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PERSPECTIVES ON CRE HEADLINES, THE STATE OF DEBT CAPITAL MARKETS, AND A PATHWAY TO NORMALCY

Bruce Cohen interviews industry leaders regarding the credit landscape.

"The Commercial Real Estate Crash Will Be at Least as Bad as 2008"
—CNBC, April 2023

"Commercial Real Estate Market Could Crash Soon"
—Fox Business, April 2023

"Why Commercial Real Estate Could Cause the Next Bank Failures"
—Forbes, March 2023

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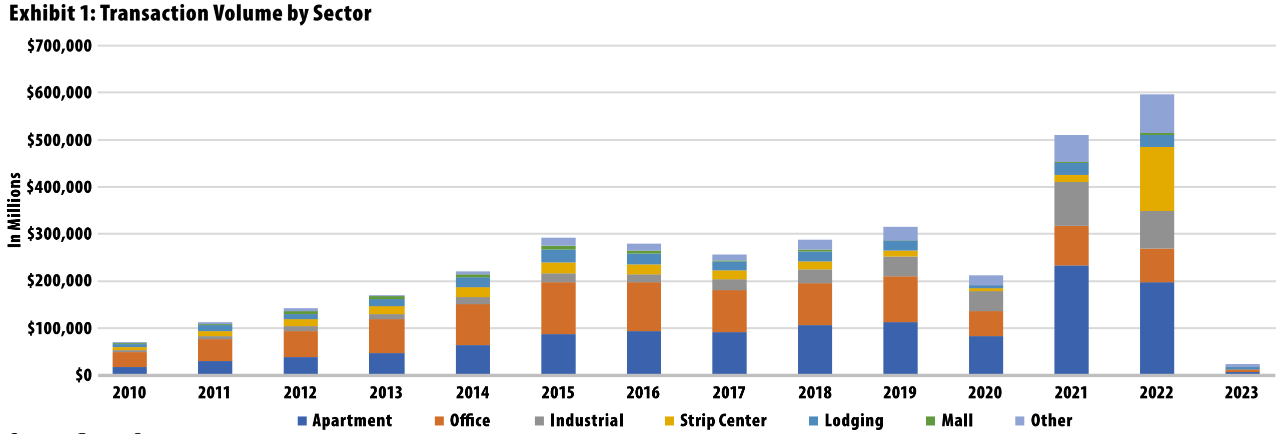
Whether problems in commercial real estate lead to more bank failures or, conversely, illiquidity among banks precipitates a crash in real estate, pundits appear to have little doubt of the crisis ahead. The most negative market observers have argued that the contraction of credit will lead to a deep recession; a decline in office values will contaminate other asset classes; and a wave of upcoming maturities will lead to unprecedented levels of loan defaults, further challenging an already troubled lending market.

This article seeks to confirm, challenge, or provide a more nuanced perspective on these claims through the lens of institutional real estate investors. To achieve this, the team at Temerity Strategic Partners spoke at length with five industry leaders possessing panoramic views of the credit landscape: Bob Foley (Partner, TPG Real Estate), Mark Gibson (CEO of Americas and Co-Chair of Global Capital Markets Board, JLL Capital Markets), Bryan McDonnell (Head of US Debt and Chair of Global Debt, PGIM Real Estate), Willy Walker (Chairman and CEO, Walker & Dunlop), and Miriam Wheeler (Head of the Americas Real Estate Financing Group, Goldman Sachs).

How Did We Get Here?

