The following transcript has been edited for clarity and ease of reading, without compromising the intended content of the webcast.

Bruce Kirsch

Welcome to the Fall 2020 Linneman Associates Capital Markets Webinar, presented by Linneman Associates and Real Estate Financial Modeling. This is your host, Bruce Kirsch, founder and CEO of REFM, provider of financial analysis tools, and training to the CRE business since 2009. We are pleased to have an insightful program for you today presented by Dr. Peter Linneman, founder of Linneman Associates, which for those of you who do not know, is a strategic and investment analysis advisory firm headquartered in Philadelphia. This webinar will be different from our standard format in that Peter and I will be having a question and answer conversation. Note that with this new format there are no PowerPoint slides prepared. Welcome, Peter.

Dr. Peter Linneman

Thank you, Bruce. I look forward to having more of a fireside chat with you as opposed to me carrying forth.

Bruce Kirsch

There is a lot to talk about right now. The famous Chinese curse says, "May you live in interesting times," and in November 2020 we certainly do live in very interesting times. We have had an election but, in some jurisdictions, ballots are still being counted as of our recording. What is your general post-election outlook?

Peter Linneman

The only wild card with this election was the vast number of mail-in ballots compared to previous elections. President-elect Biden appears to have won. If the current President or any official believes that there were improprieties with the election process, there are many state laws which detail how to resolve such issues. I would hope that the legal process is followed through to everyone's satisfaction. People have said to me that it is terrible that the election is appealed, but it is within everyone's rights to request recounts. If you take out a loan, you have the right to declare bankruptcy to stop paying the loan and to protect your asset. Similarly, everyone in an election has the right to appeal ballot counting. There is a detailed mechanism built into the system to verify election results.

Based on historical elections, however, I do not think the appeals will change the results of the election without there being a smoking gun. The Republicans picked up some seats in the House, though the Democrats maintain the majority. Alaska is still counting, which is odd considering the state's small population. It would appear that Georgia will be the key to taking the Senate with two runoff elections taking place in January. The Republicans closely held the seats in the first round, and others more politically knowledgeable than me, have told me they will likely win one or both seats in the runoff as well. I feel bad for everyone living in Georgia as they will be subjected to another two months of political advertisements. The Democratic Party spent over $100 million for one Senate seat in South Carolina. Lots of us in contentious states like South Carolina or Pennsylvania have not seen any nonpolitical ads for months. Now that you have two seats up on the same day, that determine who will hold the majority of the Senate, the two parties could spend $500 million in advertisements. The residents of Georgia are likely to not see a single ad between Thanksgiving and January 5th that is not political. On January 6th Georgians will be surprised to see that Wal Mart and Target still exist!

It looks like we will finish this election with a Republican Senate and a House with a slightly smaller Democratic majority. This will mean a moderate two years in terms of policy. You will not see major tax overhauls or new seats added to the Supreme Court. We have had many divided governments, and the good news is that Joe Biden has spent his lifetime in the chambers of Congress cutting deals and making compromises. He is saying all the right things about unifying the American people, but this election was clearly not unifying. I do not expect to see QAnon, the KKK, Bernie Sanders, and Antifa getting together to sing Kumbaya. We will still be divided, and COVID will still be here.

It will be a grim couple of months as far as COVID is concerned, with cases rising and families getting together for the holidays. The good news is that soon, several vaccines will be announced and hopefully released, so help is on the way. It feels like the early months of 1945, when everyone knew the end of the war was in sight but still very far away with a lot of human and economic carnage to come. Nobody wanted to die on the last day of the war.

Bruce Kirsch

To respond to your comments, I happen to be in Georgia, and you are spot on. Fortunately, people will be so frustrated by the advertisements that they will probably go to the polls so they do not have to deal with it again four years from now. It could actually drive a better turnout than the general election.

We happen to be recording this on Veterans' Day. I read a heartwarming article in the Washington Post about a soldier who wrote his infant son, the author of the article, a letter from the frontlines at D-Day. The major takeaway is that this will not last forever. People need to keep that in mind. However, we are coming into the cold and flu season. Outdoor space heaters are selling out everywhere as people and businesses realize that the only way we will have a social life this winter will be outside.

