SPECIAL REPORT

Marcus & Millichap Capital Corporation

Capital Markets

DECEMBER 2022

Into the Unknown
Will Capital Markets Liquidity Revive?

Fed Policy Tightening Prompts Caution from Lenders — Key Trends to Look for in the Year Ahead

As the Federal Reserve continues its rate hikes to curb inflation, the capital markets have responded with overwhelming caution until there is clarity on when the Fed will stop and where interest rates are likely to settle. Several questions compound this uncertainty, including volatility in the stock market, geopolitical risk, decelerating rent growth, falling home prices, and cap rate inflation. Lenders and investors alike are taking an observant pause to avoid "catching a falling knife," while using this time to raise funds for what they believe will be impending distress in the commercial real estate market, much like they did in 2020 after the onset of the pandemic. In 2020, the capital providers that took the risk to lend or invest tended to come out on top, while much of the market missed the opportunity, due to an abundance of caution.

A recent client survey conducted by Marcus & Millichap concluded that the availability of financing is a top concern among investors for 2023. While no one has a crystal ball, this report will discuss some of the potential trends that the capital markets may have in store for the coming year. These eight prognostications are based on a few key assumptions, including that the Fed eases up a bit on its pace of rate hikes, the economy weakens modestly — but doesn't plummet — and there are no other unexpected black swan events or catastrophes.

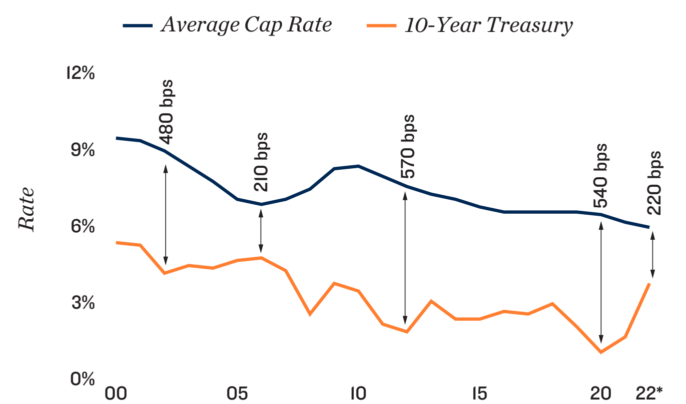
Commercial Bank Liquidity Remains Tight

Spreads Stay High for Permanent Bank Debt and Debt Fund Bridge Loans Early in 2023

At the start of the year, commercial banks get their new goals and allocations for lending. Right now, in late 2022, there is little incentive for banks to lend, other than to keep existing client relationships. Many banks met their annual goals for last year in just the first half of 2022, meaning they have had no impetus to lend to new clients in recent months. While the new goals for 2023 might mean an uptick in overall willingness to lend, the capital markets could see the existing trend generally continue. Bank allocations may stay relatively full, due to a lack of payoffs and a bevy of extensions and forbearances for loans already on their balance sheet.

Commercial banks are also likely to dip their toe back into the repo/warehouse line market. These lines will be geared to newly-raised bridge funds, from both existing and new lenders, that are seeking to take advantage of market dislocation. Spreads could nevertheless remain high earlier in the year, as the banks will stick to lower advance rates to buffer themselves from potential cap rate inflation and value fluctuation as the Fed continues to hike rates.

