

US CRE: Misconceptions, Pullbacks and Potential Opportunities

COMMERCIAL REAL ESTATE INSIGHTS – MAY 2023



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KEY TAKEAWAYS

- > The narrative surrounding US commercial real estate (CRE) seems to be applied to all property types, but we believe fundamentals outside of Office remain relatively healthy
- > With banks and CMBS having pulled back from the market, a void has been created, while we expect lending to pick back up as over \$2.5T in loans mature through 2027
- > Current market volatility can allow investors to lend at lower leverage points and higher yields, as well as more favorable structures (e.g., tighter loan covenants)
- > It can be difficult for investors to maintain, or even increase, CRE exposure in the current environment, but we believe it is the right time to do just that

THE MISCONCEPTION

Try searching for media stories on the CRE market, and those articles are likely to be negative, highlighting the difficulties faced by the Office sector due to the now-ingrained hybrid work environment.^{1,2} Market concerns have been exacerbated by the recent banking crisis, as regional banks are a large provider of commercial mortgage loans (CMLs). However, we believe the CRE debt market as a whole is getting painted with a broad brush. Office is just one of the major property types, along with Hotels, Industrial, Multifamily and Retail, but the narrative and negativity surrounding CRE seem to be applied to all sectors.

It is true that the rise in interest rates had a large effect on the entire CRE market, as it came with uncertainty around future cap rates and a lack of clarity around pricing given fewer transactions. However, we believe overall fundamentals in sectors outside of Office remain relatively healthy. On the demand side, rent and net operating income are generally growing across Hotels, Industrial, Multifamily and Retail, even if growth rates are decelerating. On the supply side, inflation has increased both material and labor costs, making it more expensive to build new properties, thereby keeping fundamentals relatively intact. Further, we believe Hotels, Industrial, Multifamily and Retail are all in better positions fundamentally heading into a potential downturn versus previous cycles.

THE PULLBACKS

Banks, both large and small, are the largest providers of debt to owners/operators of commercial properties. As shown in the chart below, they constituted 39% of loans outstanding as of Q4 2022.³ Regional banks were the lion's share of that at 70%, according to Bloomberg, given their local expertise.⁴

When the Federal Reserve began its rate hike cycle in 2022, banks also began tightening lending standards across loan types, including CMLs. In 2023, amid the regional banking crisis, banks have tightened standards even further. As shown in the chart below, the net percentage of domestic banks that tightened standards in CMLs spiked to levels last seen during the early days of the COVID crisis.

(1) As of 25 May 2023. Unless otherwise stated, the information presented has been prepared from market observations and other sources believed in good faith to be reliable. Information and opinions expressed by PPM are current as of the date indicated and are subject to change without notice. Past performance is no guarantee of future results. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. (2) For example: Financial Times. "US Lenders Warned That Commercial Property Is 'Next Shoe to Drop.'" 9 May 2023. WSJ. "What Empty Offices in San Francisco Say About Commercial Real Estate." 27 April 2023. NY Times. "Concerns Grow as Tighter Lending Threatens Commercial Real Estate." 6 April 2023. (3) Mortgage Bankers Association. "Commercial/Multifamily Real Estate Mortgage Debt Outstanding, Q4 2022." (4) Bloomberg. 13 April 2023

We have seen regional banks pull back significantly as a source of CML supply, and we expect them to be less competitive over the intermediate-term, if not the long-term. For the large national banks, which comprise the remaining 30% of bank-supplied CRE debt, we expect a gap period before they return as a meaningful liquidity source to the CRE market.⁴ We also expect that these large banks likely want to work through current investments, in particular demonstrating paydowns to reduce their denominators, before returning to the market.

