Episode 105: Commercial Real Estate in a COVID World

Speaker 1 (00:04):

Welcome to The Bill Walton Show, featuring conversations with leaders, entrepreneurs, artists, and thinkers, fresh perspectives on money, culture, politics, and human flourishing. Interesting people, interesting things.

Bill Walton (00:25):

Welcome to The Bill Walton Show. I was chairman and CEO of Allied Capital, chairman for 14 years, CEO for 13 years. During that time, one of our very best businesses was commercial real estate lending. The architect of that business, John Scheurer, was also the leader of the business and was also CEO of Allied Capital during my last year there. We took in a merger together.

Bill Walton (00:53):

Josh Scheurer is the kind of man that lives and breathes commercial real estate. John would go on a vacation to, let's say, Miami Beach, and you get John on a cell phone and you say, "John, how's it going?" "Well, I haven't been to the beach yet. I got to go down look at the shopping mall down in Key Biscayne because I'm worried about whether the roof is any good and whether it needs repaired. We got a loan on it, and I want to make sure the parking lot is okay as well." That's John. He lives and breathes it.

Bill Walton (01:20):

With all the carnage going on in commercial real estate now because of the COVID-19 lockdowns, I got curious about what's happening, how bad is it, are there investment opportunities? I called John, and we started talking. After about five or 10 minutes, I thought, "I want to share this with other people, so let's have John on the show to talk about commercial real estate, where we've been, where we are, and where it's going."

Bill Walton (01:46):

John?

John Scheurer (01:47):

Bill, it's great to be here.

Bill Walton (01:50):

It's like sitting in investment committee.

John Scheurer (01:51):

It is. We had lots of fun over the years-

Bill Walton (01:54):

We did.

John Scheurer (01:54):

... on many things.

Bill Walton (01:56):

Let's talk about what we did together in Allied Capital Commercial and then when we got into the B-piece business. I think that'll help set the stage for how much you know about what's going on now.

John Scheurer (02:07):

Okay. Well, we should probably even go back before when you were a director and before you took over. I came to work for Allied really in the summer of 1990, and I approached them with the idea that there was an opportunity to buy loans from the Resolution Trust Corporation and the FDIC and banks and life companies because there was so much distress, and they hired-

Bill Walton (02:34):

RTC had taken over all these loans from the banks when the banks went under.

John Scheurer (02:38):

Right, back in the '80s. If you remember, in the '80s, we had this huge building boom that was fueled in part by tax regulation and then convincing the S&L's that they had to get into commercial lending when they didn't really know that much about it. We had a large building boom, and then ultimately everything collapsed and the government took over.

Bill Walton (03:03):

Like all crashes, it becomes an investment opportunity, and that's where you came in.

John Scheurer (03:07):

Right. Exactly right. We looked at a whole lot of opportunities back in those days, and we started buying loans at a discount on all kinds of commercial property all over the country. It involved a lot of due diligence. Similar to today, you had appraisals on a lot of properties, but the appraisals weren't worth very much because underlying assumptions had dramatically changed. We were a little bit flying blind, but we had to figure out what was good and what was not so good. So we invested in a lot of pools, and then that-

Bill Walton (03:49):

But I think the important thing that ought to be stressed here is that, and this gets to my joke about you, not wasting, investing your vacation time, we didn't have any documentation. We didn't know what we had, so we needed to develop a team of people to go out and look at the properties, talk to the rent roll people and whatever, to really get to know them firsthand, not just rely on a piece of paper.

John Scheurer (04:13):

Right. Well, that's exactly right. Commercial mortgage documentation was a lot less stringent in those days, so many files had almost no information. You're right, we had to develop all the policies and procedures to go figure out whether things were good or not good, or whether we thought there was a possibility of making or losing money. We did that, and we successfully bought a number of pools of loans. Then, as you know, we raised Allied Capital Commercial Corporation in '92 and-

Bill Walton (04:49):

Public company.

John Scheurer (04:50):

Public company. And then Business Mortgage Investors in January of '93. Those two co-invested in a lot of loans that we bought from the RTC and the FDIC and banks. Then similar to today, also, back in the '80s, hotel loans became problematic. By 1990 or so, you couldn't get a hotel loan anywhere. I imagine today if you go out looking for a hotel loan, you're not going to get many takers at any level, either banks or life cos. or anybody else.

Bill Walton (05:28):

Well, one of the things we're going to figure out is when it becomes investible again. I interrupt. Continue.

John Scheurer (05:35):

It's all a function of price. We started probably in late '93, '94, originating some loans on hotels.

Bill Walton (05:48):

Which means making the loans to the hotel owners.

John Scheurer (05:50):

To the hotel owners.