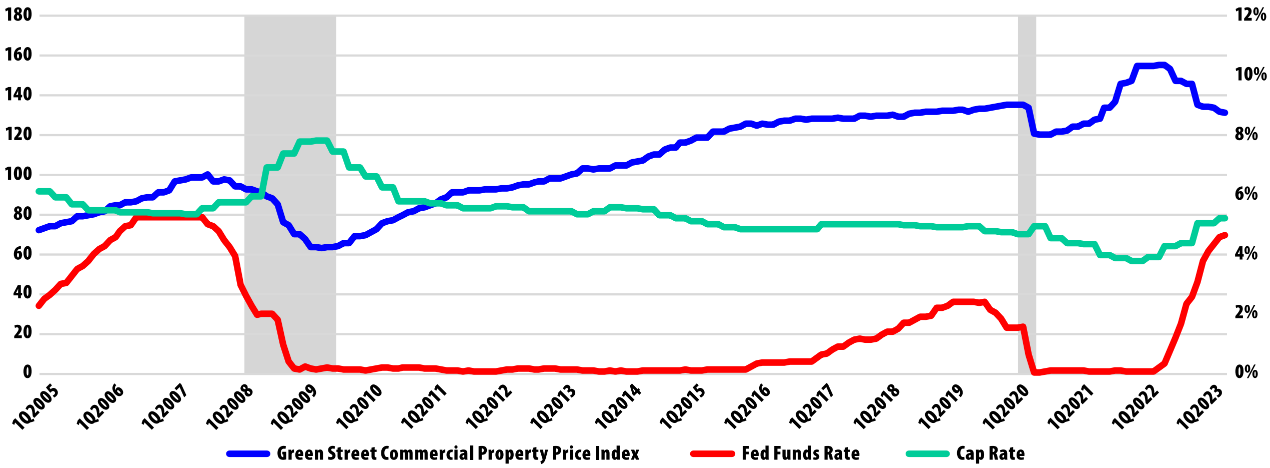
Over the past four decades, the US experienced a consistent decrease in interest rates. This decline was largely influenced by the Federal Reserve's highly stimulative approach, especially since the Great Recession. More recently, this approach was accompanied by strong fiscal stimulus measures in response to the COVID-19 pandemic. That translated to an environment of persistent growth in asset values, leading to a historic 12 months of commercial real estate transaction and lending activity between 3Q2021 and 2Q2022. The Mortgage Bankers Association estimates debt originations during that period totaled $360

Exhibit 1: Transaction Volume by Sector



Source: Green Street

Exhibit 2: Commercial Real Estate and Fed Activity



Sources: Green Street, FRED

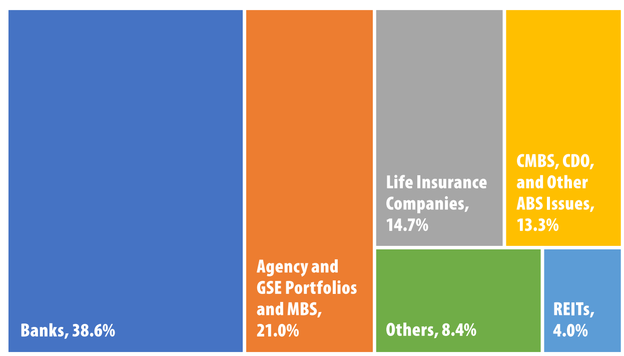
billion, and Green Street estimates commercial real estate sales totaled $650 billion across the major sectors over the same span (Exhibit 1)—both all-time highs. This level of liquidity and capital flows lowered cap rates, increased values, and created undue expectations across commercial real estate.

This came to an abrupt halt in 2Q2022 as the Fed sharply intensified its efforts to cool inflation by raising interest rates and tightening credit availability. The rapid and dramatic increase in interest rates paralyzed the market, arresting any expectations of continued growth. Quarterly sales volume fell 39% between 2Q2022 and 4Q2022, and new loan originations followed suit, decreasing 33% over the same period. The federal funds rate has surged more than 450 basis points since 2Q2022, and real estate values implied by the public markets have fallen 15% to 20%, which translates to a 30% to 40% equity diminution assuming 50% leverage. Exhibit 2 illustrates the persistent increase in valuations since the global financial crisis as interest rates remained low and liquidity was high and the immediate reversal in the face of the rapid rate increases since 2Q2022.