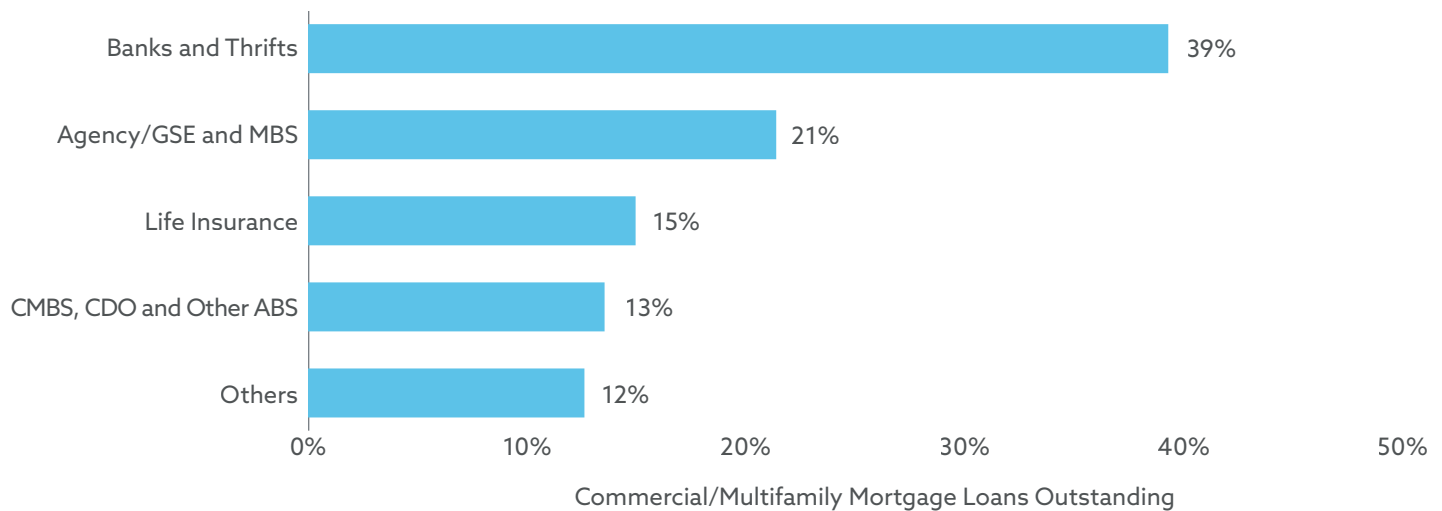
Meanwhile, the CMBS market, another large provider of CMLs (13% of loans outstanding, according to the chart below), has seen issuance plunge.³ Non-agency CMBS issuance had already declined 36% in 2022 versus 2021.⁵ Through the first four months of 2023, the run rate is 72% below the year-ago period.⁶ It is very difficult

for a CMBS issuer to warehouse hundreds of millions of dollars of CMLs and have confidence on how to price the bonds when 1) interest rates are volatile and 2) CMBS AAA spreads have more than doubled over the past 17 months (158 bps on 19 May 2023 vs. 71 bps on 31 December 2021).⁷ As such, we expect CMBS issuance to remain subdued over the near-term.