Bill Walton (05:50):

You went from buying the loans to-

John Scheurer (05:52):

Originating. Right. Then we expanded out into other property types at the same time, but my point is that we did hotels because it was the most lucrative opportunity at the time. Now, you had to be very careful, obviously. You wanted to be low leverage and have lots of equity and things like that, but we still moved in that direction. Then we did a couple of securitizations. We were early on in the commercial mortgage-backed securities-

Bill Walton (06:24):

Securitization is where you bundle a bunch of loans and sell them as a bond.

John Scheurer (06:27):

Yes. We did one in 1995 and then another one in '98. Those two totaled, I don't know, 350 million or so, roughly, in bonds. And we held a lot of subordinate bonds. Then you came in '96, I guess.

Bill Walton (06:49):

Late '96. Yeah.

John Scheurer (06:50):

Late '96, you came in, and you and I sat down-

Bill Walton ([06:55](#)):

Well, we had five separate public companies. The first thing I did to you was I said, "John, we're going to merge your company into the four other companies."

John Scheurer ([07:01](#)):

That's true.

Bill Walton ([07:03](#)):

But we did double our market cap.

John Scheurer ([07:04](#)):

We did.

Bill Walton ([07:05](#)):

It worked out, and we had really good access to capital because of that.

John Scheurer ([07:08](#)):

We did. At the time, certainly I was looking at both sides of that thinking, "Okay, well, wait a minute. Am I better off here?"

Bill Walton ([07:16](#)):

Well, you're CEO of your own public company, and I was saying, "Gee, now you can become an executive vice president."

John Scheurer ([07:21](#)):

Right. But in retrospect, you're right, it doubled our market cap, but it gave us much better access to capital ultimately, which helped us immensely in the long run. And, Bill, you and I had different skills in a lot of ways, and it gave me the opportunity to work much more closely with you. I felt like I grew substantially during that period of time.

Bill Walton ([07:48](#)):

Well, I did too. It was mutual. But I want to jump in because I want to get into today. I think the thing that gives you such a great view, and all these deals came through our investment committee, was when we got into what they call the B-piece business, which is where you buy subordinated debt financing, and it's bundled together and it's put together in a bond. Actually, I'm going to let you describe it. It's been 10 years. Bring me up to date.

John Scheurer ([08:23](#)):

You take a pool of mortgages, and you take the cash flows from those mortgages and you peel them off, let's say, so that the first cash flows go to the senior bonds, which would be the AAA, and then they filter down, sort of like taking a bucket of water and filling up various glasses until you get to the end. This was as a result of the debt crisis in '98, when all of a sudden the capital markets froze up, there was no more money for people buying B-pieces. Anybody who was putting commercial mortgage loans on repo facilities, repurchase agreements, so they would-

Bill Walton (09:12):

So you took us into this business, and we ended up dominating it. At one point, you were known as the King of the B-Piece Industry.

John Scheurer (09:21):

Well, I don't know about that, but I was certainly-

Bill Walton (09:23):

Well, I remember that. You were a big deal.

John Scheurer (09:24):

I was in the royal court maybe.

Bill Walton (09:26):

We underwrote over 7,500 loans that had 55 billion face value, and for all types of commercial property. We did 1.8 billion over, what, six years?

John Scheurer (09:36):

Yeah.

Bill Walton (09:39):

As a consequence, you and me, as part of the investment committee, we saw basically every single piece of commercial real estate loan being underwritten during that period.

John Scheurer (09:48):

We did.

Bill Walton (09:49):

We got a great overview of the whole hotel, office, retail, multifamily, industrial, the whole list.

John Scheurer (10:00):

We did.

Bill Walton (10:02):

But we did do something pretty smart, which was, in 2005-

John Scheurer (10:07):

We sold our entire portfolio.

Bill Walton (10:10):

Which was two years before the whole thing blew up.

John Scheurer (10:12):

Yeah. Now, I will say that the people who bought it resecuritized our entire portfolio and got most of their money back, so they could have... For us, that would've been another alternative.

Bill Walton (10:26):

Well, you and I had long discussions about whether or not to sell that portfolio-

John Scheurer (10:29):

We did.

Bill Walton (10:30):

... so you get the last word. They made money on it.

John Scheurer (10:33):

No, listen, it was a great move. It was a great move, clearly-

Bill Walton (10:36):

We got out of it.

John Scheurer (10:36):

... because who knows if the securitization, that market would've held up when we were trying to do it? And we got a great price.

