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INVESTMENT MANAGEMENT

GLOBAL PERSPECTIVES

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CHALLENGING TIMES FOR COMMERCIAL REAL ESTATE

HIGHLIGHTS

- The commercial real estate (CRE) industry faces multiple challenges, including shifts in office space demand, higher interest rates, declining asset values, and mounting financial strains.
- Small banks are disproportionately exposed to the industry's challenges since nearly 70% of CRE loans are sourced from them and account for nearly half of their total loans and leases.
- The acute financial strains facing the CRE industry pose the risk of a credit event and may be a signal that interest rates are close to peaking.

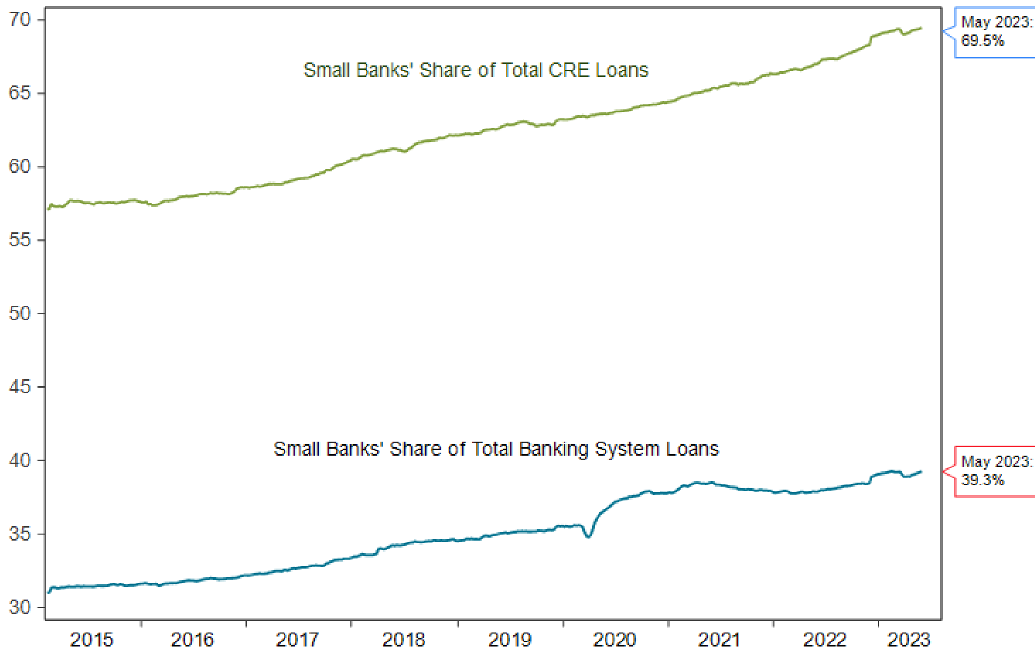
THE EVOLVING LANDSCAPE OF THE COMMERCIAL REAL ESTATE INDUSTRY IN THE WAKE OF THE PANDEMIC

The US commercial real estate (CRE) industry has faced unprecedented challenges in the wake of the COVID-19 pandemic. As businesses closed their doors, office spaces became vacant, and remote work became the norm, the demand for commercial properties plummeted. With the economy potentially facing a recession, the CRE industry continues to grapple with an evolving landscape characterized by shifting demand for office space, higher interest rates, and potential risks to financial institutions stemming from their exposure to CRE debt.

Although the CRE industry is estimated to account for just about 5% of GDP, it punches above its weight in terms of its macroeconomic significance. That's because nearly 70% of CRE loans are sourced from small banks with below $100 billion in assets, leaving a large swath of the financial system vulnerable to potential declines in CRE loan quality and asset values **(Figure 1)**. Commercial real estate also represents a $23.8 trillion asset class, roughly tied with US Treasuries, accounting for nearly 15% of the major asset classes tracked by the Federal Reserve **(Figure 2)**.[1]

FIGURE 1

Small Banks Account For Almost 40% of All Bank Loans But Almost 70% of All CRE Loans