The Banking Sector and the Stability of Real Estate Liquidity

Against the backdrop of interest rate instability and broad-based market paralysis, the failures of Silicon

Exhibit 3: Proportion of $4.5 Trillion Debt Outstanding



Sources: FRED, Trepp LLC, MBA, FDIC

Valley Bank and Signature Bank in 1Q2023 and First Republic Bank in 2Q2023 introduced a new narrative: that the banking sector's exposure to office and the effects of regulatory-related contractions will cause commercial real estate to be the next shoe to drop. Pundits fear a vicious cycle in which illiquidity leads to value diminution, which fuels more credit contraction, and so on. Miriam Wheeler described the immediate impacts of that sentiment, "The commercial mortgage-backed securities market actually started out quite well in 1Q2023 due to supply constraints, providing support to spreads. That changed after the bank failures in early March. Bond investors' attitudes toward commercial real estate turned sharply more negative."

Exhibit 4: Select Banks' CRE Loans

Bank	CRE % of Loans	Office % of CRE Loans	CRE Loans Past Due	CRE % CET1* Capital	Office % of CET1 Capital
Zions Bancorporation	23%	18%	0.38%	197%	35%
Comerica Bank	14%	8%	0.30%	91%	7%
Webster Bank	26%	12%	0.49%	224%	26%
Western Alliance Bancorp	21%	16%	NM	217%	35%
East West Bancorp	40%	5%	0.12%	303%	15%
Synovus Bank	29%	24%	NM	254%	60%
Valley National Bancorp	46%	10%	0.54%	485%	49%

Sources: Company filings, earnings materials
*CET1=Common Equity Tier 1

Although banks certainly play an important role in providing liquidity to real estate markets (Exhibit 3) and their absence would be challenging, our panelists uniformly felt that banks had maintained strong, disciplined credit standards since the financial crisis, positioning most to be able to weather a storm. Willy Walker emphasized a recent JP Morgan analysis, "They stressed 20% defaults and 40% loss severities across the office and retail portfolio of every bank in America compressed into a three-year window. Even for those banks most exposed to those default rates, the worst outcome was 30 basis points of degradation to Tier 1 capital. Right now, the banks are experiencing earnings issues, not solvency issues."

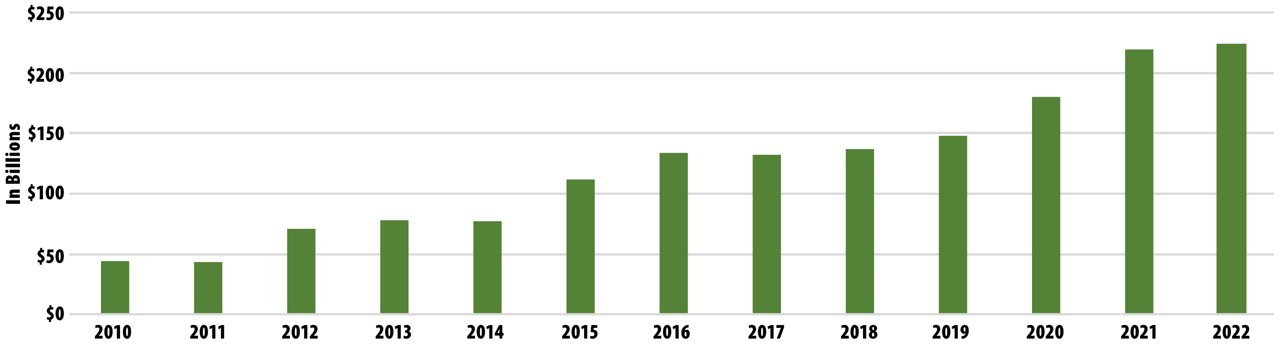
Although each panelist acknowledged the challenges that will arise from the persistent decline in office values, they also suggested the impact would be felt most profoundly by life companies, debt funds, mortgage REITs, CMBS lenders, and others rather than the commercial banks the press has focused on. Because banks are more typically short-term, interim lenders, their loans are more likely secured by new construction or assets undergoing a transition in which the banks' leverage levels tend to be more moderate. Consequently, our participants felt, the challenges in the office sector as they pertain to the banks would not become overly burdensome on the health of the overall lending markets (Exhibit 4). Walker further contextualized, "The banks' office exposure maturing in 2023 represents 2% of the total commercial real estate debt outstanding."

Our contributors also mentioned that banks had been generating additional liquidity by selling their performing loans. Bob Foley explained that "TPG RE Finance Trust, which acquired a $521 million portfolio of performing mortgages from a bank in 3Q2022, and other mortgage REITs and private debt platforms remain active and interested in acquiring performing loans off banks' balance sheets."