Bill Walton (10:46):

Yeah, well-done. So let's come up to today. We're six months into the lockdowns, catastrophic impact on commercial real estate. Categories, though, have been affected differently. We've got single family, which is not so much affected, industrial, medical, storage, apartment, student housing, senior housing, but then it starts getting really ugly when you start moving into office and hotels and malls and that sort of thing. How do you want to go at this? What piece do you want to start in?

John Scheurer (11:21):

We could start on... Let's talk about hospitality since we were talking about hotel loans.

Bill Walton (11:26):

Okay, let's go there.

John Scheurer (11:31):

The thing with hotel loans is you're renting a room every night, so when all this started, hotel revenues basically shut down. I would say probably most of the hotels in the country couldn't cover their operating expenses, let alone produce any net operating income. Supposedly, it's come back a little bit, but it's still, I don't know, 70% to 80% below where it was before.

Bill Walton (12:10):

Have all hotels been hit in the same way? Is there regional differences? Are there property-type differences?

John Scheurer (12:18):

Clearly.

Bill Walton (12:18):

Who's getting killed?

John Scheurer (12:19):

If you think about the biggest segment of the hotel market, it's Las Vegas. Las Vegas survived based on these huge conventions that would go there, and there haven't been any conventions. All of those hotel rooms are sitting partially used, and there's still operating expenses accruing to all of those owners. That's a tough piece of the market.

John Scheurer (12:44):

Then you think about airport hotels. Not many people going to airports, certainly not business travelers, so those people who stayed in all of those hotels. Those hotels, that may take a long time to come back. And it may take a long time to come back... Las Vegas itself may take a long time. Then you think of Orlando, which-

Bill Walton (13:10):

Disney.

John Scheurer (13:10):

Disney and Universal and all of those hotels.

Bill Walton (13:14):

Who's getting hurt here? Because ultimately when you think about people who may be watching and listening to this, you own stocks. I hope you don't own a lot of stocks in hotel companies right now, but they might come back.

John Scheurer (13:27):

They might come back.

Bill Walton (13:28):

So it might be a good time to own it. Then there are all the entities that own the debt, and they're underwater, presumably. The hotels are worth a lot less than the debt. Who owns that debt?

John Scheurer (13:40):

There's a fair amount of debt in the CMBS market.

Bill Walton (13:44):

Commercial mortgage-backed securities.

John Scheurer (13:45):

Securities. If you look at just that market itself, roughly, I don't know, 20% or 25%, let's say, of the hotels are probably in special servicing, let's say, and then there's probably another 40% or 50% that are on a watch list. So about 70%, roughly, is what people are thinking, of hotel loans are on some sort of potential default or watch list.

Bill Walton (14:18):

Our euphemism is special servicing.

John Scheurer (14:20):

Special servicing. Exactly.

Bill Walton (14:23):

Which means you can't pay us back, and we've got to talk.

John Scheurer (14:26):

Right. We had our special servicing platform that we also sold when we sold the portfolio, and we sold it for very little because prior to 2007 or '08-

Bill Walton (14:43):

There wasn't much going on.

John Scheurer (14:45):

No. Special servicing hardly ever made any money. It's a very labor-intensive business working out loans. But our old special servicing platform, CWCapital, which is located here in Bethesda, I guess soon to be D.C. Dave Iannarone is the chairman, who-

Bill Walton (15:06):

He's great.

John Scheurer (15:06):

... worked for us.

Bill Walton (15:07):

He's great.

John Scheurer (15:07):

Jim Shevlin is the president. Jim worked for you and I.

Bill Walton (15:11):

Are they public?

John Scheurer (15:13):

They're not.

Bill Walton (15:13):

That's too bad.

John Scheurer (15:14):

They're privately owned by Fortress.

Bill Walton (15:17):

Okay. Anyway, those are good people.

John Scheurer (15:25):

I think initially they had $18 billion worth of requests for forbearance just across their portfolio when this whole crisis started.

Bill Walton (15:37):

You're watching The Bill Walton Show, and I'm here with John Scheurer, my commercial real estate guru. We're talking about an arcane term, special servicing, which is a business which was not a very good business when real estate loans were doing well, but now that they're not doing well, special servicing is where all the action is, working out bad loans.

John Scheurer (16:00):

Working out bad loans.

Bill Walton (16:01):

CW is doing that.

John Scheurer (16:03):

It's just getting started, because you've got a couple of things happening. One, there's been fairly generous forbearance agreements offered, and then the second thing is there are restrictions on foreclosures in some states. On the multifamily side, there's eviction restrictions. There's a lot of problems that are building up that people are hoping get fixed, and they may or may not get fixed.

Bill Walton (16:35):

But most of the projections for hotels is that... Nobody knows, but you've got to assume people are going to be traveling less, or maybe not.

