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MAP THOUGHT PIECE

Commercial Real Estate: The Second Shoe To Drop

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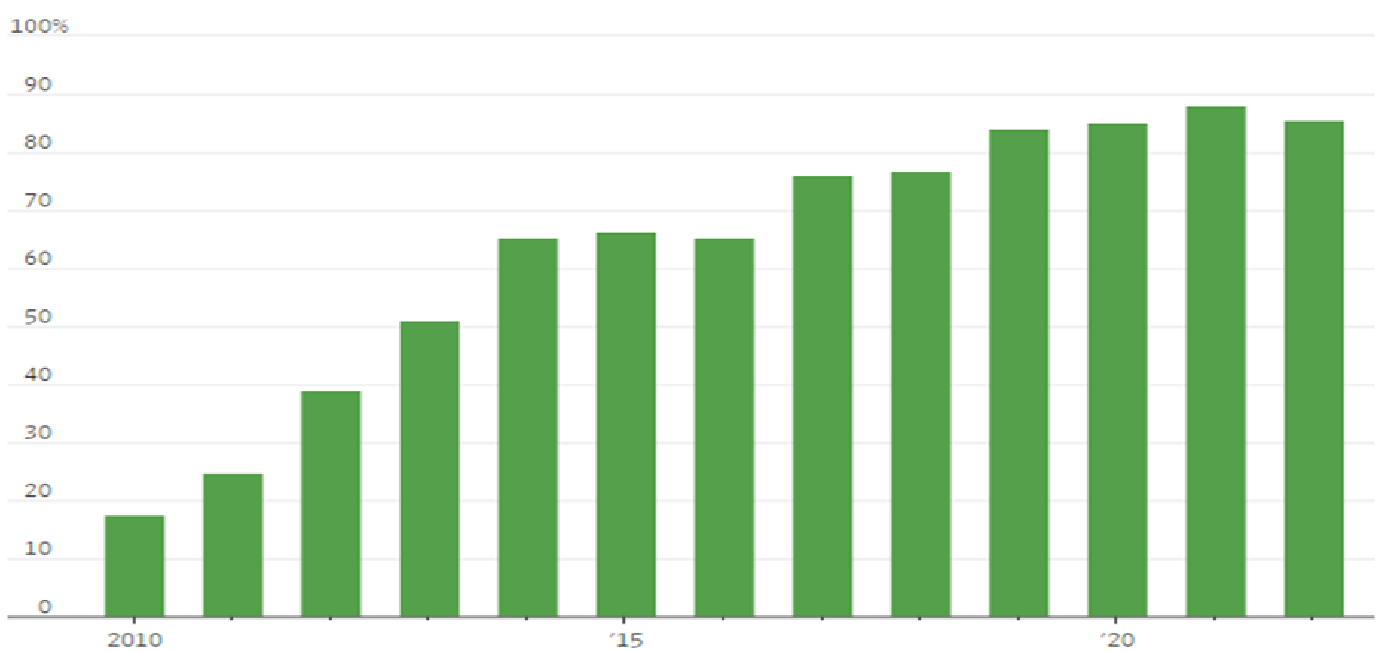
Commercial Real Estate: The Second Shoe To Drop

While still lingering in the air of an unkept house, the dust has seemingly settled following the banking panic earlier this year, which saw the collapse of the European banking giant Credit Suisse, and the 2nd, 3rd, and 4th largest bank failures in U.S. history. Credit Suisse's failure would more aptly be characterized as a gradual deterioration, which can be chalked up to a decade-plus of poor investment and management decisions. However, the collapses of Silicon Valley Bank and First Republic occurred because of a failure to identify the duration risk of long-dated, low coupon treasuries, investments that ultimately lost value and forced banks to realize significant losses to meet withdrawals. With these failures in the rearview mirror, banks are starting to grapple with the potential losses from commercial real estate.