He continued, "However, in terms of new originations, we observe in our lending and equity investing businesses that lending activity from smaller and midsized banks has diminished. That will be felt in the areas where those banks lend and presents opportunity for other lenders." While the headlines contemplate liquidity issues among the banks, our panelists spoke of significant capital available elsewhere for commercial real estate, but at pricing borrowers are reluctant to accept. Larger banks and other non-bank lenders are well positioned to fill liquidity voids created by contraction among the regionals, specifically within institutional asset classes.

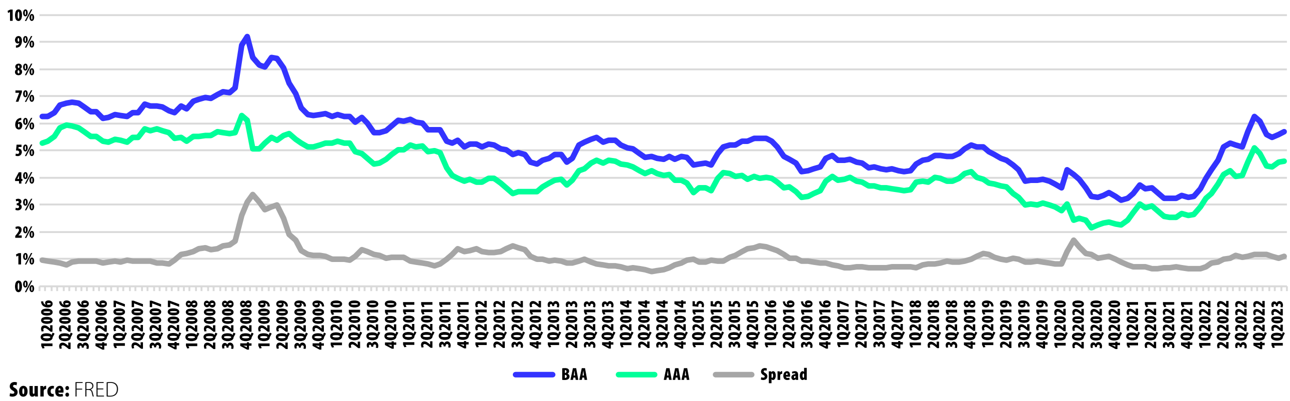
Mark Gibson stated that "life insurance companies might stand to gain market share in areas where they had not traditionally participated, including construction debt, large credit facilities, and higher-yielding, equity-like products." Bryan McDonnell confirmed this sentiment, "People tend to forget that lenders are investors too. Like equity investors, we are seeking to deliver the best risk-adjusted returns and will allocate capital accordingly." McDonnell also noted that,

Exhibit 5: Global Private Debt Fundraising



Source: Preqin

Exhibit 6: Aaa and Baa Seasoned Bond Yields



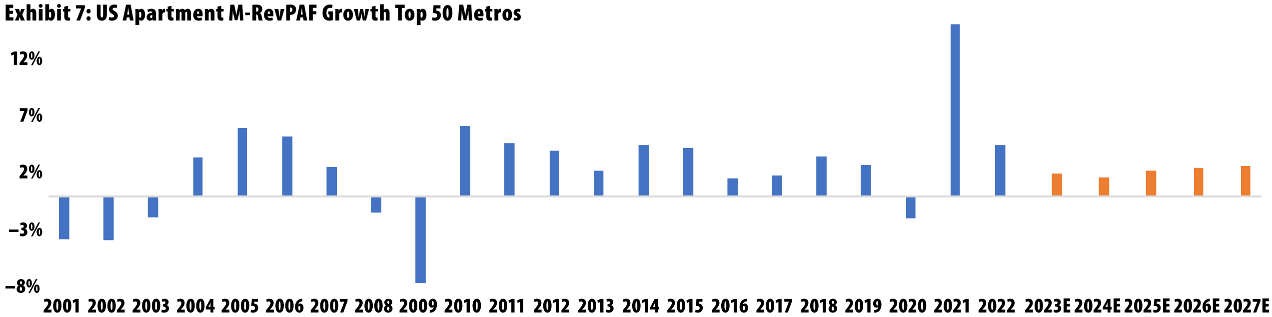
Source: FRED

increasingly, large platforms such as PGIM have both equity and debt capital available to them and can rotate to alternative places in the capital stack, allowing these firms to meet the capital needs of the market. Bob Foley affirmed, "Shakespeare wrote, 'neither a borrower nor a lender be,' but many of us are both. This presents a unique perspective from which to make investments as we can toggle between debt and equity."