John Scheurer (16:45):

Yeah. When I said in the beginning this is similar to early '90s, when you had a lot of hotels and lenders didn't want to touch them, and you didn't know how they were going to do, ultimately I think the hotel market comes back, but there'll be pockets of it that may not be quite the same.

Bill Walton (17:10):

Well, is it going to be the vacation traveler may come back, but the business traveler probably won't? I think there's going to be a permanent change in the way people do business. Everybody has gotten used to Zoom, and it's pretty nice to just get out of the shower, go to your living room all ready to go and get in front of the camera, and not have to go to the airport.

John Scheurer (17:34):

Right. No, I would agree with you. If there's a permanent change and you have less business travel, so all the hotels that were built around airports, maybe they don't do so well. Do people ultimately want to go to conferences less, like the big events in Las Vegas and Orlando and some of the other big conference towns? Maybe. Maybe they don't want to go to those quite as much. So maybe those things were overbuilt, and the rates are going to have to be lower, and the returns on equity.

John Scheurer (18:10):

The other thing is when you look at the CMBS portfolio, I think Moody's did a study recently. They were looking at appraisal reduction potentials for hotels, and it's between 25% and 30%, let's say, already. You're going to have a reduction in the value, certainly, of hotels for some period of time. If you think about it, all the people that, if you've got a hotel loan, and let's say it's, who knows, for ease of calculation, let's say it's $100 million, and you had a $70 million loan on it, and all of a sudden the property is worth $70 million, and it's a non-recourse loan, are you going to continue to put money into it?

Bill Walton (18:57):

The answer is no.

John Scheurer (18:58):

Probably not. You're just going to say, "Okay, Mr. Lender, I'll give you the keys or I'll give you the property back." There may be a lot of deed in lieus happening in the hotel industry.

Bill Walton (19:10):

In terms of who's feeling the pain from this, most of the hotels are owned... A branded hotel like a Hyatt or a Marriott or a Hilton or something like that, they're not owned by the hotel chains. They're managed by them. You've got a group of local investors, most of them very high net worth, and this is a part of their portfolio. They're not going to like it, but it's just one of the things that go with the territory. What I'm looking for is some cataclysmic outcome... I'm not looking for it. I'm just trying to probe to see where that's happening. I don't see it happening. I just think this is going to be repricing.

John Scheurer (19:51):

Right. Yeah. No, I agree with you on the hotel side. Certainly, if all your net worth is tied up in hotel equity, it's going to be really painful.

Bill Walton (20:03):

Well, then you weren't thinking.

John Scheurer (20:04):

Right. But if it's spread out between that and a lot of other things, then-

Bill Walton (20:10):

Which is where I think most of the investors are in this kind of property.

John Scheurer (20:13):

Yeah, you would think so.

Bill Walton (20:15):

Most of the guys we dealt with, this was a part of everything else. So any final word on hotel before we get to... I want to get into office and retail. Anything else on-

John Scheurer (20:29):

No, not on hotels. I do think most of them are going to come back, and they'll be repriced.

Bill Walton (20:39):

This is one of the brutal realities of the capital markets, is there's this constant repricing of assets. There are booms and there are crashes, booms and there are crashes. This just absolutely goes with the territory if you're an investor or a lender.

John Scheurer (20:54):

Right.

Bill Walton (20:56):

Office?

John Scheurer (20:57):

Office. Okay-

Bill Walton (20:59):

What are the occupancy rates in Manhattan?

John Scheurer (21:02):

Well, there's a new-

Bill Walton (21:03):

I know the number.

John Scheurer (21:04):

There's a new metric. Used to be you look at percent leased or whatever, and now it's percent occupied. Nationally, I think that occupancy rate is around 25%. People across the country-

Bill Walton (21:18):

Measured by who is going into the office.

John Scheurer (21:20):

Yeah, who's going into the office. In Manhattan, they say 10%, 12%.

Bill Walton (21:24):

I've heard 10.

John Scheurer (21:25):

Yeah, 10.

Bill Walton (21:26):

It could be 12.

John Scheurer (21:26):

Yeah. That leaves a huge hole in the infrastructure that was there to take care of all of the office users, all of the little restaurants, the shops, the-

Bill Walton (21:39):

What's happening in suburban New York? Are offices in Westchester now beginning to see people wanting to be there because they're closer to their house, or what's the-

John Scheurer (21:49):

Well, I think you're seeing the same thing that you're seeing in the residential housing market. People are looking to move out into the suburbs. What is it? I saw used car prices are up 10%, which is just off the charts, because everybody wants a car and they want to be able to commute in to work or get a car-

Bill Walton (22:10):

Gas prices are low.