Peter Linneman

It is going to be a challenge. As you know, I was very concerned about unrest, riots, and looting related to the election. So far, it has not happened which is very good news, especially for cities. Had there been massive looting and damage in cities it would have set them back three or four years. Cities have enough to recover from after COVID and the last round of unrest as it is.

Bruce Kirsch

I saw pictures of landlords putting up plywood barriers in front of gorgeous lobbies. I am thankful that it did not come to that.

I would like to switch gears to talk about the Linneman Letter, which for those who do not know is a phenomenal quarterly publication offering market insights and research. In an earlier issue, you pay homage to the impressionist painters, especially pointillist painters. If you look closely at a pointillist painting, you see nothing but dots, but if you look at it from afar, you see a picture. You say one of the things you do as an economist is, like abstract painters, look at scattered dots in the market and find patterns and trends and put them together into something cohesive. Let us talk about your concept that you have called the Butterfly Recovery.

Peter Linneman

A lot of people, even trained economists, tend to get too close to the picture so they only see the dots but not the picture. One of my skills is looking at dots from all over and putting them together. Government data, non-government data, and even anecdotal information from colleagues, can all be brought together to make a complete picture. This has not been a typical cyclical recession. This recession was caused by local, state, and federal governments around the world telling us we were not allowed to do certain things because of COVID. We were not allowed to go to restaurants, go to movies, or in China and other countries, you could not even leave your home. The second cause was, even if we were not forbidden from doing certain things, many of us chose not to do them over COVID fears. For example, I was allowed to fly within the U.S, but I have not flown. I am allowed to have people in my home, but I have not. The recovery will not be finished until both factors are receded in the U.S. and abroad. Once people are allowed and willing to participate in the economy, things will get back to normal.

Unfortunately, this recovery will not be fast. It will happen in fits and bursts over a long period of time, like the flight of a butterfly. Butterflies do not fly in a straight line. They will go side to side, up, down, sometimes a little backwards, but overall they still go forward. If you think of the two factors causing this recession (government restrictions and personal concerns) the recovery will come in fits and bursts. Philadelphia, for example, has just decided not to reopen schools. My wife and I have been allowed to go to the gym for some time now and have done so. However, with cases increasing we are now considering whether we want to continue to go for the next couple months. This is me slowing the economy, as opposed to the government. As long as these examples continue to occur, the butterfly will keep fluttering backwards as it goes forward.

To look at one metric that could show how much the economy has recovered, watch NFL or NBA stadiums. Once they are full, it shows that the government has said we are allowed to go, and enough fans have decided they want to go. That will mean the economy is back to normal. This is a good metric because everyone can turn on the TV and look at the stands at different sports games. Today you can see most stadiums have very few people. Even if the Eagles were allowed have every seat on sale, they probably would not sell out because not enough people are willing to go.

This is why it is a Butterfly Recovery. I get data every day, or dots, that show two steps forward and one step backward. We have come a long way from the bottom in late May but still have a long and slow path forward. Airports, hotels, and overall tourist activity all show we have a long way to go.

Bruce Kirsch

People tend to talk about these things in hushed tones. We whisper to each other about flying or going to the gym because they have become so taboo. We are in a completely different realm right now. Along those lines, deal flow has been down.

Peter Linneman

A huge reduction. There has been a little bit holding on in industrial and apartment properties, but office, hotel, seniors housing, and retail deals are pretty much gone. There are basically no loans to be had for these property sectors other than for large companies like Wal Mart or Amazon. On the other hand, banks are forbearing. They have unlimited reserves due to QE 1, 2, 3 and now QE Infinity. The Fed and other regulators have told banks to forbear with the massive reserves. Interest rates are also low, so as long as you have a positive NOI you can service a new loan at 150 bps over the short-term rate. That could continue for easily another year. Loans that are challenged are securitized like CMBS or things with negative operating income. It is one thing to say, "I will forbear," but it is another thing to say, "I will give you a new loan to replace the old one."

