September 2023

COMMERCIAL REAL ESTATE OUTLOOK: THERE'S A STORM ON THE HORIZON. THEN WHAT?

There's a hurricane swirling at sea, and every forecasting model and meteorologist indicates that it's about to make landfall. That's the feeling among commercial real estate (CRE) investors these days as rising interest rates, a sharp pullback in bank lending, and a massive "maturity wall" (estimated at more than $2.5 trillion through 2027) come together to darken the horizon. No one knows precisely where the storm will hit, or whether it will be a Category 3, 4 or 5, but it's coming, and there's no avoiding it.

There will be damage. Some of it may be extensive, especially in the troubled office sector. The impact of societal shifts, headlined by the realities of work-from-home and automation/artificial intelligence (AI), has created an oversupply of properties that could decimate the sector. Meanwhile, capital markets have turned against office amid higher interest rates, wider cap rate valuations, and the resulting pressure on property values. Across the CRE space, interest rates have doubled or tripled in less than two years. As those trillions of dollars' worth of low-interest rate loans reach maturity, refinancing will be difficult to find. And for those that do, it will be the most expensive it's been in decades, and likely to come with tighter covenants. **Amid a resetting of property values, some borrowers will not find a clear path to refinancing, which will likely lead to increasing defaults and loss of assets. The crisis for regional banks—a significant provider of CRE financing—has only accelerated already ongoing efforts to improve their balance sheets and tighten credit standards. In short, demand for CRE debt will likely rise as supply is going down, leading to problems for borrowers and many existing portfolios.**

There will also be opportunities, especially for nonbank lenders with capital available to deploy. Some lenders will have to sit on the sidelines. That's especially true for those with excessive existing office exposure that need to preserve liquidity for the unknowns coming to that sector. But others, especially those that didn't overextend their leverage in post-COVID originations (when it was in vogue to do so), will be rewarded as the storm passes. The reduction in traditional bank lending capacity, coupled with the continued volume of real estate loan maturities, will likely create many attractive opportunities both to acquire deeply discounted loans and to lend on high-quality properties, with the highest yields in recent memory and lower leverage levels.

Key Takeaways

- Investor sentiment toward commercial real estate is weak, given a host of challenges. But we believe all of the pressure points—rising interest rates, a deficiency of debt capital in the face of a steep maturity wall and increasing demand, and even the potential for a surge in defaults—will create opportunities for nimble credit investors.
- We see a bifurcation in CRE among asset classes. **There are some broken properties, and possibly even a broken sector in the office market. Otherwise, it's more a case of broken balance sheets, as so many properties are over-levered and/or undercapitalized.** Broken balance sheets will no doubt bring some pain to borrowers and some investors; however, they also will likely drive the opportunity set.
- Investors with available capital can position themselves to take advantage of the uncertainty in the CRE market, even during what appears to be a difficult time ahead, by going on offense in the right circumstances. That's especially true for those who can look beyond the short-term volatility and remain focused on the longer-term fundamentals.
- We continue to view newer-vintage multifamily located in primary and secondary markets as having the best credit quality and risk-adjusted returns within CRE credit. In our current view, the historical recession resistance of Class A and B multifamily offers relative insulation from some of the key issues in CRE, as well as long-term secular growth drivers.
- Well-positioned investors will be able to lend through this correction and be rewarded when the CRE storm subsides, providing the potential for equity-like returns.