John Scheurer (22:12):

And gas prices are low. Somebody else said it used to be... A while ago, you look at a suburban office, and it always had a higher vacancy rate than downtown office. Now, all of a sudden, suburban office occupancy rates are increasing.

John Scheurer (22:29):

Another anecdotal thing I heard the other day, it used to be that there were old single-story office parks that might not have been doing so well, and now people want to lease those things quickly, because it's great. Their workers can drive in. It's much more spacious and inexpensive.

John Scheurer (22:54):

The one thing that is going to come out of all of this, Bill, is if you think of where rents were in Manhattan, let's say, or San Francisco, if they were $80 a square foot or $100 a square foot, depending on where you were, or more, but if all of a sudden you can rent space for $20 or $30 a square foot or something like that, the other piece of that is, what percent of your workers are going to come back to work on a full-time basis? You and I talked about this many times over the years when we had multiple offices around the country and how hard it was to keep our culture, our credit culture-

Bill Walton (23:46):

We've talked about that. In hindsight, I think it was a bad decision to have multiple offices because you can't keep the credit culture that you have when you've just got one space that people can work in. I think we've adapted to this virtual Zoom way of doing business, but I don't know how sustainable that is.

John Scheurer (24:06):

I don't know either.

Bill Walton (24:09):

I think people have got to touch and feel and communicate, and you read people in a way in person that you don't read them if you're looking at them on Zoom.

John Scheurer (24:18):

Right. I agree with you, but does that mean you have to come into the office five days a week?

Bill Walton (24:24):

No.

John Scheurer (24:24):

No. Probably you can get by with less.

Bill Walton (24:28):

One, a day. Yeah, something like that.

Bill Walton (24:32):

I forgot something on hotels. I wanted to circle back, just because this is so interesting. Occupancy rate at hotels have stayed plummeted, depending on the number, yet hotel occupancy in one country has been going up straight through this whole COVID thing.

John Scheurer (24:48):

Isn't that shocking? And which country could that possibly be, Bill?

Bill Walton (24:53):

I'm leaving that to you.

John Scheurer (24:56):

China. I pulled this slide, but I don't know that I believe anything that comes out of China. This showed that their occupancy in September was back up to where it was in September of 2019.

Bill Walton (25:11):

It had dropped. It's now at about 67%, and at the beginning of this it was, what, 10%?

John Scheurer (25:16):

Yeah, and it's all the way back up. It's hard to believe, isn't it?

Bill Walton (25:24):

I don't-

John Scheurer (25:25):

I don't know.

Bill Walton (25:27):

I think we're outside of our area of expertise here.

John Scheurer (25:31):

I agree.

Bill Walton (25:33):

That's a number that really strikes me as being strange.

John Scheurer (25:35):

Yeah, very strange. But in any event, it was one that we had to talk about.

John Scheurer (25:45):

Office, in the face of all of that, you've got to say to yourself, okay, how long does it take cities like New York and San Francisco, Chicago to come back? There's been multiple effects from COVID, and some of it is how locked down these cities were vis-a-vis the suburbs or other parts of the country, and how many small businesses that serviced those office buildings go out of business and aren't there to serve office users. Do you want to go into the office if there's no place to get lunch, if there's no place to do your dry cleaning, all of those things? It could take quite a while for all of that to come back. In our lifetimes, we remember New York in the '70s and '80s, and you lived in New York. It was a tough place to be.

Bill Walton (26:52):

Well, it was tough, but you still had restaurants.

John Scheurer (26:55):

That's true.

Bill Walton (26:55):

And you still had museums, and you still had all the things that it doesn't have now. We're going to get to that in just a second, as soon as we finish out the office piece.

John Scheurer (27:06):

Okay, well, I've got one last thing to say about office, too, which is-

Bill Walton (27:09):

I also want to know when we can start buying office buildings. At what price do we-

John Scheurer (27:14):

Well, interestingly enough, as you might guess, there's not much leasing activity around the country for office because people are nervous. What do they want to do? Do they want to commit to more space someplace? I don't think so. But in March, I think, Amazon bought the old Lord & Taylor building in New York and saying, "We're going to convert this to office use."

Bill Walton (27:46):

Oh, that's interesting. We're wondering what's going to happen to the department stores, so that's-

John Scheurer (27:51):

There's one use. If you think about it, you have this wide-open space that works well for-

Bill Walton (28:00):

It's a great atrium space.

John Scheurer (28:01):

It is a great atrium space. There's another building in New York where there was a lease signed in August, substantial amount of square footage, and it was for another tech company to do something similar. The tech companies may already be thinking, "This is a great opportunity for us. We can pick up space." Ultimately, young people like to be in these city centers. Maybe they're not there every... Maybe they don't live there. Maybe they're only there a few days a week.