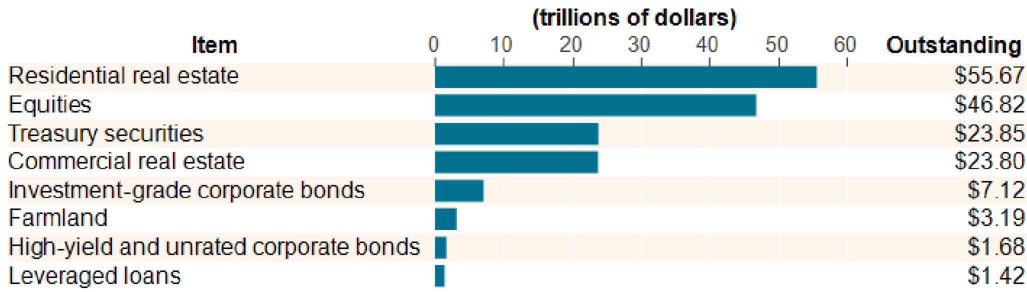
Sources: GW&K Investment Management, Federal Reserve, and Macrobond

Small banks have been aggressive lenders to the CRE sector and have sourced nearly 70% of CRE loans despite accounting for roughly 40% of total banking system loans.

[1] Board of Governors of the Federal Reserve System, "Financial Stability Report," May 2023.

FIGURE 2

Size of Selected US Asset Markets as of 2022: Q4 (Trillions of Dollars)



Source: GW&K Investment Management, Federal Reserve, and Macrobond

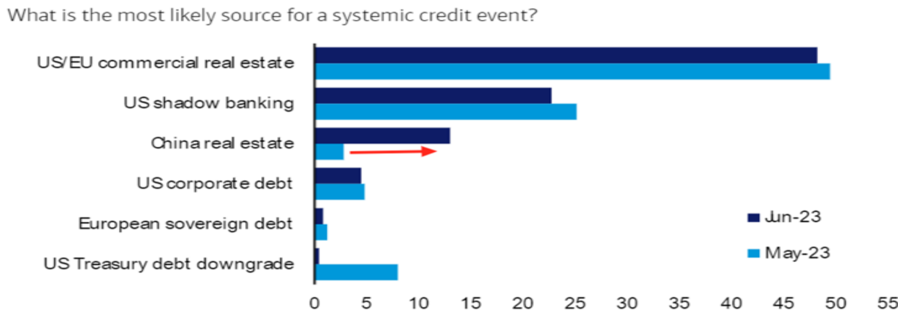
Despite only accounting for about 5% of GDP, CRE represents a $23.8 trillion asset class accounting for almost 15% of the $163.6 trillion market capitalization of the major US asset classes tracked by the Fed.

Because of the challenges faced by the CRE industry, a recent Bank of America survey of fund managers showed that CRE is widely viewed as the most likely source of a "credit event," a euphemism for a financial crisis **(Figure 3)**. In this article, we'll assess the challenges facing the US CRE industry and argue that the acute financial strains facing this important industry may be a signal that interest rates are close to peaking.

FIGURE 3

Commercial Real Estate: The Most Likely Source of a Credit Event

What is the most likely source for a systemic credit event?



Source: BofA Global Fund Manager Survey

Recent surveys of fund managers conducted by Bank of America have shown that nearly half of respondents believe that the CRE industry is the most likely source of a credit event.