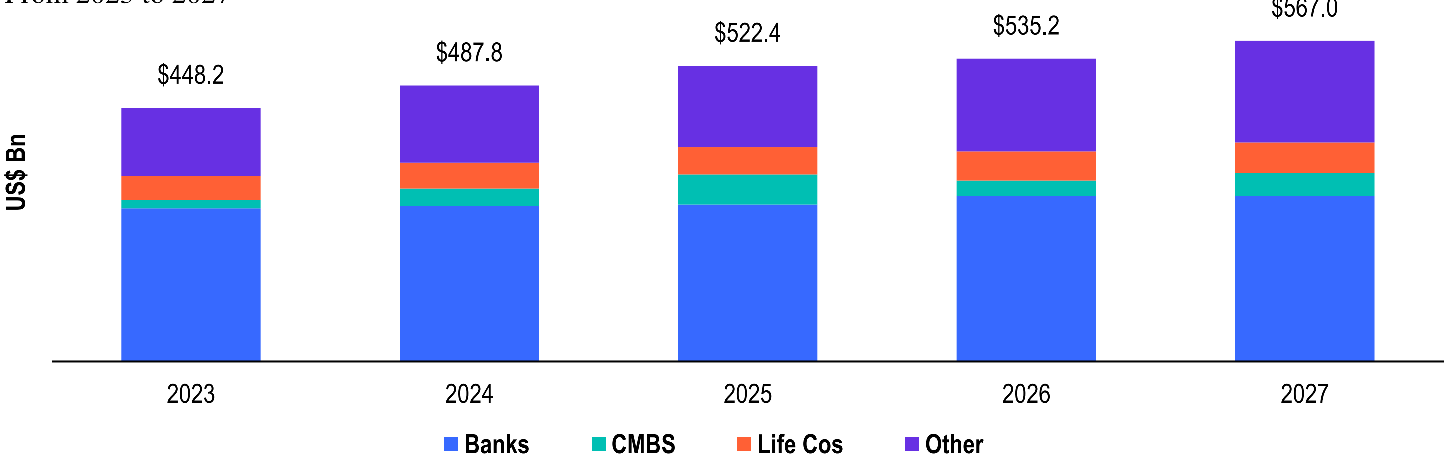
How did we get here?

In a way, we've already seen the perfect storm. In the wake of the great financial crisis (GFC), the U.S. Federal Reserve (Fed) sharply lowered its benchmark federal funds interest rate, from the 5% range in 2006 to near zero at the end of 2008. Except for some rate hikes from 2015-2018, when the federal funds rate peaked near 2.5% before the pandemic drove the Fed to cut it back, the key rate was near zero for the better part of 15 years. The Fed also grew its balance sheet: it was less than $1 trillion in 2007, reached the $4.5 trillion range from 2014-2018, then surged to nearly $9 trillion in 2022, following a pandemic-fueled buying spree of U.S. Treasuries and mortgage-backed securities. By that time, another $4.5 trillion or so in government COVID relief funding was pumped into the economy. Money was basically free, and everywhere. **Investors piled into the CRE space, often using the asset class as an alternative for fixed-income instruments that offered next to no yield. This fueled a surge of three- to five-year floating rate loans at low interest rates, providing the bricks that make up the maturity wall. Property prices rose, and many—if not most—CRE firms, both equity shops and lenders, ratcheted up their leverage levels.**

In 2022, of course, inflation surged to four-decade highs. As virtually any economics professor will attest, inflation is a monetary phenomenon. The government cannot create the amount of money it did and avoid massive inflation. To help put the Fed's balance sheet in perspective, we prefer to write out all the zeros in $9 trillion: $9,000,000,000,000. It's eye-opening. In the face of this record inflation, the Fed responded with unprecedented levels of monetary policy tightening, driving rates from 0% to back above 5% in less than 15 months, in an attempt to rein in rising prices. In 2023, we witnessed three of the four largest regional bank failures in history, as well as a shotgun wedding between two massive Swiss investment banks, leaving the banking industry fragile as deposit outflows surged. Banks tightened credit standards and pulled back on lending, severely limiting the supply of available loans. The cost of financing across the economy skyrocketed: We've seen floating loan interest rates that would have been priced below 3% in 2021 rise to no less than 8.00% today, and in most cases above 8.50%. Values have started to fall, with broad CRE prices declining in the first quarter of 2023 for the first time since 2011, according to Moody's Analytics, and the forecast continues to grow darker.

Those short-term, floating-rate loans are scheduled to mature in the near future, leading to the biggest source of headlines in the CRE universe in recent years: the maturity wall. Morgan Stanley's oft-quoted figure, with $1.5 trillion in CRE credit reaching maturity by 2025, seems accurate, and there's another $1 trillion-plus coming due through 2027. As those loans mature, some borrowers are going to face meaningful challenges.

