate loans available (up to 30 years for retail properties). Our borrower clients have consistently been locking 10-year fixed-rate loans in the high 3% to low 4% range, and longer-term deals are pricing in the mid-4% area. Further, while 18 to 24 months ago life insurance companies were extremely focused on grocery-anchored shopping centers, they are now also actively lending on infill neighborhood centers with strong occupancy history and robust line-ups of service-based tenants (with offerings/experiences that consumers cannot buy on the internet). In many cases, depending on leverage, 30-year amortizations also are attainable from life company lenders.
- **CMBS lenders.** While CMBS lenders have historically excelled at providing high-leverage loans (up to 75% loan to value), they are now actively competing for lower-leverage loans by offering significant interest-only payment periods. For example, in many cases, 10-year, full-term, interest-only payment periods are attainable at 65% LTVs or

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less in the CMBS market. This structure has allowed CMBS lenders to compete with life insurance companies by offering aggressive loan constants that can only be achieved by eliminating all amortization. This is a structure that has been well received by borrowers who want to maximize their cash flow, but also want to reduce their "debt pressure" in the event of an economic downturn. Even though this is a very attractive strategy, since CMBS lending still has some well-known downsides, our team stresses the importance of choosing CMBS lenders based on strong relationships and trust.

- **Debt funds.** For borrowers that have become "gun-shy" of the CMBS market due to poor servicing experiences with master servicers post-securitization, debt funds have become a very viable source of permanent financing. Most investors are aware that debt funds have become a huge force in the construction and bridge lending spaces; however, many don't realize that there are debt funds in the market making permanent, balance-sheet loans. Similar to CMBS lenders, debt funds offer permanent loans with interest rates that are more expensive than life insurance companies, in exchange for their willingness to lend at higher leverage points (but without having to work with a CMBS lender).
- **Conclusion.** Overall, life insurance companies are typically our recommended source of long-term retail debt because their loans don't usually require reserves or structure around major tenant lease expirations, and they also have far less potential for post-closing problems. During the term of a life company loan, there are no events of default associated with debt-coverage ratios as long as the borrower is making timely payments, no re-margining risk, and usually no ongoing net worth or liquidity covenants. There also is a more significant alignment of interests between a life insurance companies and borrowers, as life insurance companies strongly prefer not to take properties back for regulatory reasons (accounting charges in the life company industry). Life companies also are nimble and allow borrowers to operate properties with minimal lender oversight or approvals. ▲