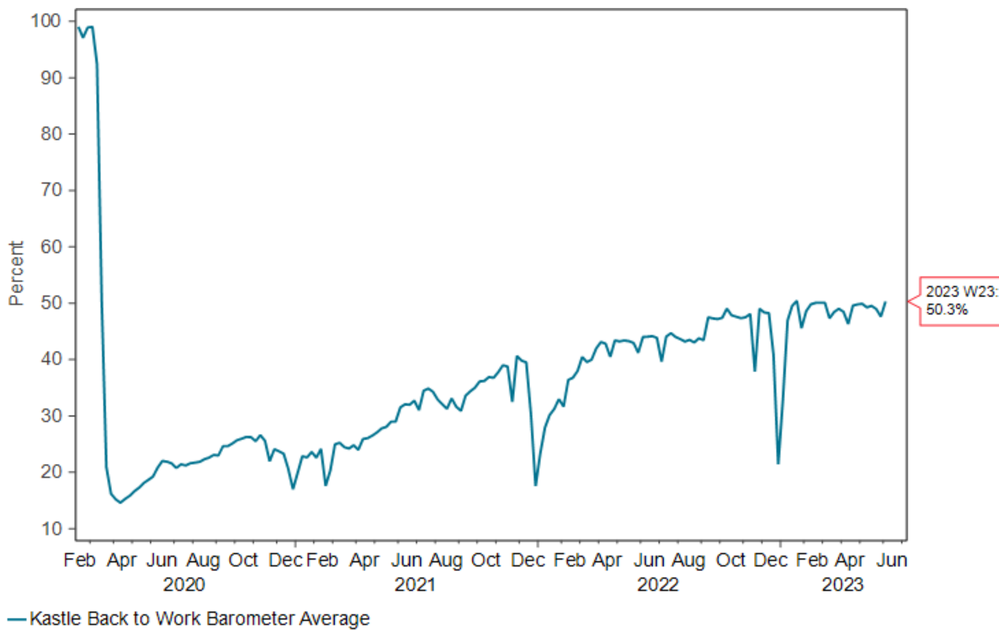
THE SHIFT IN DEMAND FOR OFFICE SPACE

One of the most significant trends impacting the CRE industry in the post-pandemic world is the shift in demand for office space. The widespread adoption of remote work and the uncertain nature of return-to-office policies have left many companies reconsidering their office space needs. While some firms are downsizing their office footprint, others are adopting hybrid work models that require less in-person office space. This shift has led to an oversupply of office properties, which, in turn, has resulted in declining rental rates and property values in many metropolitan areas. The long-term implications of these trends on the CRE industry remain unclear, but continued shifts in demand for office space will likely reshape the industry's landscape for years to come.

The data is clear and concerning. More than three years after the pandemic started, office occupancy remains around 50% in the 10 largest US metro areas **(Figure 4)**. According to Kastle Systems, based on employee access records in more than 2,600 buildings across the country, occupancy rates vary from as low as 37% in the San Jose metro area to as high as 58% in the Houston metro area. But those rates compare to almost 100% immediately prior to the pandemic. Not surprisingly, vacancy rates have also been on the rise.

FIGURE 4

Office Occupancy Remains Low vs Pre-Pandemic Peak: Share of Workers in Office in 10 Largest US Metro Areas



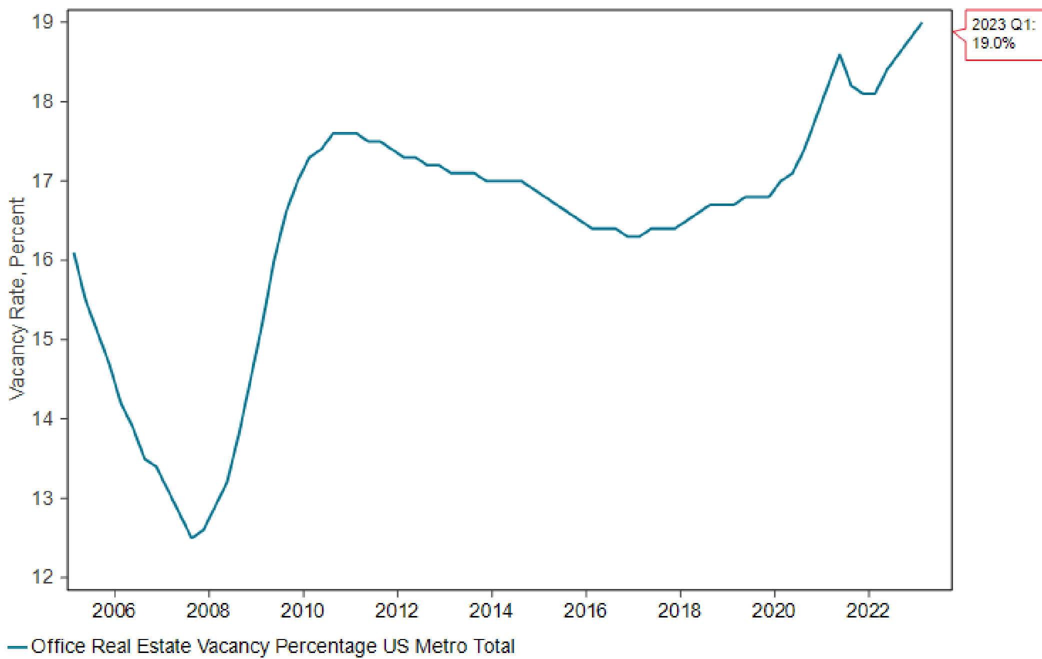
Sources: GW&K Investment Management, Kastle Systems, and Macrobond

More than three years after the start of the pandemic, office occupancy in major US metro areas has only recovered to about 50% as workers' preferences have favored hybrid work schedules.