Private lenders, on the other hand, do not have unlimited reserves. They may not have the ability to forbear. You will see some activity there, but I do not see massive opportunity there. Where I do see good opportunity is in multifamily, which we talk about in the upcoming issue of the Linneman Letter. Multifamily is doing okay, but unemployment is still high. We now view it as good news that we only had 750,000 people filed for unemployment last week. It used to be a bad week if over 300,000 people filed unemployment. So multifamily will struggle, but it has the benefit that if one tenant is lost the entire business will not necessarily collapse.

A simple exercise featured in the next issue of the Linneman Letter is to imagine you buy at a 4.5% CAP rate, you can borrow at about 2.8%, you get amazing coverage on current NOI both of debt and interest. Using those numbers, we did the following exercise. What if income over the next 12 months falls by 10% and falls by another 8% over the following year? An 18% drop in income from today is fairly dramatic. What you will find is you still have debt coverage of about 1.1% and and interest coverage of about 1.9% so you are not going to lose your property even after the 18% drop in income. Even if income fell further you can still cover the interest, in which case they will switch to a sweep loan. After six years you will have recovered from the 18% drop to be back to where you started, and income will go up 1-2% every year after that. That turns out to be a 9.5% IRR even with a huge drop in income the day you purchase. That is an attractive deal. Your cash-on-cash will be 2% at the worst in a world where ten-year treasury is 80 bps. The math is similar from other sectors but the lumpiness of Multifamily makes it more attractive. In office, for example, losing one tenant could mean losing all of your income. I feel good about buying multifamily because the spread is spectacular. Even if you lose income you will do good, and if you do not lose income you will do great.

Bruce Kirsch

It is not unexpected but interesting to see some corporate training clients change their curriculum from office modeling to industrial. It is important to see what that means. Generally speaking, what do you think is the future of office?

Peter Linneman

I am a big fan. People are more productive in an office than at home unless they are doing something creative like writing. Most people are not disciplined enough to focus at home or do not have the necessary facilities. My brother Doug could easily work from home like the rest of our team, but he struggles to focus at home so he goes to the office even though he is the only one there.

Gensler just did a study that found that most people are anxious to go back to work as long as it is safe. The notion that everyone will be working from home in the future is a myth. Most of us cannot do it. Academics think they can work from home because they do not want to interact with students, but the students do not feel the same way. Once it is safe to get back to the office and we do not need to worry about COVID related lawsuits being filed by employees, people will go back to work. Companies care about their employees and customers and want them to be safe, which is why they are not rushing to get their people back. But once it is safe companies will want their people back in the office to bring back productivity. Great businesses like Microsoft could be managed remotely but they never could have been built from the ground up remotely. It is the building and growing that need to return.

There is also a psychological aspect to returning to the office. If no one is going to work, I am missing none of the socialization or office politics. However, if 65% of the team is working in the office, I need to be there to keep up with what is going on socially and to protect myself from the office politics. There will be a tipping point at which enough people have returned to work that everyone else wants to follow. Offices will benefit from this over the long term because the inefficient new offices with shared workspaces will be gone. Those offices will be retrofitted to be more like traditional offices with cubicles and more square footage per worker once employees are working in person. We will also see new leases once people return to work. Right now, the only new leases come from expiring leases where tenants will only renew for one year at a time, meaning there are few totally new leases being signed right now.

As for industrial, people are focusing on it right now with good reason. Industrial properties for online retail use about three times the square footage of traditional warehouses so there is good news in this sector. However, industrial real estate is still struggling. Somebody owns the warehouses that service airports, casinos, convention centers, and other casualties of the COVID shutdown. A year ago, these suppliers were thriving, but now they have nothing to supply. The owners of these facilities will struggle to survive until the tourist industry recovers.

Bruce Kirsch

What are your thoughts on brick retail versus online retail?