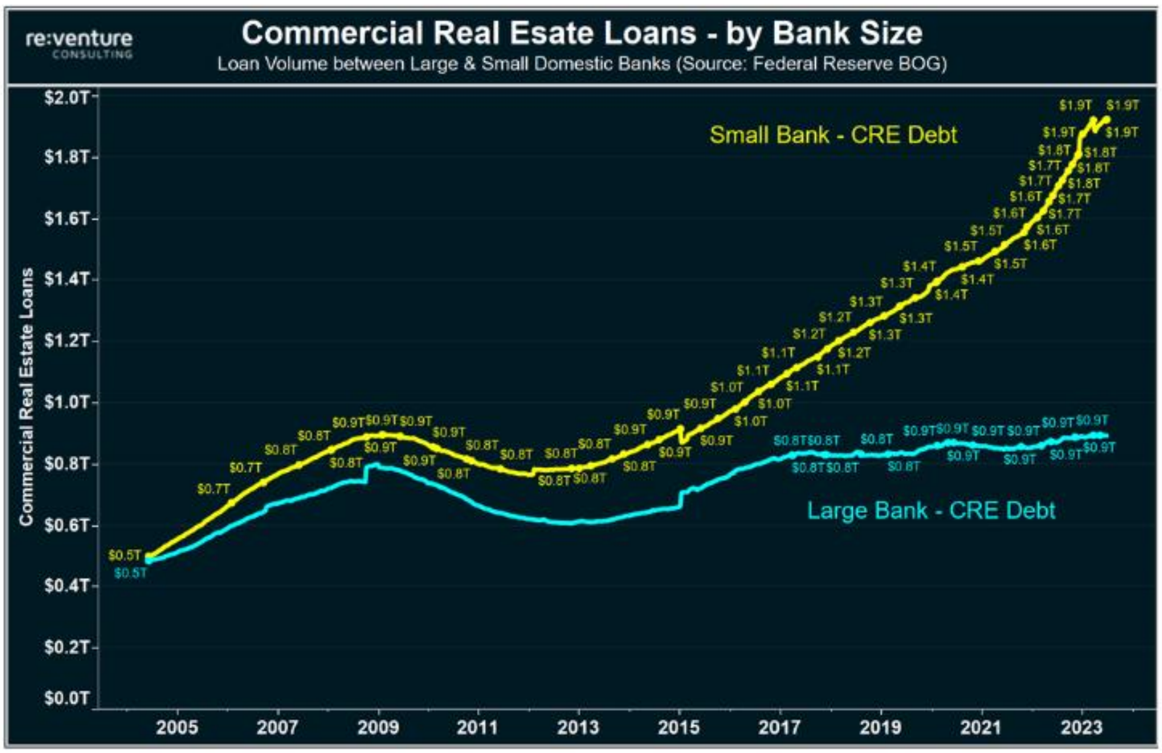
U.S. Commercial Mortgage Maturities by Lender Type
From 2023 to 2027



How bad is it?

Capitalism doesn’t work without consequences. Some market pundits have said the situation could get worse than the GFC. Others have said CRE is “almost perceived to be uninvestible.” It’s not good, but in our view, it will not approach the GFC bloodbath (with the possible exception of the office sector). Yes, the maturity wall is huge, and it appears unavoidable.

Banks (and insurers, for that matter) are important sources of CRE financing as both lenders and buyers, and their involvement in real estate lending has increasingly become a focus for regulators. Three of the four largest bank failures in U.S. history happened in the first half of 2023, driving concerns—and headline after headline—about regional banks’ balance sheets. CRE exposure drove many of those headlines, because those smaller banks’ role in the asset class essentially doubled in the past 10 years, rising especially sharply after the pandemic. As a result, banks pulled back on CRE lending, becoming more selective and/or refusing to take on more exposure, drying up that key source of funding even as the maturity wall looms.



Small banks have the biggest exposure to the commercial debt crisis (Source: Fed BOG)

Since the GFC, in the era of ultra-low interest rates, most borrowers would simply refinance in the face of expiring debt. Alternatively, they would “extend and pretend,” a GFC-era phrase for lenders lengthening loan terms and ignoring short-term declines in property values. It’s a solution that many turned to, once again, at the beginning of the pandemic in early to mid-2020. A rolling loan, the saying went, gathers no loss.

