Key Questions

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Is Commercial Real Estate the Next Shoe to Drop?

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Concerns Over the Future of Commercial Real Estate Are Justified but May Also Be Overstated

As the stresses within the US banking system become better understood, it seems likely that we will be able to define this moment in time as having three phases:

1. The acute liquidity phase.
2. The chronic liquidity phase.
3. The credit (dare we say, more traditional) phase.

The acute liquidity phase first materialized in early March when two relatively high-profile banks were closed following a rapid drain of their deposits. With the benefit of hindsight, most have concluded that insufficient risk management and unique concentration issues ultimately led to their demise.

These bank failures are viewed by some as idiosyncratic in nature. However, they did expose a larger, more chronic situation affecting nearly every financial institution: unrealized losses within securities portfolios and the need to lift deposit rates, which will translate into smaller profits going forward, all else equal.

We will not discuss these concepts in detail here. These issues are broad-based and will require time to be fully addressed. They will also gradually dissipate over time. They do pose certain challenges, but by and large, they do not pose systemic risk on par with prevailing circumstances circa 2008.

Concerns Over Commercial Real Estate Loans

The third phase of this period of banking system stress rests with credit. More specifically, concerns over the potential of future credit losses, especially on loans tied to commercial real estate (CRE).

CRE is a $20 trillion market. Bank loans account for $2.8 trillion of CRE debt, and of that amount, a relatively modest $400 billion is maturing this year. CRE is comprised of a great number of diverse property types ranging from traditional office space to retail, multifamily (i.e., apartments), industrial/warehouses, storage, technology infrastructure, hospitality, healthcare and several others. Most of these sectors are loosely correlated with one another, and each features various other unique attributes, including their use of leverage, their customer mix, and distinct supply/demand drivers that influence asset values.

Among these sectors, office is experiencing considerable challenges because of changing patterns resulting from the COVID-19 pandemic and the subsequent decline in demand for space. That said, office represents roughly 15% of the entire CRE market.

The banking system is strongly tied to the CRE market as commercial banks finance the majority of CRE debt (50.3% as of the third quarter of 2022). The types of CRE loans that banks originate can generally be broken into four categories (ranked from least risky to most risky based on historical net charge-off data):

1. Owner-occupied.
2. Multifamily.
3. Investor-owned.
4. Construction and development.

Owner-occupied (22% of the CRE market) is the least risky. An owner utilizing the property for a business is likely to be more reliant on the property. Multifamily (21% of the CRE market) and investor-owned (41% of the CRE market) carry slightly more risk. The property is dependent on the rents paid by the underlying business and/or tenant. Finally, construction and development (16% of the CRE market) carries the highest risk. The possibility that the property will not be completed leaves less security for the lender.

Factors That Could Lead to Losses

Ultimately, there are different levels of risk within CRE loans and the exposure to the different categories can vary from bank to bank. However, what has investors particularly nervous about the CRE market, and the associated bank loans, is a combination of factors that could eventually lead to increased losses.

Higher interest rates lead to higher borrowing costs. That is especially true for adjustable-rate and floating-rate loans, which make up approximately 70% of outstanding loans and most commonly need to be refinanced. Because interest rates have risen so quickly and substantially, though, many borrowers have had little time to react.

Typically, when faced with higher borrowing costs, the borrower might attempt to increase revenue by raising prices and/or rents. However, this may not be easily accomplished if 1) the demand for real estate has significantly diminished, such as is the case for office real estate; or 2) the consumer cannot absorb the higher price. Both factors have the potential to be stressors in the market and determine future severity. If the revenue needed cannot be secured, this could cause a problem as the debt service coverage levels could weaken to the point where defaults could occur on the loans.

These same higher interest rates typically equal lower property values, further compounding the problem. Lower property values could result in higher loan-to-value (LTV) levels, leading borrowers to decide between 1) introducing more equity to reset the LTV level or 2) abandoning the property and defaulting on the loan. If the outlook for the CRE market appears poor, there is a heightened risk that more borrowers may decide to abandon the property instead of retaining it.

In both cases, a bank would seize the properties as the security, but risks remain for the bank:

- The properties may now be worth less than the loan amount, including the fixed costs associated with re-selling the property.

- The demand for the property may be lower than expected, further hampering the recovery effort.

The result of these scenarios would be the bank taking a loss on the loans, which factors into why banks with high and/or growing CRE exposure have come into focus.

The potential for losses increases the need to scrutinize banks' differing exposure to CRE. Small banks generally carry an outsized risk. Most of the CRE loans originated since 2012 (~80%) were from this group. Furthermore, CRE loans, on average, make up 44% of small banks' total assets compared with larger banks' exposure of just 13%.

However, investors should understand that every bank is different, and each may have a different risk profile. Two banks with the same nominal amount of CRE exposure do not necessarily carry the same amount of risk. That requires a deep dive by investors to assess bank-specific CRE exposures and risks.

Key Takeaways

How commercial real estate credit will affect the overall economy remains to be seen. But the risks are real and rising. A bigger pullback on credit likely will lead to a bigger economic impact. The banks with fewer and/or more conservative CRE loans are likely to outperform the peer group. So are the banks that have sufficiently set aside reserves to realize potential losses.

The stresses in the CRE market have not yet been fully realized, but the demand for CRE and the strength of the consumer may eventually determine if the risks have been overstated.

Furthermore, as noted earlier, the $2.8 trillion in CRE debt outstanding, while sizeable, is dwarfed by the $11 trillion residential mortgage. And thus, while any significant reverberations in the CRE market will be undeniably felt throughout the economy, we do not think it poses the same level of systemic risk.

Sources: Federal Reserve, FDIC, BofA Securities

For more information, please contact your advisor.

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