According to one estimate, no rent is being paid on nearly one-fifth of offices in US metro areas **(Figure 5)**. More pain may be on the horizon for the CRE industry as Bloomberg finds that half of large firms (over 50,000 employees) are planning to cut their office space.[2] As Bloomberg notes, "Cities including Los Angeles, San Francisco, and Boston have already seen landlords hand back the keys as vacancy rates soar amid anemic demand for all but the best new space."

FIGURE 5

No Rent Is Being Paid on Nearly One-Fifth of US Offices: Percent of US Metro Office Space That Is Vacant



Sources: GW&K Investment Management, Reis Inc., and Macrobond

Despite the economy's recovery since the pandemic office vacancies in US metro areas have continued to climb, reaching a new high of 19% in the first quarter of 2023.

[2] Jack Sidders, "Half of Large Firms Plan to Cut Office Space, Knight-Frank Says," Bloomberg News, June 6, 2023.

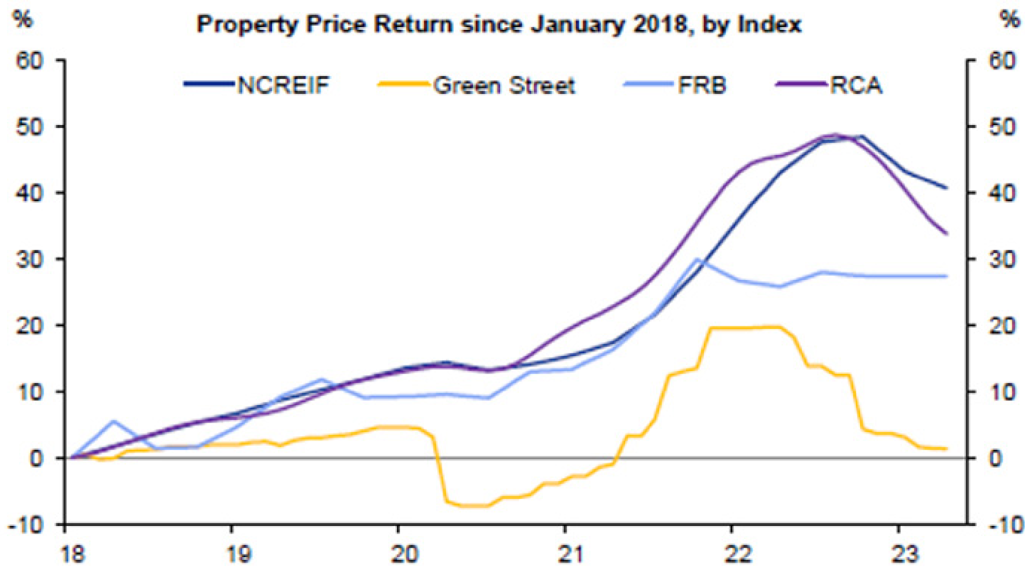
THE IMPACT OF HIGHER INTEREST RATES ON CRE ASSET VALUATIONS AND FINANCING

Higher interest rates pose another challenge to the CRE industry, as they typically lead to lower asset valuations and increased financing costs. In response to rising inflation, the Federal Reserve has aggressively raised interest rates, which has led to an increase in the cost of capital for CRE investors. This increase in borrowing costs has contributed to a decline in commercial property prices, which could potentially lead to further declines if interest rates continue to rise. Moreover, higher interest rates have also resulted in tighter lending standards, making it more difficult for CRE investors to secure financing for new projects or to refinance existing debt.