Margins Compress, Similar to Past Cycle

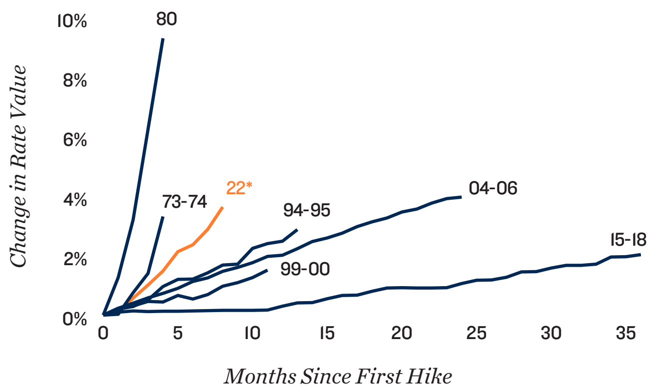


Borrowing Costs Up this Year, Still Historically Low

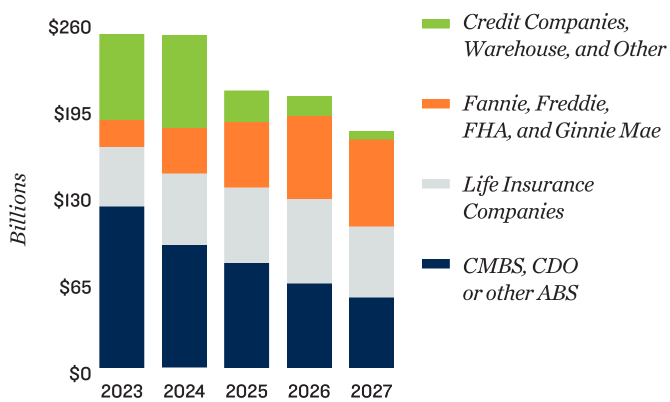
Period	Fed Funds Rate	2-Year Treasury	10-Year Treasury	Bank Prime Rate	30-Year Mortgage
Dec. 2019	1.55%	1.61%	1.86%	4.75%	3.74%
Dec. 2021	0.08%	0.68%	1.47%	3.25%	3.11%
Aug. 2022	2.33%	3.25%	2.90%	5.50%	5.55%
Nov. 2022*	3.83%	4.38%	3.68%	7.00%	6.58%
Average	4.92%	5.27%	6.20%	7.53%	7.95%

** Fed Funds Rate (midpoint), Treasuries, Bank Prime Rate and CRE Cap Rate as of Nov. 30, 2022, 30-Year Fixed Rate Residential Mortgage as of Nov. 23, 2022; Table average for 1977-2019*
Average cap rate for apartment, retail, office and industrial sales $1 million and greater
Sources: Marcus & Millichap Research Services; CoStar Group, Inc; Federal Reserve; Real Capital Analytics

Speed of Fed Rate Hikes

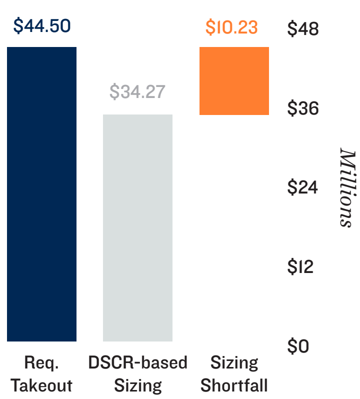


Future Loan Maturities



Refi Scenario: DSCR Dictates Shortfall

Cost Basis	$55.0 mil.
Stabilized NOI	$3.0 mil.
In-Place Debt	$44.0 mil.
Req. Takeout Refi	$44.5 mil.
Yield on Cost	5.45%
Debt Yield	6.74%
Refi Interest Rate	5.75%
Amortization	30 years
DSCR	1.25
DSCR-bd. Sizing	$34.27 mil.
Sizing Shortfall	**$10.23 mil.**



** As of November 30, 2022*
❖ Hypothetical multifamily refinance scenario, in-place debt based on 80% LTC, figures are rounded
Source: Marcus & Millichap Research Services; Federal Reserve; Mortgage Bankers Association

Cash Becomes King

Well-Capitalized Investors Can Capitalize on Market Dislocation, while Highly-Leveraged Borrowers May Face Challenges

Expect higher leverage options to remain less available — particularly for construction loans, renovation loans, and other highly transitional business plans. This is due, in part, to constraints in debt service coverage ratios that are trumping debt yield and loan-to-value limits for the first time in recent history. As interest rates rise, leverage will reduce further, leading to a necessity for price decreases to hit target yields. All cash buyers, or buyers who can take a lower leverage level of "negative leverage," will be able to acquire assets at lower price points, as they will not be held hostage to the current capital markets environment.

Rescue Capital

Mezzanine Debt and Preferred Equity Capital Will Once Again be Prevalent and Available for Pending Maturities

A massive $121 billion of maturities in the CMBS/CDO market alone will hit next year in a landscape fraught with volatility and uncertainty. A substantial amount of capital is being poured into commercial real estate funds that are designed to take advantage, expecting 15 percent to 20 percent-plus internal rate of returns. Mezzanine debt and preferred equity are the easiest placement positions for this capital, as there is no need to seek leverage from outside sources. Expect this capital to initially target multifamily and industrial assets that cannot refinance out construction, bridge, or possibly even maturing perm debt.

This rescue capital will seek to "fill the gap" between the maturing debt positions and where new perm debt is constrained, based on DSCR, for vehicles like agency debt, insurance company debt, bank debt, and CMBS debt. These subordinate debt players will be leverage constrained based on asset basis and debt yield, rather than DSCR. As the year winds on and the amount of capital chasing these product types is greater than the opportunities available, expect these funds to start considering hospitality, retail, and select office transactions as well.