John Scheurer (28:32):

Then as you look around the country, there's been a building in Charlotte that recently sold. Charlotte is a market that... You could almost say it's almost suburban somewhat in the way that it works, as opposed to being a big city like New York or Chicago or whatever. There's been a building sold in Miami. I'm in a fund in Florida, and we bought a building in West Palm Beach. There's one for sale that we're looking at right now, and the metrics are still very good, even if the occupancy is 25%, but it's rented to 98%. It's in a great location. There's been a ton of movement in the southeast. So some of it is jurisdictional and geographic.

Bill Walton (29:32):

What effect have the stimulus bills had on all this? Because it seems to me that they've masked a lot of pain. We've shipped trillions of dollars to people, and everybody is getting their piece of it. Small businesses, nonprofits, they've all gotten a cushion of money to pay things, and they're paying rent or whatever they're paying, but that money-

John Scheurer (29:55):

It's run out.

Bill Walton (29:55):

... is going to run out.

John Scheurer (29:56):

It's run out. That's right.

Bill Walton (29:57):

We're arguing as we speak about whether there's going to be another one. Once that money runs out, do we hit a cliff?

John Scheurer (30:07):

Could be, because all of a sudden delinquency rates go up more, some of these tenants can't pay the rent. If you think of the PPP loans, those extended across a lot of small businesses that, yeah, you're right, if they can't pay the rent, the landlords won't get it, and then the-

Bill Walton (30:30):

So in a way, we really can't... You're watching The Bill Walton Show. I'm here with John Scheurer, and we're talking about the effect of the stimulus on the commercial real estate market, the stimulus bills, the trillions of dollars, and what might happen when that runs out. I don't think anybody really knows the answer, but we're going to try to figure it out.

John Scheurer (30:50):

Right. Okay. We were talking about office before, but again, I think it'll be similar... There'll be a repricing of certain assets in certain locations. Maybe it's not as dramatic as the hotel, but there'll still be a repricing. Some suburban assets will become much more attractive and prices will be higher, and some urban assets will be less.

Bill Walton (31:18):

You probably know this as well as anyone, that real estate values and cash flows are really driven by social changes and fashion, really. The number of department stores has decreased from 10% of retail sales to like 1%-

John Scheurer (31:38):

Two or one.

Bill Walton (31:39):

... or 2%, something like that. That's all changed. I guess we're trying to chase what the trends in society are going to be. That's really going to tell you where you want to be in real estate.

John Scheurer (31:52):

That's right. The one thing that we've seen over many years, or at least the last 30 years, is that people like to be near cities if they're working properly. They like to be near city centers. Just the city center concept, if you think about that, that's been highly successful in developing a lot of, even, communities, even if it's a-

Bill Walton (32:26):

City centers historically, but city centers post... We're talking about social cost. City centers post-Black Lives Matter occupying inner cities, you go to downtown D.C. now, you look around the Hay-Adams and that whole neighborhood in there, it's all boarded up. It's all graffiti-

John Scheurer (32:43):

It's scary.

Bill Walton (32:44):

... by all sorts of people. That part of the inner city is not seductive.

John Scheurer (32:49):

No. Certainly not.

Bill Walton (32:51):

Unless we reclaim that, then it's going to be harder to see that you want to be downtown at your office.

John Scheurer (32:57):

Well, think about New York, your experience in New York in the '70s-

Bill Walton (33:02):

I loved New York, even in the '70s.

John Scheurer (33:05):

In the '70s. But it wasn't that safe, wasn't that clean. Maybe it didn't matter because you were so young.

Bill Walton (33:12):

I was young.

John Scheurer (33:13):

It was fine.

Bill Walton (33:14):

Seemed okay to me.

John Scheurer (33:17):

But it really took, what, a decade or almost two to get New York really going again. D.C., we had the same thing in the '90s. It became unattractive-

Bill Walton (33:30):

At 14th Street, you couldn't even-

John Scheurer (33:32):

Yeah. No, it wasn't safe. It wasn't that well-run. How these cities react to this is going to play a huge difference on how they recover. If you're a small business trying to get started in New York or D.C. again, if you go someplace and get one permit or one license that does everything you need to do, and you don't have to go to six or 10 different places to start your business, that might make it easier. If there's lending programs to help these small businesses get going, that'll go a long way.

Bill Walton (34:11):

If you want to track this, you want to track the lease expiration schedules. Occupancy is way down, but they're still filly leased. When they come up, that's the moment of truth.

John Scheurer (34:22):

That's the moment of truth. The thing is, in the office, it's spread out over a number of years, so it'll be years before we see the full effects of this, which, if you think about that, it gives some of these municipalities an opportunity to, if they can act quickly and fix things, then make it desirable for people to come back, maybe some of their tenants stay.