Commercial real estate property values have faced a tumultuous period recently, with various indices reporting varying degrees of declines **(Figure 6)**. The financing landscape has also evolved, posing hurdles for investors and property owners alike. A recent report from Goldman Sachs[1] sheds light on this challenging environment, analyzing the recent market trends and their implications for CRE lending.[3]

FIGURE 6

Different Indices Depict Varying Pictures of Commercial Property Prices



Sources: NCREIF, Green Street, Federal Reserve Board, RCA, and Goldman Sachs Global Investment Research

Different indices of property prices give different pictures of market conditions, but the appraisal-based Green Street index shows a sharp 25% year-on-year decline in office prices.

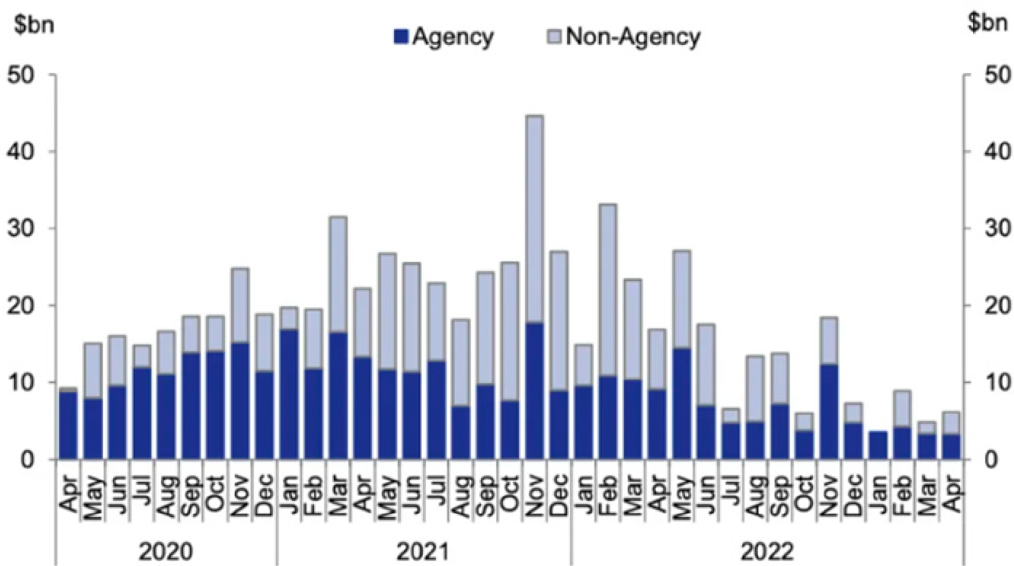
[3] Lotfi Karoui, "Divergence in Leveraged Finance Markets," Global Credit Trader, Goldman Sachs Investment Research, May 18, 2023.

The stark contrast in property value data arises from the different methodologies employed by various price indices. Transaction-based indices are more reflective of current market conditions but are hindered by low trading volumes, while appraisal-based indices offer stability but may lag in response to market fluctuations. Amidst this conflicting data, the Green Street Commercial Property Price Index emerges as a reliable indicator, as it is appraisal-based and tracks a consistent basket of properties. This index reveals a 25% year-over-year decline in office property values and a 21% drop in apartment property values, indicating that the private market still has some adjustments to make in catching up with the public market.

Financing trends in CRE, too, have been affected by the market environment, with the Goldman Sachs report providing valuable insights into bank lending and securitization channels. The report identifies the commercial mortgage-backed securities (CMBS) market as a real-time barometer of investor sentiment, which has been pointing towards a slowdown in CRE lending. CMBS issuance has plunged to its lowest level since 2010, with widening spreads, declining leverage, and shrinking appetite for office properties **(Figure 7)**. These issues face the CRE sector as an impending wave of maturities will force property owners to refinance their assets. According to data analytics firm Trepp, a record $270 billion of bank-held commercial mortgages will mature this year alone.[4]

FIGURE 7

Total CMBS Issuance in The First Quarter Marked The Lowest Quarterly Volume Since 2010, a Trend That Was Extended in April