Construction Financing Limited

Groundbreakings Slow Down until Construction Costs Retreat, Due to Investor Underwriting

While history generally shows that building in a time of crisis tends to pan out well for those who are fortunate enough to capitalize their transactions, developers will have a difficult time proving to limited partnership investors that their transactions pencil. While construction costs have begun to decelerate, expenses are still at historically elevated amounts. Like the period after the great financial crisis, there can often be no level at which a land buy pencils for LP investors who will conservatively underwrite higher exit cap rates to account for possible cap rate inflation.

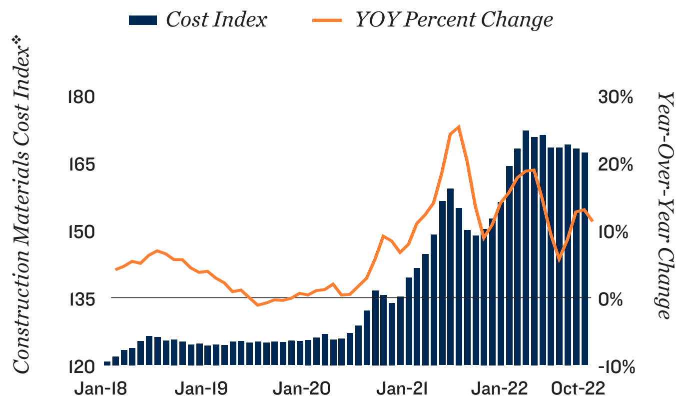
Deglobalization and housing supply/demand imbalances may continue to foster double-digit compounded growth for some industrial and multifamily locations. However, the LP equity for new development is likely to be limited, as investors will not be willing to underwrite the high rent growth necessary to offset potential cap rate inflation. The lack of development that results from this method of underwriting may exacerbate supply/demand imbalances, and lead to even greater rent growth in some markets and product types. As construction costs eventually decline, investors will re-evaluate, but expect many developers to put their development deals on hold or try to trade their land at discounts to well-capitalized buyers.

Distressed Sales

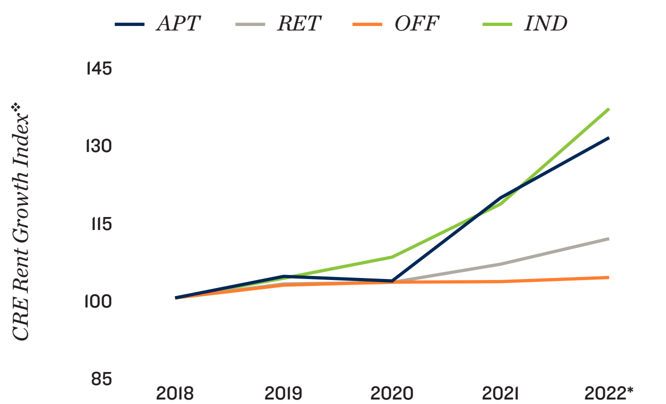
Distressed Purchases Will be Prioritized by Bridge Lenders

Buyers of distressed debt, real estate owned, and other existing assets from distressed buyers will be prioritized by bridge lenders, due to their "reset basis" that will be deemed to be more in line with current valuations. Higher leverage bridge lending may be available for these transactions, albeit at a still elevated cost of capital levels. Both performing and non-performing debt will be traded at elevated levels, as lenders clear allocation and potential workout issues from their balance sheets. Debt buyers who have experience purchasing debt and working out loans with borrowers will have increased opportunity.

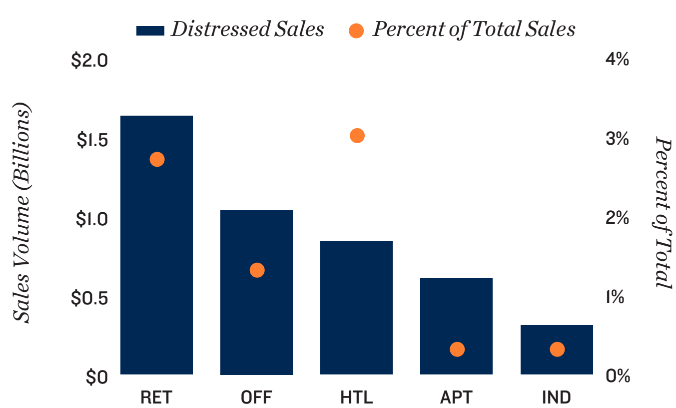
Construction Material Costs Still Elevated



Rent Growth Indices



Sales of Distressed Assets in 2022**



* Forecast
** Sales $2.5 million and greater
❖ Construction Materials Index : 2009=100; CRE Rent Growth Index: 2018=100
Sources: Marcus & Millichap Research Services; Federal Reserve; CoStar Group, Inc; Real Capital Analytics; RealPage, Inc.