In fact, since the early 1980s, interest rates generally have trended in one direction: down. For the past 40 years, lenders and borrowers alike were rewarded by waiting, allowing interest rates to decline and assets to regain value, and ultimately exiting the loan via a refinance. **For 40 years, time healed all wounds in CRE. And once again, time is what everyone is hoping for. But what if interest rates do not go back down? What if, for the first time in four decades, interest rates revert to the mean and stay there? What if interest rates were so manipulated by central banks around the world and so artificially low that they do not revisit those low levels?**

Time is running out. Borrowers likely won't be able to refinance the current amount of debt on their properties. For example, consider a borrower who secured a loan with a monthly debt service payment of $100,000 in 2021, and bought a lender-required interest rate cap (IRC), an instrument that protects the borrower from rising rates. As LIBOR and SOFR, the benchmark indexes used to calculate debt service, rose from 0% to 5%, the monthly loan payment rose with it, going to $125,000, then $150,000, and eventually $300,000. When the payment reached $125,000, the IRC kicked in, meaning the IRC provider (not the borrower nor the property) had to cover the difference. However, when that loan matures, the IRC expires, making the debt service costs essentially triple. And the burden falls solely on the borrower/property going forward.

The bottom line is this: Debt is available, but not in the same amount as before. It is also meaningfully more expensive.

That leaves a few choices, and none of them are ideal. To retain ownership, in almost all cases, new capital is going to need to come into the capital stack. That capital comes in only two forms: debt or equity. For example, a firm that borrowed $50 million as a senior loan a few years ago might only qualify for $40 million today. The borrower is left to come up with $10 million in cash, either through more expensive mezzanine debt, preferred equity or fresh common equity. Undoubtedly, that common equity would be meaningfully dilutive if the existing ownership brought in new partners. Another option is to simply sell the asset, crystallize losses and move on to greener pastures. The last option, which is already happening with seeming regularity in office properties, would be to walk away and hand the asset back to the lender.

What about CRE equity investing? Why debt? Why now?

We get asked regularly about the relative value of investing in CRE equity compared to CRE credit in the current environment. We often answer with a question: How long do you plan to hold the investment? Investment horizon in our view, may be the most important variable, yet it's often overlooked in the equity versus credit debate. If an investor is willing to own an asset for 15 to 20 years, the entry point is less critical. The compounding effect of inflationary rent growth over that long of a holding period will typically lead to a positive investment experience. Other than office, if an investor is buying a CRE asset in a strong market, with a good location in that market, it would be hard to fathom a scenario where that asset is not worth more in 2038 or 2043 than it is worth today. We believe there are few, if any, better long-term inflation hedges than CRE.

On the other hand, if the investment horizon is less than five years, we find CRE equity nearly uninvestible today. Historically, CRE equity investors have targeted internal rates of return (IRR) in the mid-to-high teens. This is typically a combination of high-single-digit/current cash returns, coupled with a gain upon exiting an asset. Today, an equity investor using leverage would get little to no current income on a new investment net of borrowing costs, meaning the bulk of the potential return would be backloaded at the exit. Debt investments, on the other hand, are cash flowing immediately, with a quantifiable return at repayment. **In other words, with higher interest rates, the cash flow from properties is essentially going to the lender. The reward for equity investors, if in fact it comes, is likely years down the road.**

We are in arguably the most uncertain asset valuation times since the GFC. If mid-to-high teens IRRs are the historical target for CRE equity investments, they should be even higher today, to offset the higher level of risk and unknowns. We are not witnessing any opportunity, in scale, in the equity space that would produce those types of returns. **It is very easy to take the position: "Values are down 20% to 30%, so this is a great time to buy." But, were these assets overvalued, and falling to a fair level? Or, were they fairly valued and therefore now undervalued? We believe it is the former, certainly in the shorter term. We do not see any near-term catalyst for a V-shaped recovery in CRE asset values.**

That being said, even if returns on equity investments have not widened with the current uncertainty, if an investor can achieve similar returns in credit investments as in equity investments, does the investor not pick credit every time? That is where the market stands today. **Credit investments can make mid-teen returns, in line with historical equity returns.** The real question then becomes: **Should an investor choose the 15% return at a 75% loan-to-value presented by CRE**

debt, or the 15% return at 100% loan-to-value provided by CRE equity? We believe it's hard to get that one wrong.