Sources: Trepp and Goldman Sachs Global Investment Research

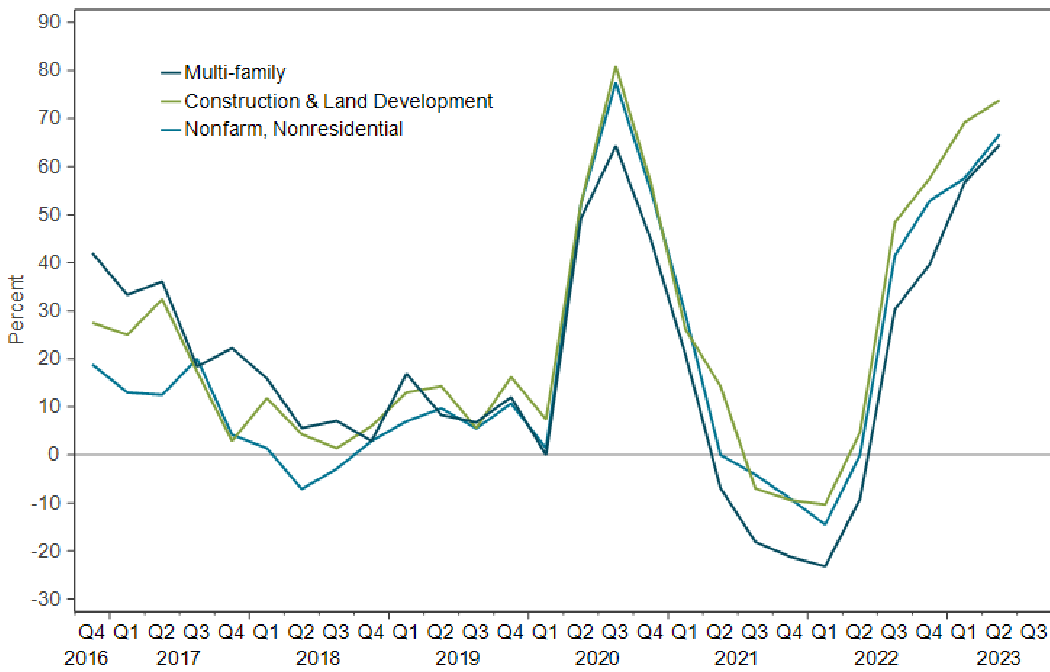
Issuance of commercial mortgage-backed securities (CMBS) has plunged to its lowest level since 2010, indicating challenging conditions for CRE firms that need to roll over maturing debt.

[4] Kyle Cambell, "Big Commercial Real Estate Downturn Could Sink 300+ Banks: Report," American Banker, June 9, 2023.

While data on bank lending activity has not yet shown significant changes, the report anticipates challenging financing conditions soon. This is supported by evidence from the Fed's Senior Loan Officer Opinion Survey, which reveals more conservative CRE lending standards, higher loan loss reserves, and increased charge-offs for CRE loans **(Figure 8)**. These trends add further complexity to the CRE landscape, making it increasingly difficult for investors and property owners to navigate.

FIGURE 8

US Net % of Banks Tightening Standards For CRE Loans: 4Q2016 – 3Q2023



Sources: GW&K Investment Management, Federal Reserve Senior Loan Officer Opinion Survey, and Macrobond

A net two-thirds to three-quarters of banks are reporting tightening standards on CRE loans, which is comparable to the tightening of standards seen during the Covid crisis.