The commercial real estate market has been in limbo since the start of the COVID pandemic, as investors speculated how long it would be until the world returned to normal. The World Health Organization declared an end to the pandemic earlier this year, yet office occupancy rates are still struggling to meet half of pre-pandemic levels.[1] Employees discovered they rather enjoyed the freedom of working from home, and many employers, keen to cut expenses, have embraced remote and hybrid work models, allowing them to slash their physical footprint. Technology firms like Amazon, Meta, Salesforce, and more have indicated they're downsizing or halting construction on new buildings, corresponding with the highest national office vacancy rate since 2011 (over 12%) and the highest recorded square footage of sublease availability (about 212 million sq ft).[2]

As demand shrinks and more offices become available through expiring leases and companies looking to sublease unused space, the value of commercial real estate has taken a hit. Something else to factor in; since 2013, more than half of new Commercial Mortgage-Backed Securities have been interest-only, and those percentages have steadily increased as shown below.

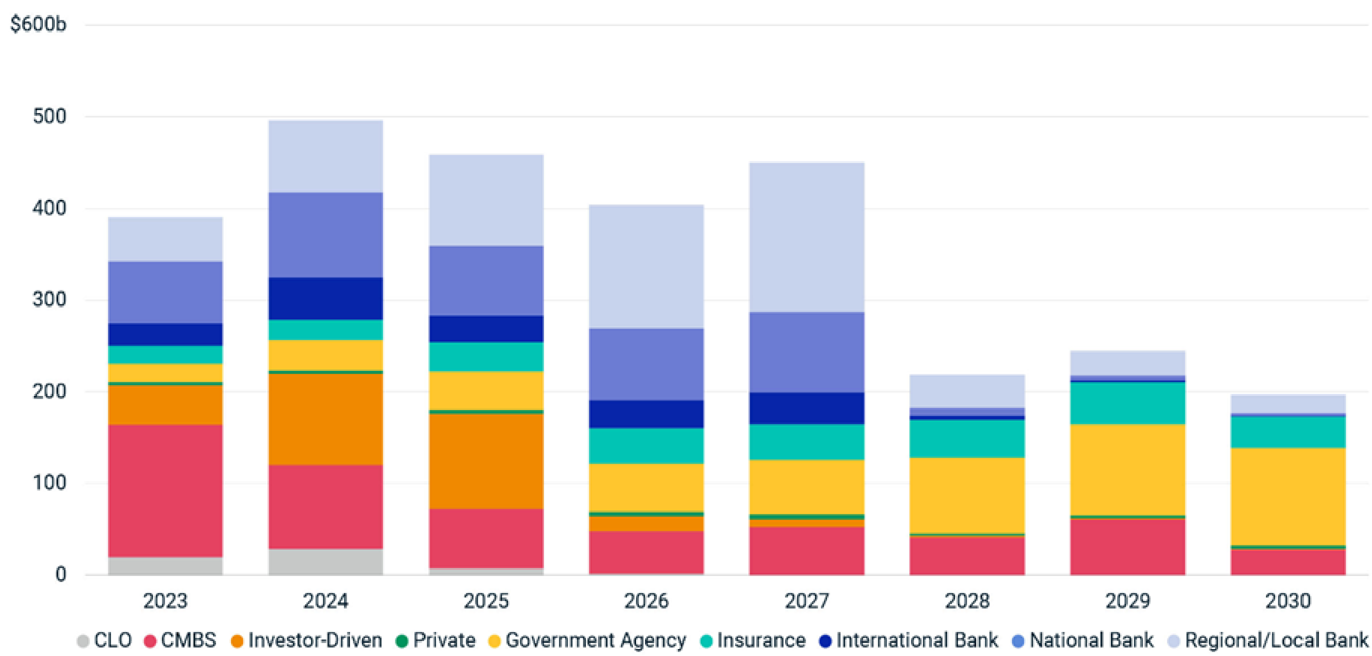
Share of CMBS loans that are interest-only, by year of issuance



Source: Trepp

"What's wrong with interest only loans?" Well, the owners of these buildings are essentially left with two options, either pay up for a building that lost 15%-25% of its value or refinance the loan at a significantly higher interest rate. When left with those two options, most will choose to default on the debt funding the building, leaving banks and large insurance companies scrambling to find buyers.[3] Fitch estimates that 35% of pooled securitized commercial mortgages coming due between April and December 2023 will not be able to refinance based on current interest rates and the properties' incomes and values. Xiaojing Li, managing director at data company CoStar's risk analytics team, estimates that as much as 83% of outstanding securitized office loans will not be able to refinance if interest rates stay at current levels.