CRE troubles are bifurcated: There's the office sector, and then everything else.

The forthcoming storm's impact on CRE will vary by asset class. The most troubled area of the market is office, where vacancy rates are at historic highs, weighed down by the persistence of the pandemic-fueled, work-from-home trend. Defaults have increased, and some of the largest, well-capitalized, sophisticated sponsors are simply walking away. Delinquencies are on the rise. Buildings are being discounted, and available sublease space is rising, seemingly across the country. There has been a fundamental shift in the demand for office space. Workers from home don't need a desk. AI doesn't need a seat, either; it just needs a server. We believe that means office values will likely continue to drop, perhaps precipitously.

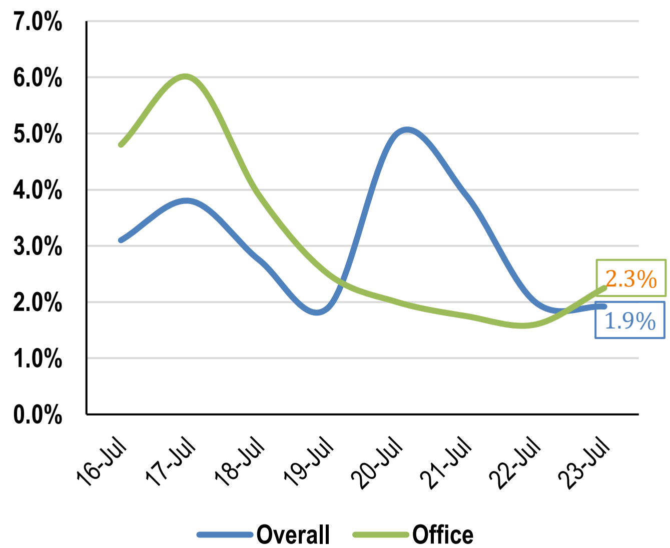
For better or worse, CRE is one of the most highly leveraged asset classes in the financial world. Debt is the proverbial tail that, more often than not, wags the valuation dog. Obtaining a new office loan right now is as difficult as it has been in decades, with the possible sole exception being 2009. The debt that is available for office is largely in the capital markets, much of it in the form of commercial mortgage-backed securities (CMBS). They offer lower leverage, are covenant-heavy and very inflexible. In our view, that does not represent an efficient liability. If debt is not readily available for office buildings, it becomes increasingly difficult to value them. In addition, office remains one of the most expensive asset classes to maintain in terms of tenant improvements (TI), maintenance and capital expenditures. The capital needed to keep an office building full in "normal" times was significant; the TI packages being offered to tenants today defy logic and cannot be sustained, in our view.

In short, our view of the office sector is that it is soon to be flooded with broken properties, potentially leading to a broken asset class. Investors will recall when Amazon and e-commerce came to the fore, many thought the situation would present an insurmountable challenge to brick-and-mortar retail CRE. **The retail apocalypse never transpired. It might in office.** That's not to say that *all* office properties will bring trouble. There will always be demand for office, and many buildings will continue to operate successfully, provided the landlord is well capitalized enough to continue property improvements and keep them relatively full. But if landlords do not have the means or the willingness to spend capital on properties, we believe some properties will be worth nothing more than the land on which they sit. Lenders will likely take over such properties as occupancy drops, and the lenders are unlikely to pour enough money into a sinking ship to save it. To liquidate such a building may require a valuation at or near land value, because the cost to bring it back to life will be too high to make it worth much more.

In the first half of 2023, we've seen signs of delinquencies rising across CRE, primarily in the office sector. It's not yet as dramatic as it is likely to be, but the outer bands of the storm are starting to hit. CMBS are one place to see it, as the 60-day delinquency rate rose for three consecutive months through June, according to Fitch Ratings, with expectations for a continuing increase through 2023 and beyond, especially as more and more loans reach maturity. S&P Global, meanwhile, reported that delinquency rates on nonresidential property loans rose for three consecutive quarters through March 2023 (latest available), noting that the first-quarter increase was the largest since the height of the pandemic.