Peter Linneman

I am a believer in good retail. Bad brick retail can mean a lack of good products or a failure to excite the interest of customers. Bad retail has always faced challenges. Good retail, however, always finds ways to thrive. Of course, good retail can become bad retail over time as trends or management change. A lesson I learned from Al Taubman is that you cannot lower your rent enough to change the price of your product. If you cannot lower the price of your product you cannot bring in customers. A lot of landlords think a bad location can be fixed with lower rent. But if tenants are not able to attract customers, lower rent will not matter to them. Today we are seeing a culling of several years' worth of bad retail in the span of a year. This bad retail would have failed within the next several years anyway, either to online or to better locations. People forget that the beauty of competition is the weeding out of the weak. The sales of weak shopping centers or retailers do not disappear, they go to other, stronger shopping centers. In the short term, everyone was challenged by this year's downturn. In the long term, the strong retailers are going to come out stronger than before because they eliminated so much of their competition. Because of the aforementioned Butterfly Recovery this period will still be difficult for good retail, but they will survive.

Bruce Kirsch

We will come out of this downturn eventually. If we take a step back and imagine we are looking back from five years from now, what opportunities will I have missed?

Peter Linneman

The one I think people will miss the most is the apartment experiment I described. You can take huge drops in income and still do okay long term. As for other opportunities, the best thing to do right now is to not do much at all. You may come across some unique opportunities that are worth pursuing, booking for great opportunities now is like trying to catch a butterfly. Having said that, we are past the bottom. We could easily go down again because of new restrictions the government may place as cases rise this winter, as well as what we decide we are unwilling to do. We are not necessarily out of the downturn, but it will not be as bad as the initial shutdown. We have learned a lot since March about the way the virus works.

Five years from now we will look back and see the same thing we saw in 2015 versus 2009. The Fed put enormous amounts of money into the banking system. At first it maintained liquidity and people say we never got inflation from the flooding of reserves. That is not true. We never got consumer inflation, but we did see enormous asset price inflation from 2009-2019. By and large, the money chased assets rather than consumer goods. Bonds, stocks, real estate, gold, and silver all saw massive inflation. On the consumer side, the two products with notable inflation were healthcare and higher education, but both of those are also assets in a way. We are setting the stage for the same thing for the coming decade. This means higher multiples and lower CAP rates like we saw last decade, starting a year and a half from now.

All of my analysis shows that it is money chasing that drives CAP rates, not interest rates. If I told you there was going to be five times as much money chasing, you know the CAP rates will be down.

Bruce Kirsch

There is so much to talk about but unfortunately, we do not have time for it all. I do want people to know that everything we have talked about today is just a taste of what is addressed on a regular basis in the Linneman Letter. You can find more information about the Linneman Letter at www.Linnemanassociates.com , and REFM at www.getrefm.com .

Peter, thank you so much as always. Two webinars ago I asked you how you stay positive during tough times? Your answer was that it beats the alternative.

Peter Linneman

That is absolutely still true! We will survive. I will say two things to end on my part. The 20th anniversary of the Linneman Letter is coming up next year. I was looking at our first issue for fun and I realized that since then we have had the Dot-com Crash, 9/11, the Financial Crisis, endless natural disasters, COVID, and endless political scandals, but through all of that, the world did not come to an end. At each of those moments there were people saying the world was ending, but it never did. And that is the one thing that Linneman Letter has done consistently over these 20 years. We have always said the world will go on and that we will recover. And if the world is coming to an end, it does not matter.

The second thing I will say is that we will not have a chance to speak to our listeners until after the holidays. So, I want to say happy holidays to all. Stay safe and stay smart. Like the soldiers in 1945, do not die needlessly right before the end of the war.

As you get ready to go through the holiday season, all I can say is to do good. No matter how difficult things are for you, there are always people who have it worse. Be ready to lend an emotional helping hand, a kind word, or a dollar if you can. There is no shortage of good causes and of people struggling. Be alert to people that you know and care about who suffer from depression this winter and get them the support if they need it.

Happy holidays, stay safe, and thank you very much, Bruce.

Bruce Kirsch

Yes, thank you Peter. We will see you again next year. Maybe we will have flying cars by then, but we will just have to wait and see. Happy holidays and take care.