All our panel members reminded us that Fannie Mae and Freddie Mac (the agencies) are standing by to execute their stated mission of providing liquidity to middle-market housing, with fresh caps of $75 billion each. Walker further noted that, intuitively, CMBS lenders are likely to plug a portion of the hole left by regional banks, particularly in the non-construction space. McDonnell expanded, "CMBS can scale effectively and go into tertiary markets. It would be a natural replacement for certain borrowers if regional bank contractions do occur." Wheeler did note, importantly, that "buyers of AAA-rated tranches of CMBS issuances are typically banks, life companies, and money managers. As banks manage their real estate exposure, it could lead to a smaller pool of buyers for CMBS securitizations at the most senior and largest part of the capital structure, constraining issuances until fears relating to commercial real estate subside. Over time, however, the CMBS market should be able to absorb a lot of the stabilized product that was going to the regional banks and increase its share of total lending activity."

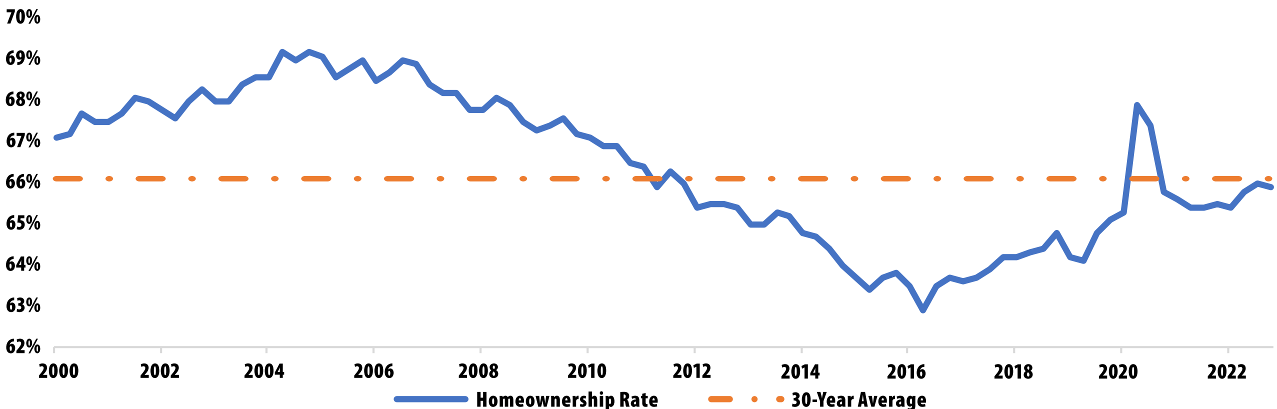
Our five participants were in consensus that as fixed income becomes an increasingly attractive investment vehicle, capital rotation into debt (Exhibit 5) and pivoting among lending institutions could ultimately fill any gaps left by contraction among the regional banks. Wheeler

Exhibit 7: US Apartment M-RevPAF Growth Top 50 Metros



Source: Green Street

Exhibit 8: National Homeownership Rate



Source: Green Street

observed, "There's a huge amount of capital formation occurring to take advantage of this potential opportunity in commercial real estate." Walker summarized, "There's enough stability in the system today that you don't have a run on the banks, you don't need a federal facility set up, and … private capital whether from insurance companies, CMBS, debt funds, or elsewhere is going to be formed to meet that need."

While it's clear that providers of capital will move to meet supply gaps left by the banks, capital reformation takes time. Concerns over near-term credit contractions are warranted, and the credit landscape could remain shallow before regaining stability.