CMBS Delinquencies

Percentage of loan balances in Fitch-rated U.S. CMBS that are delinquent by at least 60 days or in foreclosure.



	July (%)	Month Earlier (%)	Year Earlier (%)
Hotel	3.48%	3.98%	6.13%
Retail	4.99%	4.98%	5.69%
Mixed-Use	2.04%	1.97%	2.59%
Office	2.25%	2.01%	1.24%
Industrial	0.37%	0.44%	0.14%
Mulitfamily	0.45%	0.48%	0.30%
Self-Storage	0.00%	0.00%	0.03%
Other	1.54%	1.49%	1.20%
Overall	**1.92%**	**1.91%**	**2.05%**

Taking a look outside the office.

Elsewhere in CRE, we view the story as more about broken balance sheets than anything else. Generally speaking, properties outside of the office sector are running at strong occupancies. Rents are being paid, and cash flows are solid. Multifamily and industrial were meaningfully overvalued in 2021 and early 2022, and many borrowers over-levered. **During our fourth-quarter 2021 earnings call, we spoke extensively about the lack of cap-rate tiering between multifamily assets based on quality and location, and we expressed our concerns about a multifamily correction. The market is now in the midst of that correction and repricing. Yes, people will lose money, but then they'll pick themselves up, dust themselves off and get back to business.** Meanwhile, the correction will likely provide opportunities.

The industrial sector has held up well, benefiting from e-commerce and the demand for logistics and warehouse properties, which has outstripped supply in some regions. We continue to believe that reshoring, the ongoing process of increasing domestic production and manufacturing of goods in the U.S., is in its very early days and may provide further support for the sector.

Hospitality is a tale of two segments: leisure versus business travel. Leisure-oriented hotels have done phenomenally well in a post-COVID world, and more often than not, we witnessed performance outpace the previous highs realized in 2019. Checkpoint levels for the Transportation Security Administration have returned to 2019 levels, suggesting that leisure hotel performance will likely stay strong. The leisure traveler, it seems, is officially back. That said, the business travelers have not returned to their pre-pandemic habits. They may not, ever. Videoconferencing and virtual meetings have forever changed the business traveler. If a salesperson used to visit a client four times a year, perhaps that is now twice a year in person and twice a year virtually. The business and convention business has recovered meaningfully from the dark days of COVID, but not to pre-pandemic levels, and there's some uncertainty as to when (and whether) that will happen.

As for **retail**, the apocalypse never came to be, with the exception of class B and C malls in secondary and tertiary markets. Open-air retail, especially in strong demographic areas, has done incredibly well over the past decade. New construction slowed supply dramatically, and centers have largely remained full. While Amazon and a seemingly endless offering of delivery services have changed our everyday lives, it appears that open-air retailers can co-exist and even thrive, especially those offering restaurants, nightlife and/or experiential retail. There will continue to be large valuation gaps between grocery and nongrocery anchored retail, but performance at the asset level appears to be fundamentally stable.

Multifamily may offer a port in the storm.

The asset class that stands out above the rest is multifamily. **We prefer multifamily for a number of reasons. Class A and B multifamily have historically been recession-resistant, and the sector has long featured the best credit quality and risk-adjusted returns in CRE.** Going forward, we view multifamily as an area of the market that will not be as vulnerable to technology. Everyone needs a place to lay their head.

While we believe the basic operational fundamentals of multifamily are superior to other CRE asset classes, one of the most compelling reasons to invest in multifamily is liquidity. In an otherwise illiquid asset class, multifamily meaningfully stands out because it can almost always be sold within 90 days or less, even if pricing is variable. The key role of Fannie Mae and Freddie Mac, the federally backed mortgage companies that provide debt to the industry, is to drive that liquidity. Indeed, even in times of meaningful credit dislocation, the government has yet to stop lending in the sector. **We believe the combination of government-supported liquidity and superior asset/credit quality places multifamily far above other sectors, especially now.**

The rising costs of mortgage financing has made home ownership more of a challenge, and with interest rates likely to remain higher for longer, we believe that reality will continue to push people toward rental properties. In addition, the space has some long-term secular trends going for it. Notwithstanding the historically high supply of multifamily units on the horizon, the overall supply of housing continues to lag demand nationwide. We believe migration patterns in the United States—folks moving away from high-tax, high-cost-of-living areas, such as California, New York and Illinois, to more affordable, low- or no-income tax states—will likely continue. In 2022, six of the 10 fastest-growing counties in the U.S. were in Texas, while the others were in the Phoenix area and Florida. The story was much the same in big cities, as populations in New York, Los Angeles and Chicago declined, while Dallas, Houston, Orlando and Atlanta continued to expand.