A Thaw on the Horizon

Perm and Light Transitional Bridge Spreads Eventually Decline, Leading to More Activity

As the Fed starts to ease up on rate hikes and it becomes apparent that inflation is rapidly decelerating, bond investor sentiment will improve, leading to tighter spreads on CMBS and CLO tranches. This should lead spreads to decline on both CMBS perm loans and light transitional bridge debt. The decrease in spreads may offset some of the future Fed rate hikes in the base rate. This will lead to all-in rate levels not too dissimilar to those obtainable now, but with the added benefit of increased lending options and competition. Eventually, the increased competition will lead to more bridge lenders providing financing on more highly transitional assets and less desired product types as well.

A Huge Uptick in For-Sale Housing & Condo Inventory Lending

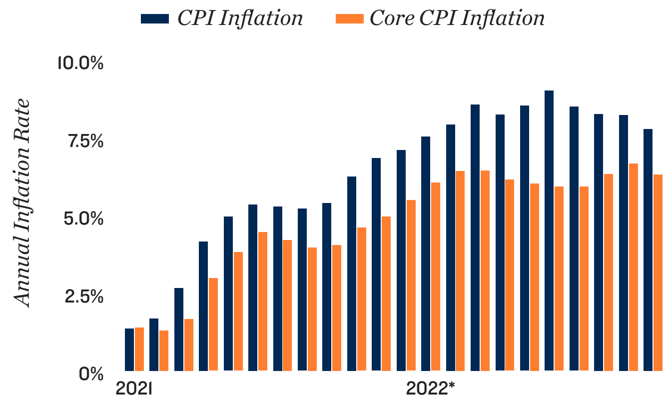
As unsold for-sale product absorption declines in the face of rising interest rates, borrowers will seek to refinance their maturing construction loans with condo inventory loans, collateralizing unsold units in order to buy more term to sell them out. Expect high-yield private money and debt fund capital to chase after these opportunities and lend at a reasonable reduced basis level that they feel comfortable with in markets they are familiar with.

As Inflation Subsides and Fed Slows Down, Pent-up Capital for CRE Transactions is Released

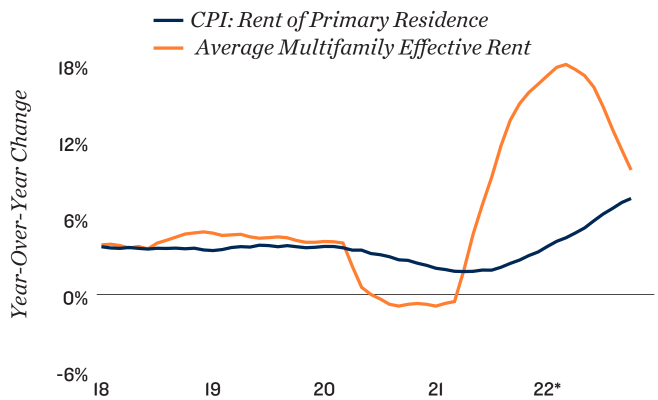
While the capital markets will likely stay relatively constrained in the near term as the Fed marches on with its rate hikes, expect the capital markets to thaw progressively over the year as inflation is reined in. Much of the inflation data lags by about half a year, and more of the raw data suggests inflation is already greatly reduced, more than it is showing in current CPI figures. As the results are released, the Fed should eventually start to indicate a slowing or stopping of rate hikes, after which lending will pour back into the market in force. This could potentially drive down spreads faster than expected, due to the amount of liquidity already present and growing for CRE transactions.

Where base rates will settle is anyone's guess, but expect the current all-in rate environment to stay for an extended period. It is prudent to take the appropriate maneuvers to mitigate risk for existing assets, but also figure out ways to otherwise profit from market dislocation as we head into the unknown.

Inflation Starting to Trend Down



CPI Rent Factor Lags Market: A Good Sign



** Through October*
Source: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve; Real Capital Analytics; U.S. Bureau of Labor Statistics;

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; Mortgage Bankers Association; Real Capital Analytics; RealPage, Inc.; U.S. Census Bureau; U.S. Bureau of Labor Statistics