A World of Haves and Have-Nots

Our contributors agreed there has been a clear paradigm shift among institutional investors' attitudes toward where they are focusing their capital deployment. Given the heightened attention to risk management and the dramatic increase in interest rates, lenders and equity providers have become vastly more discerning, something our panelists viewed favorably. According to Gibson, "People forget about risk in frothy markets. The current environment is more normal as it relates to underwriting, pricing, and risk management than anything over the last several years." One panelist spoke of the difference in the spread between AAA and non-investment grade for all asset classes (Exhibit 6 shows bond yields) as compressing during robust capital markets and widening considerably when that reverses.

From a capital perspective, this discernment is playing out in real time—with lenders prioritizing their longstanding, largest, and most valuable borrowers. However, the panelists acknowledged debt providers are limiting new originations to lower-risk assets in more favorable markets. McDonnell noted that "even the agencies are being extremely specific on their requests, both in

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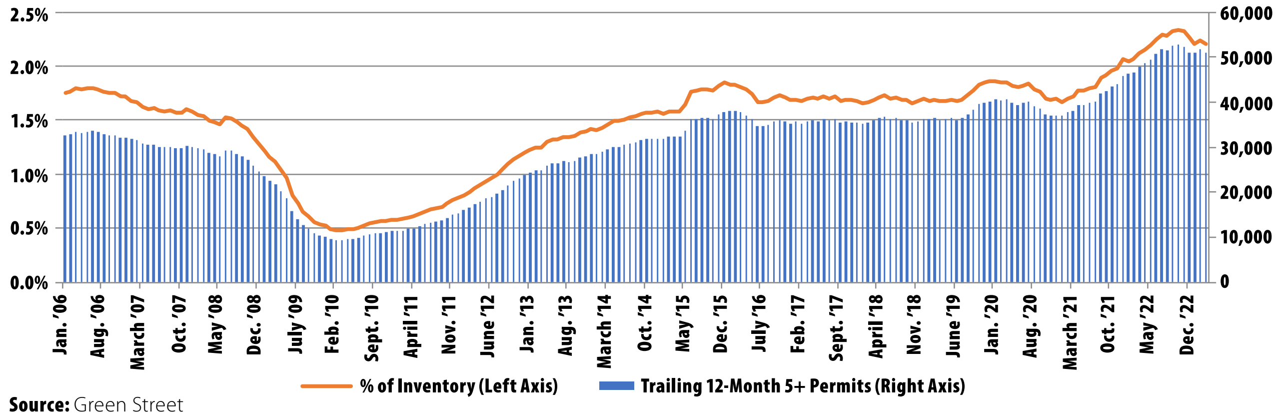
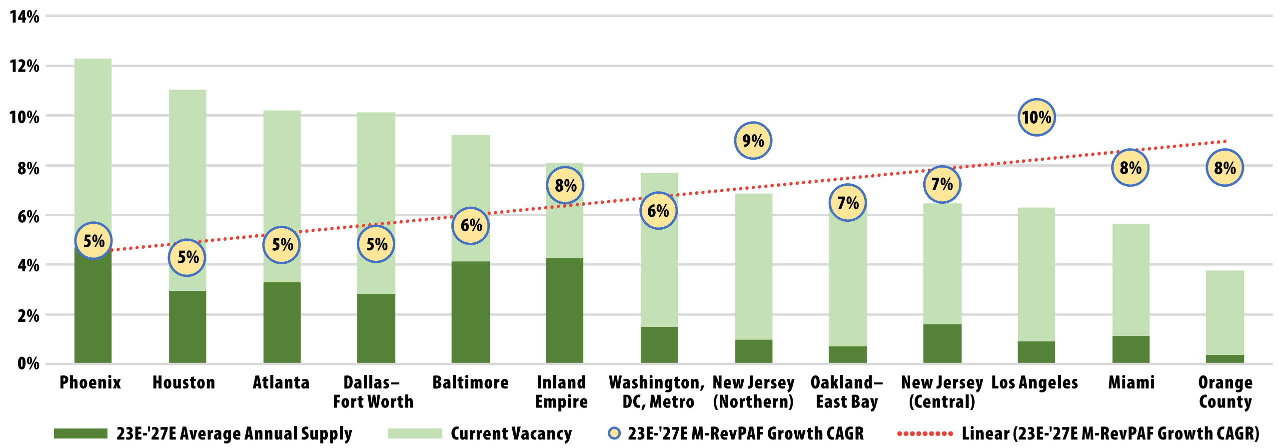
Exhibit 9: Trailing 12-Month Permits