But not all multifamily is alike. Back in that early 2022 earnings call, we expressed our concerns about complacency in multifamily markets. Specifically, we saw a lack of cap rate tiering, both in terms of major markets versus secondary and even tertiary markets, as well as in terms of different vintages and asset quality within the same market. With prices rising, we worried that the lack of tiering was not a healthy market dynamic, and it turns out we were right. **Now, as values adjust lower, we're concerned that the complacency on the way up appears to also be happening on the way down. When analyzing the potential future losses within the lending sector, we hear a recurring theme: "Oh, it's multifamily. It will be fine." Rest assured, a 6.5% debt yield on a 1978 vintage multifamily property in Macon, Georgia is wildly different than a 6.5% debt yield on a 2019 vintage property in Miami. Not all multifamily is created equal.**

That's why, especially in recent quarters, our focus in multifamily has been on higher-quality, newer-vintage assets in strong primary markets. We continue to believe that in the current valuation pullback, higher-quality, newer-vintage assets and primary markets will be less volatile, have stronger value retention and will be more liquid.

Looking through—and past—the storm

A lot of what we've covered here feels like bad news. For borrowers and for many existing CRE portfolios—especially those who are overleveraged—it is**. For those with capital to deploy, a slightly longer-term perspective, and the willingness and ability to build a quality portfolio, we believe it really is good news.** We believe the confluence of events adds up to a tremendous opportunity set in an asset class that has historically been a good choice as a hedge against inflation. **We firmly believe that sophisticated lenders, capable of lending creatively throughout the capital stack, will produce equity-like returns through debt investing, with a cushion against valuation declines. That's a dynamic that does not often present itself, and it has us excited.**

Market dislocations, after all, create opportunities to invest low and separate yourself from the rest of the market. We're thinking defensively, but within an overall offensive mindset, fueled by the awareness that many of our competitors can't play offense right now. Some don't have the liquidity to do so, especially when many have existing portfolios that are heavily weighted (often 25% to 50%) in office sector properties. We prefer floating-rate senior mortgages, especially in multifamily, in areas with positive population trends, especially in the Southeast and Southwest.

We're already seeing the benefits to nonbank lenders as bank financing dries up, and we're looking to fill the growing void in the lending market, including places where historically we have not been an active participant. We have been writing loans that we might not have been able to compete for in 2022 or earlier. **Today's environment has provided nimble investors with liquidity the chance to move further up the capital stack, earning better returns on stronger loans. We believe that the opportunity set will grow as conditions worsen and will continue to expand as things recover.**

Conclusion

Indeed, there will be some damage from this hurricane, though the extent will vary. Some ships may sink, while others will deal with the choppy waves and still be floating when the weather settles. To some extent, it might be time to batten down the hatches and ride it out for a time, to survive and then thrive. In our view, it is wise to be selective and build capital that is ready to deploy when the time comes. We believe the issues driving concerns in the space, which have scared off many lenders, together with investable capital add up to an attractive opportunity set over the next 36 months, leading to a promising risk/return equation. **The key, in our minds, is to be disciplined yet nimble through adversity, combining a defensive mindset with an opportunistic offense when interesting situations present themselves. We believe that those who will thrive in this environment must also be very mindful of portfolio positioning, with a focus on sectors and markets with strong pricing power and cash flow growth over time.**

Investing with a seasoned team that has navigated choppy seas before is paramount. Operational scale and industry-wide relationships with both borrowers and bankers are equally important. **In the next 24 months, we believe investors may write some of the best risk-adjusted return loans that we've seen in decades.**

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