These potential losses, while not astronomical, are significant, and could pose a serious threat to regional banks. The following graphic from MSCI shows the volume of maturing commercial property loans by lender type in billions, with 2023 and 2024 setting record levels of maturing loans. Although the total volume of maturities drops in the three ensuing years, the amount of expiring commercial mortgages held by regional banks continues to increase going forward. If interest rates remain elevated for an extended period, these small regional banks, (which have seen higher than usual outflows of deposits) could be forced to offload swaths of commercial property at discounted rates.[4]



As mentioned, the brunt of potential losses is yet to come, but some commercial property owners have sold buildings this year at deep discounts. San Francisco's struggle to combat homelessness and rising crime has been well documented, and unsurprisingly, that has bled into real estate values. A Japanese bank, Mitsubishi UFJ, sold a 22-story building at 350 California Street for a figure around $60 million, representing an 80% discount to a 2019 valuation.[5] However, these preliminary fire sales aren't limited to troubled San Francisco - office buildings in Santa Ana, Los Angeles, Milwaukee, Chicago, Philadelphia, and D.C. have also seen losses in the range of 35%-60%.[6,7]

Credit ratings agencies are noticing. Moody's recently cut credit ratings of several small to mid-sized U.S. banks, saying it may downgrade some of the nation's biggest lenders, warning that the sector's credit strength will likely be tested by funding risks and weaker profitability. Moody's cut the ratings of 10 banks by one notch and placed six banking giants, including Bank of New York Mellon, US Bancorp, State Street, and Truist Financial on review for potential downgrades.[8] S&P cut ratings on Associated Banc-Corp and Valley National Bancorp on funding risks and higher reliance on brokered deposits. It also downgraded UMB Financial Corp and Comerica Bank citing deposit outflows and higher interest rates. The ratings agency also cut KeyCorp's ratings on the back of constrained profitability.[9]

One last thing to consider - banks will likely be facing additional regulatory hurdles in the near future. The sustained elevated interest rates and increasing delinquency rates on current loans has already forced banks to tighten their pockets, but it is nearly guaranteed that increased government regulation will follow any large-scale crisis. After the failures earlier this year, President Biden called for more oversight of banks with $100 to $250 billion in assets.[10] The Federal Reserve has also drafted additional mandates that if passed, would force banks to hold more assets, use standardized risk assessment models, and account for unrealized gains and losses.[11] While the proposed changes could help prevent a repeat of Silicon Valley Bank's fate, the same regulations would also make life more difficult for all banks, especially the already struggling regionals.

With a value-based investment approach, MAP is focused on achieving attractive, long-term risk-adjusted returns – finding hidden gems in the markets coupled with relatively low risk. Although regional bank valuations have become more attractive on a relative basis, from our perspective, at this time, the risk simply outweighs the potential reward.

Please do not hesitate to contact your MAP representative with any questions.

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[1]https://www.kastle.com/safety-wellness/getting-america-back-to-work/
[2]https://www.wsj.com/articles/meta-lyft-salesforce-and-other-tech-firms-dump-office-space-as-they-downsize-11668477701?mod=article_inline
[3]https://www.wsj.com/articles/interest-only-loans-helped-commercial-property-boom-now-theyre-coming-due-c3754941?mod=article_inline
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[5]https://therealdeal.com/sanfrancisco/2023/05/09/sks-buys-350-california-street-in-san-francisco-paying-60m-to-68m//
[6]https://www.wsj.com/articles/rise-in-distressed-sales-signals-new-chapter-for-beleaguered-office-market-bbff313c?mod=hp_user_preferences_pos2#cxrecs_s
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[11]https://www.reuters.com/business/finance/sp-downgrades-multiple-us-banks-citing-tough-operating-conditions-2023-08-22/

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