Source: Green Street

Exhibit 10: Vacancy, Supply, and M-RevPAF Growth Trends by Select Industrial Markets



Source: Green Street

terms of where they're being aggressive and where they're pulling back from a market and product perspective." All the contributors felt that until capital providers find clarity around interest rates, values, and liquidity, capital will disproportionately gravitate toward high-quality operators with the best assets in the strongest markets.

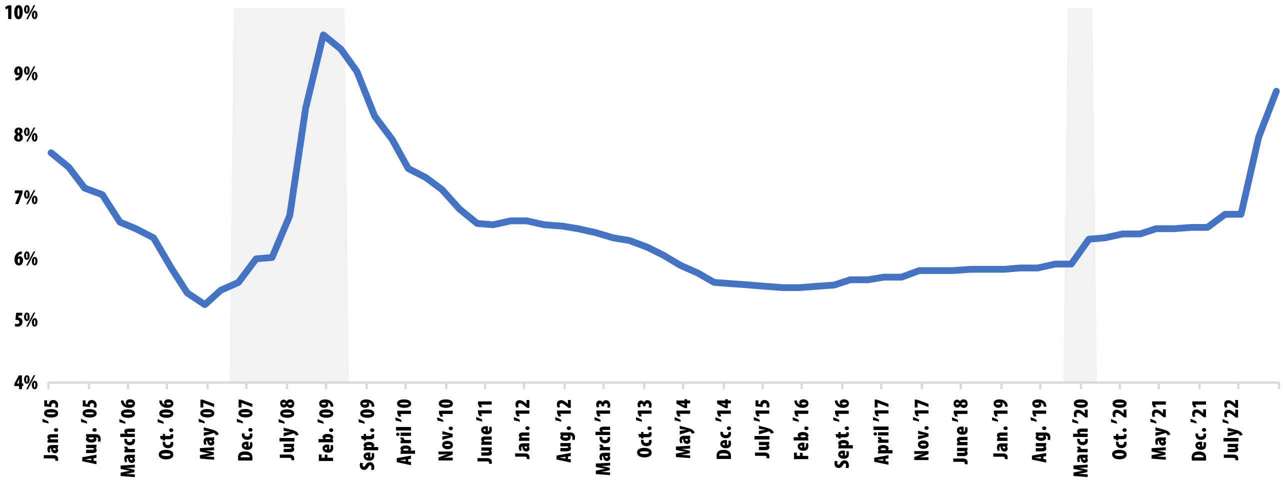
CRE Fundamentals Generally Hold Steady, But Office Will Remain Turbulent

Interestingly, except for office and some retail, the panelists all spoke of persistent fundamentals across property types, ascribing the value declines experienced in the second half of 2022 as tied mostly to the actions of the Fed.

Several panelists noted that the apartment sector continues to benefit from a national housing shortage, homeownership rates below the 30-year historical average, and broad demographic tailwinds. Over the past three decades, 2021 marked the largest single-year increase in rental growth, and though operating fundamentals moderated as 2022 progressed, landlords generally enjoyed occupancy resiliency and above-average rent growth (Exhibits 7 and 8).

As the considerable number of projects started in 2021 and 2022 begin to deliver in 2023 and 2024 (Exhibit 9), the potential for lingering rent growth compression exists in select markets. However, Walker noted that "given the absence of construction financing from the back half of

Exhibit 11: Office Cap Rates



Source: Green Street

2022 into the first half of 2023, the resulting lull in new deliveries during 2024 and 2025 will invariably improve operating fundamentals and valuations of existing assets at that time."