Bill Walton (34:54):

I want to shift to retail, malls and whatever, which is also Manhattan, and restaurants and that whole thing. We talk about closing restaurants. Well, the first-order effect is it crushes the restaurant owner, but the immediate effect is you get the person that owns the property doesn't have anybody in there who can rent it. You can see that in D.C., Wisconsin Avenue, things. Every week, Sarah comes back and says, "Well, this one shut down" or "That one shut down." That seems to be a rolling problem. There's something like 40% of the restaurants in Manhattan that people don't think are coming back.

John Scheurer (35:35):

40 or 50 or more percent. Yeah.

Bill Walton (35:42):

Tell me about that.

John Scheurer (35:44):

There's two components here, really, retail itself, which includes malls, but restaurants, and then the whole, I don't know if you want to call it the Amazon phenomenon, or the order online or click-and-deliver phenomenon, or whatever it is. First off, as you well know, we've been way overretailed. We have the highest retail square footage per person-

Bill Walton (36:17):

Yeah, what are those numbers? You sent me-

John Scheurer (36:18):

It's like 24%-

Bill Walton (36:19):

In America, we've got-

John Scheurer (36:20):

24 square feet per person in the U.S. versus-

Bill Walton (36:26):

We've all got our own four-foot-by-six-foot retail-

John Scheurer (36:30):

We do. Then if you look at the rest of the world, next is Canada at like 16%.

Bill Walton (36:36):

16 feet.

John Scheurer (36:37):

16 feet. Sorry. Then it drops down to most of the rest of the world is under 10 or under five. So we've been overretailed for a long time.

Bill Walton (36:51):

Germany is 2.3 square foot per people. Those Germans are not going to want you.

John Scheurer (36:57):

No, but they didn't build all the shopping centers and things that we did either. We were going towards click and deliver anyway, but this has dramatically increased that. A lot of that retail has to get repurposed. Maybe it becomes last mile delivery points for various retailers. Some of it converts to quasi-industrial or something like that.

Bill Walton (37:28):

What happened with a lot of these retail spaces, though, was as people went to buying things from small retail shops and went to Walmart to buy stuff from China, those spaces didn't go empty. They started filling up by service businesses, gyms, salons, nail parlor, things like that. Yet if you look at where we are now, almost a third, maybe half of those people can't pay their rent, the beauty salons, gym, fitness, entertainment, all these people that are service businesses. It's the service businesses that are getting clobbered right now.

John Scheurer (38:07):

Yes, all those people. It's heartbreaking if you think about what's happening to all of the small businesses, because they're all entrepreneurs that had the courage to get out-

Bill Walton (38:18):

It's heartbreaking.

John Scheurer (38:19):

Yeah, it is.

Bill Walton (38:21):

There's no focus on it, because you look at the stock market, and the stock market is doing fine. Those are all the large-cap companies. Those have not been hit in the same way these small businesses have. We've got two Americas right now. We've got the big-company America and the small-business America. Small-business America hasn't recovered, doesn't even show any signs of it.

John Scheurer (38:45):

No. They really have no way to recover without-

Bill Walton (38:51):

Even then, especially, the clock is ticking on the PPP money because that's going to run out.

John Scheurer (38:56):

That's holding up, so maybe that number ends up being much higher. The real challenge on keeping all of these urban areas together, even some of the suburban areas, is you have to provide those services for people somehow, some way. You have to have entrepreneurs that are going to get out and take a chance and work on it, so you've got to make it easy for them. It has to be light on regulation in order to help get their businesses going, and then they're going to need capital. And they're probably going to need rent relief.

Bill Walton (39:33):

Well, I think you sent me something. Retail closures, the headline is they face mass extinction.

John Scheurer (39:41):

Right. Well, what is it? The highest we've ever had was around 9,000 or something.

Bill Walton (39:48):

9,800 in 2019.

John Scheurer (39:50):

2019. We're projecting like 20,000.

Bill Walton (39:52):

That went bankrupt. Yeah. Now we're 20,000.

John Scheurer (39:54):

Yeah. Who knows where that goes, depending on... Then bankruptcy, as you well know... Fortunately, we didn't have to deal with it all that much, but we certainly did over the years-

Bill Walton (40:08):

One of the things we didn't do was we didn't get into retail.

John Scheurer (40:12):

No, that's true.

Bill Walton (40:14):

Sarah worked for Phil Merrill, who ran Washingtonian magazine, and they made a fortune on ads from restaurants in the magazine, probably still do. But Phil would tell you, "I'll run their ads, but I'm not going to invest in them." If you own a strip mall or commercial real estate, you're renting to a restaurant, you know it's going to last, what, two years, three years for most of them?