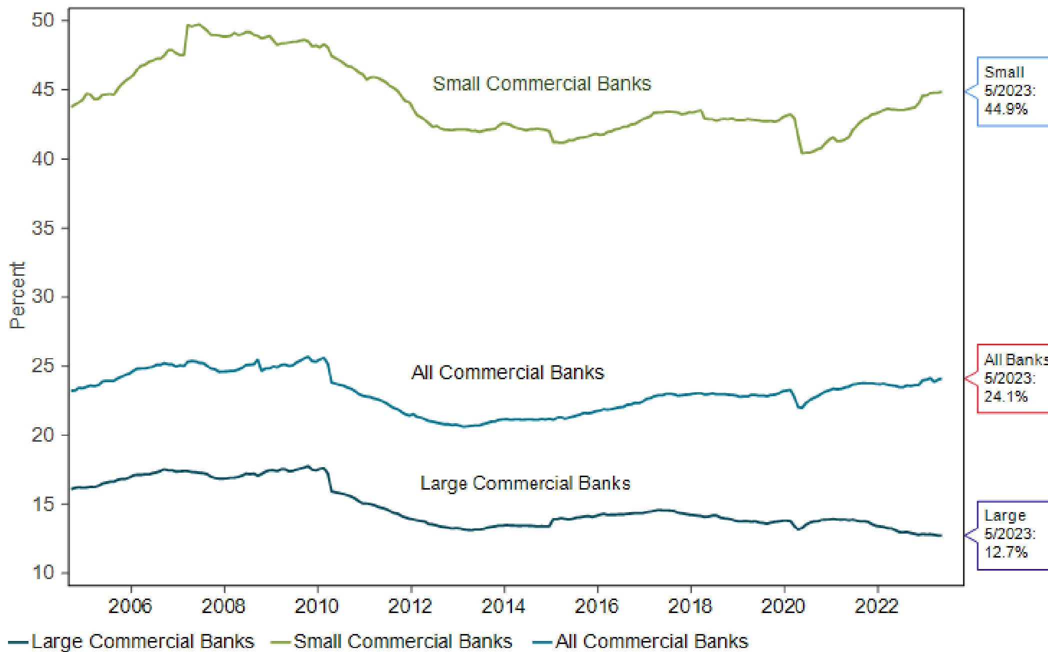
Considering these findings, commercial real estate investors and property owners must be prepared for a continued decline in property values and a tightening lending environment. Adapting to these changing conditions will be critical in ensuring the stability and success of CRE investments in the coming months.

THE BANKING SYSTEM'S EXPOSURE TO CRE AND POTENTIAL RISKS

The US banking system's exposure to CRE loans has been a growing concern, as banks carried $2.9 trillion of CRE loans on their books at the end of May 2023, accounting for nearly one quarter of their total loans and leases. Smaller banks are particularly vulnerable, with nearly $2 trillion, or two-thirds, of the total CRE loans. These loans account for 45% of their total loans and leases, highlighting the banking system's disproportionate risk to potential CRE loan losses in smaller institutions **(Figure 9)**.

FIGURE 9

Small Banks Have Greater Exposure to CRE Loans: Share of CRE Loans Out of Total Bank Loans And Leases



Sources: GW&K Investment Management and Macrobond

Nearly one-quarter of all bank loans and leases are to the CRE sector, but roughly 45% of small bank loans and leases are to CRE loans compared to only 13% for large banks.

Fears over the potential impact of the CRE sector on the banking industry have been stoked by JPMorgan Chase & Co. CEO Jamie Dimon's recent warning that US CRE is most likely to bring the next crisis to the banking industry. A similar warning came from real estate advisory firm CBRE, which recently estimated that more than 300 banks have enough commercial real estate loans on their books to see their Tier 1 capital wiped out under a worst-case scenario. Under this extreme scenario, the report estimated that the assets of the failed banks in the scenario totaled about $600 billion, roughly three times the size of Silicon Valley Bank, which failed in March.

To be sure, CBRE views this scenario as unlikely. Indeed, they have expressed a relatively rosy view of the future for CRE, partly because they assume that the Fed will succeed in bringing inflation under control and be cutting interest rates before too long.[5] That said, they see offices as the most challenged sector within the CRE sector, with office valuations taking as long as nine years to recover versus two, three, and four years respectively for industrial, multi-family, and retail. In offices, the devil is in the details: 80% of the vacancies are in 10% of the buildings, most of which were built from 1980 to 2009 in downtown areas and in weaker submarkets where there's higher crime and fewer amenities.

The Federal Reserve's May 2023 Financial Stability report reinforced concerns about the challenges facing the US CRE industry, emphasizing the need for policymakers to closely monitor the industry and implement proactive measures to support a robust recovery.[6] The report found that banks have tightened their lending standards and reduced their origination of new CRE loans since the pandemic. Banks still face significant risks from their existing CRE loan portfolios, especially those concentrated in hard-hit sectors or regions. Moreover, nonbank lenders, such as private credit funds, have increased their market share in CRE lending by offering more flexible terms and higher leverage to borrowers, making them more vulnerable to liquidity and solvency shocks if CRE market conditions deteriorate further.