Key demand drivers for industrial also hold, with retail sales now 20% above 2019 pre-pandemic levels and e-commerce continuing to drive last-mile distribution needs (Exhibit 10). The reduction in Amazon's demand has been met in part by other large retailers, whose distribution strategies are now catching up. The industrial sector could also benefit from continuing trends in reshoring, which involves the relocation of production and manufacturing of goods back to the US. Recent deliveries have been absorbed, and slowdowns in construction should alleviate supply pressures on rent. Coastal markets with barriers to supply should experience outsized NOI growth in the coming years, and Green Street predicts national revenue growth to average approximately 6% through 2027.

Although multifamily and industrial continue to exhibit positive fundamentals, the same cannot be said for office. Work-from-home trends decoupled office from the post-COVID-19 economic recovery, and sensitivity to the current economic instability further contributes to weakness across the office sector. "Previous office downturns, especially in the late 1980s and early 1990s, suffered from oversupply due to new construction producing market softness; now, the weakened fundamentals relate to demand uncertainty," remarked Foley. Capital providers are aware of these headwinds to value and liquidity in office (Exhibits 11 and 12). "There's simply no market for office at the moment," stated McDonnell. Gibson expanded, "The narrative around work-from-home will get decidedly better as occupiers are requiring employees to come into the office. That said, relative to present capital markets and valuation conditions, the top 10% to 15% of office inventory will outperform many competing asset classes, while the next 35% is currently priced 25% to 50% off previous valuations. The bottom 50% of inventory is seeking validity as currently, there is little to no market or liquidity." Existing lenders realize they must either provide seller financing or facilitate accommodative extensions until valuations settle. While flight-to-quality among tenants could result in valuation stability for best-in-class buildings, the remainder of the office market will be illiquid until the capital markets determine how to underwrite and price highly volatile office cash flows.

Return to Normalcy?

Our panelists agreed that fundamentals across institutional-quality commercial real estate (except

Exhibit 12: Office Origination Volume

	Origination Volume Index (2001 Average Quarter = 100)				Percent Change		
	Q1	Q2	Q3	Q4	YoY Q4	Q3 to Q4	YTD-YTD
2019	116	193	176	215	29%	22%	23%
2020	126	55	74	94	–56%	26%	–50%
2021	83	137	150	209	122%	39%	66%
2022	108	123	85	92	–56%	9%	–30%

Source: MBA

office) remain strong, and the recent slowdowns in lending activity and transaction volume are mostly attributable to three quarters of unprecedented rate hikes causing value declines and uncertainty among market participants.

The consensus among our contributors was that the amount of institutional dry powder on the sidelines, attractive private credit yields that will boost lending appetites, and persistent underlying fundamentals across commercial real estate have the potential to expedite a return to normalcy once the Fed signals victory over inflation.

But when will this occur? Estimates varied from 12 to 24 months. The panelists specifically pointed to the forward curve, where short-term rates are higher than long-term rates, suggesting that market expectations anticipate a successful curbing of inflation and reduction in short-term rates. Both Chicago Fed President Austan Goolsbee and European Central Bank President Christine Lagarde recently mentioned that the Fed will likely look to the actions of the FDIC as it constricts credit availability through its supervisory efforts as a tool to moderate its need to increase rates or impose quantitative tightening, potentially accelerating a return to interest rate stability.

Our participants all added caveats to their comments by acknowledging the many exogenous factors that could adversely impact their outlooks. Global tensions, political upheaval, mistaken policy steps by the Fed, unduly aggressive regulatory behavior, more surprises in the banking sector, and other forms of shock to the system could conspire to reduce capital availability, risk taking, and other critical lubricants to a normal market environment.

The commercial real estate industry has undergone an extended "Goldilocks" period, characterized by strong economic growth, low inflation, and low unemployment in which a series of tailwinds, largely driven by capital flows and inexpensive debt, allowed a rising tide to lift all boats. However, the introduction of the most significant rate increases in history has paralyzed the market and will continue to pose challenges as practitioners navigate a world with slower growth and less liquidity. Although the failures of SVB, Signature, and First Republic banks have rightly drawn concern from the press, institutional investors would be well served to consider the context our panelists provided, who each agreed that despite the potential for ongoing turbulence, commercial real estate is resilient and should effectively navigate the short-term challenges that lie ahead. ■

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