John Scheurer (40:38):

Yeah. It used to be seven years, I think, was the average life of a restaurant. Then I think, you're right, it's gone down over the... Who knows what it would be now?

Bill Walton (40:52):

We're running out of time, which is making me upset. There's an interesting thing about malls with closed anchors. Malls back in our day, you had Bonwit Teller. Maybe that's not a great example.

John Scheurer (41:08):

JCPenney.

Bill Walton (41:09):

JCPenney.

John Scheurer (41:10):

Sears.

Bill Walton (41:14):

Sears. The rule of thumb is if you've got a mall and you've lost three or more of those big box, or I don't know what the title is of those, the bigger store tenants-

John Scheurer (41:23):

Yeah, the anchors.

Bill Walton (41:24):

... the anchor tenants, your probability of staying in business is low.

John Scheurer (41:28):

Low. Right. There's a lot of those malls that are going to have to be repurposed for something.

Bill Walton (41:34):

I think that's an opportunity-

John Scheurer (41:36):

I do.

Bill Walton (41:36):

... for somebody somewhere.

John Scheurer (41:37):

I do.

Bill Walton (41:38):

Right now, what I'm worried about as we talk about this is, we talk about economic growth, I think we could see a second dip that's coming out of this as the-

John Scheurer (41:49):

Well, certainly if we don't get another additional stimulus of something to help these people, all our small business owners in this country, they're the ones that are going to be in real trouble.

John Scheurer (42:02):

But do you remember malls... Just as long as you went on this topic, and I'm maybe jumping around on you. But one of the best deals that we did back in the '90s, it was probably the late '90s, we helped finance a mall outside of Jacksonville, Florida. It was failing-

Bill Walton (42:21):

What a story that was.

John Scheurer (42:23):

This is a 650,000-square-foot mall, and the anchors had gone. It was 80% vacant, and it was a disaster. We helped a group buy the loan at a discount for like $3 million or $3.5 million. The developer came to us with a plan, and the plan was amazing, which was you had the City of Jacksonville agreed to put in $5 million in equity, they agreed to move in a police substation, they leased 20,000 or 25,000 square feet for their offices, they put in a transit station, and then ultimately the... This was in an area that had rapidly declined, and what ultimately happened, then Publix opened one of their first inner-city grocery stores in there. The mall became successful. It became a community center where there hadn't been much of a community before. We ended up owning part of the equity and-

Bill Walton (43:29):

John, you just put in high relief what private equity, what active investors do. I had a guest on the show, who will go unnamed, who's written all these essays now about how people in the financial sector add no value to the economy. I think about the hundreds and hundreds of deals that we worked where they'd gone under, we had to find tenants, we had to find this, we did that. We were in the donut business. Remember that?

John Scheurer (44:01):

Bill, don't ruin the conversation. Got sick eating donuts.

Bill Walton (44:06):

We were the only customers.

John Scheurer (44:10):

That's true.

Bill Walton (44:11):

Had to do something.

Bill Walton (44:18):

Multifamily and single-family renting, what's the story there?

John Scheurer (44:24):

There is another interesting one. Delinquencies in multifamily ticked up in September from August. Overall, they've probably looked pretty good, but again, you've got the issue where there are eviction restrictions, so you don't know for sure exactly how many of these people are paying. How many of them are small business owners that can't afford to pay their commercial-

Bill Walton (44:54):

Sam thing.

John Scheurer (44:54):

... rent either? Right. There could potentially be fairly substantial. Then think about in New York, New York rents were notoriously high, particularly in nice buildings. A lot of young people who, in the next five years, might've moved out of New York are looking around saying, "We're moving out," and rents are off 10%, 20%.

Bill Walton (45:23):

Well, as a former young person in New York, and your daughter was a young person in New York-

John Scheurer (45:31):

We did too.

Bill Walton (45:32):

You can now rent a studio apartment that has 600 square feet for only $5,000. I'm exaggerating.

John Scheurer (45:38):

No, I know.

Bill Walton (45:38):

But it's not so good.

Bill Walton (45:40):

Well, John, let's come back in six months and assess where we are, because I think for people who look ahead and don't look backward, I think there will be opportunities. We'll have a much clearer picture then than we do now.

John Scheurer (45:55):

We will for sure.

Bill Walton (45:57):

Okay. John Scheurer, star real estate investor, thank you for joining, my great partner. It's been so much fun. We'll talk in six months. You and I will talk before that, but we'll talk with everybody else then. Thanks for watching and listening to The Bill Walton Show. See you soon.

Bill Walton (46:13):

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