The Fed's report underscored the financial institutions' exposure to CRE debt as a risk to financial stability, as losses on CRE loans could impair their capital and liquidity positions and reduce their ability to lend to other sectors. The report also warned that stress in the CRE sector could spill over to other markets through fire sales, contagion, or confidence effects. As the Fed continues to raise interest rates in response to inflation, it will be essential for the central bank to balance its efforts to maintain price stability while also considering the potential implications for the CRE industry and the broader economy.

CRE STRAINS MAY SIGNAL A COMING PEAK IN INTEREST RATES

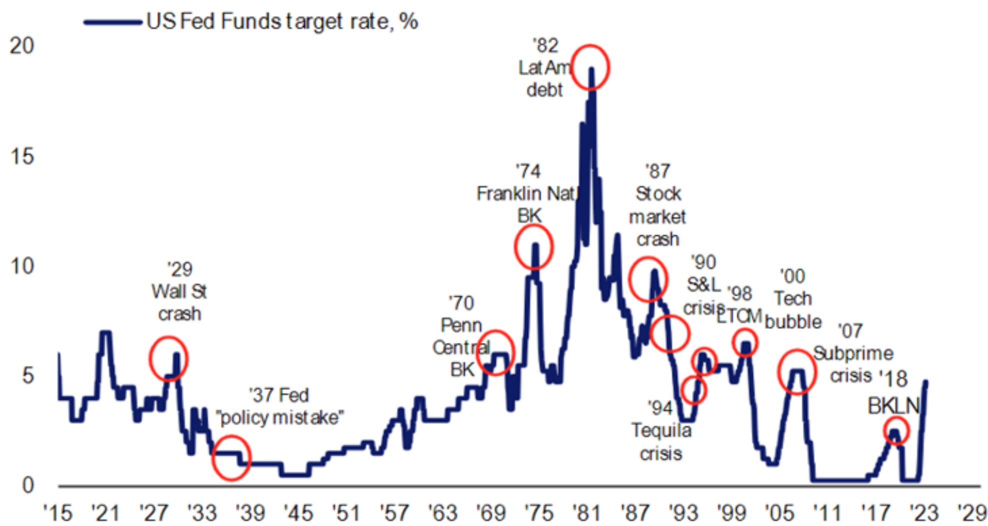
In conclusion, the strains in the CRE sector serve as a reminder of the potential risks and vulnerabilities that accompany tightening cycles. While it is impossible to predict the exact timing of credit events, keeping a close eye on the CRE industry's challenges may provide valuable insight into the likelihood of a coming peak in interest rates and the eventual shift to the next Fed easing cycle.

[5] Harrison Connery, "Recession Coming, But Real Estate Has Reason for Optimism," *The Real Deal*, June 7, 2023.
[6] Board of Governors of the Federal Reserve, Financial Stability Report, May 2023.

As experienced Fed watchers will attest, past Fed tightening cycles have always “broken” something before they come to an end, setting the stage for the next Fed easing cycle **(Figure 10)**. With the CRE sector currently facing challenges such as rapidly rising interest rates and potential risks to financial stability, it may be signaling that the end of this tightening cycle is coming into view.

FIGURE 10

Fed Tightening Cycles Always “Break” Something



Sources: GW&K Investment Management and Macrobond

Fed tightening cycles almost always result in “breaking” something, and such financial disruptions tend to signal the end of tightening cycles. Is CRE poised for a credit event in this cycle?

The Fed's monetary policy has become genuinely stringent due to one of the most aggressive rate-hiking cycles in history. This is evident in inverted yield curves and a significant decline in broad money supply. Economists predict an economic contraction in the latter half of this year.

A visit to major business districts in the US confirms the challenges faced by the CRE sector. Recent headlines about defaults and setbacks highlight the predicaments. If a recession occurs as anticipated, more stories like these can be expected, along with credit events involving banks.

All these indicators suggest that the peak of the Fed's rate-hiking cycle is near. While the Fed may not have completed its actions, the mounting pressures on the CRE sector indicate that the catalysts for an easing cycle are within sight. While easing alone may not solve the challenges faced by the office segment of the CRE sector, lower rates should gradually have a positive impact on other parts of the industry, residential real estate, and the overall economy in the coming years.

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