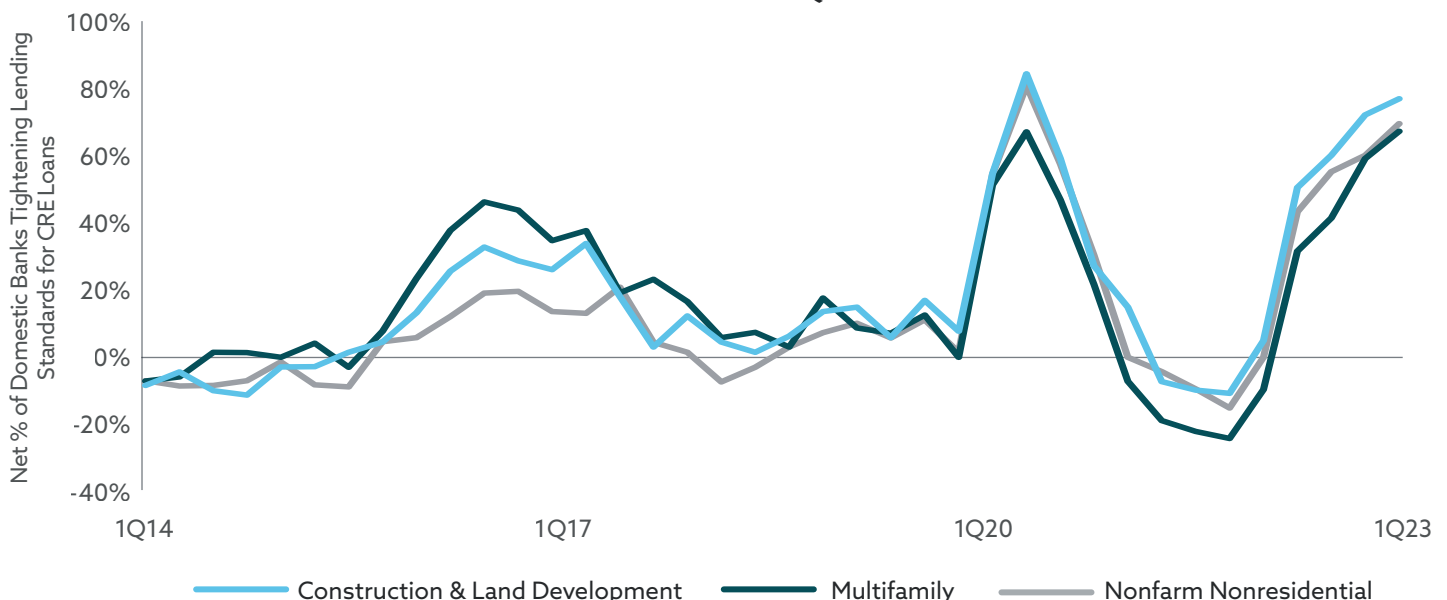
THE POTENTIAL OPPORTUNITIES

With banks and CMBS having pulled back from the market, a void has been created. This has already led to a reduction in overall financing activity. Loans on new construction are down, which might make sense given elevated material and labor costs.⁸ But we believe that refinancing activity should pick back up on existing properties. As shown in the chart on the next page, over \$2.5T in CMLs mature from this year through 2027.⁹

BANKS ARE THE LARGEST PROVIDERS OF LOANS TO CRE³



BANKS HAVE REDUCED THE LIQUIDITY PROVIDED TO CRE¹⁰



(5) Bloomberg. 26 January 2023. (6) Bloomberg. 22 May 2023. (7) ICE Data Services. OAS of the ICE BofA AAA US Fixed Rate CMBS Index. 17 May 2023. (8) For example, see FundFire. "Multifamily Real Estate Stumbles with Slower Deal Volume, Fundraising." 10 May 2023. (9) Trepp, Inc. Based on Federal Reserve Flow of Funds data through Q3 2022. (10) Federal Reserve. 8 May 2023. Past performance is no guarantee of future results.

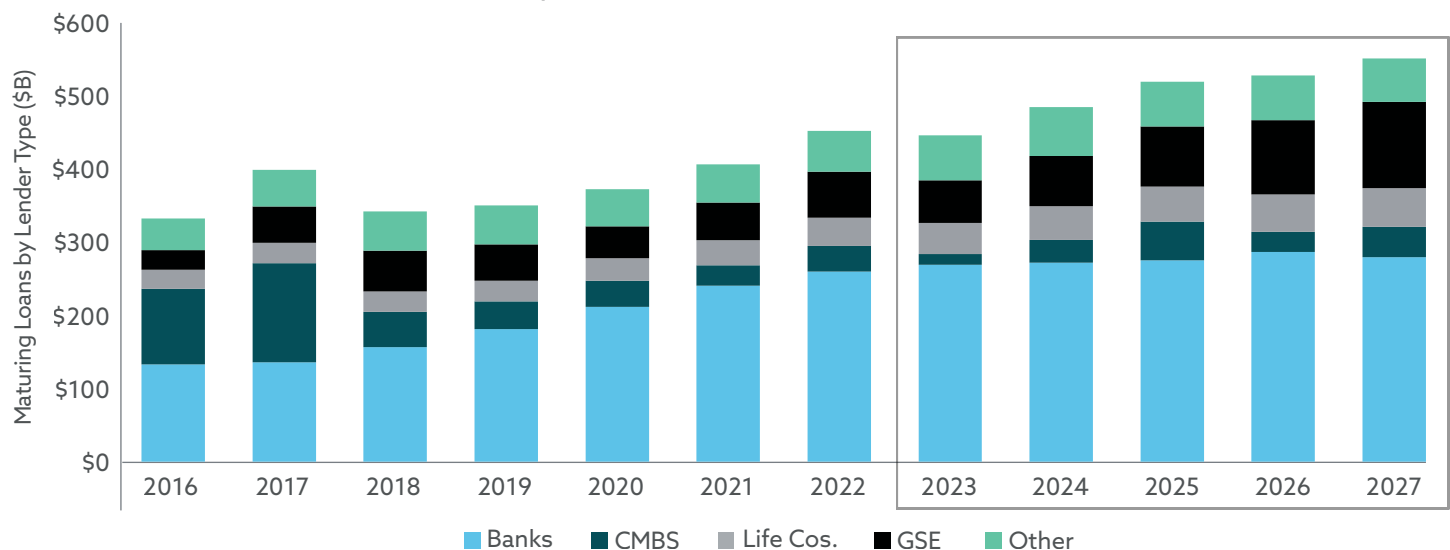
It can be difficult for institutional investors to maintain, or even increase, CRE exposure today given the headwinds discussed above. However, we believe it is the right time to do just that. Current market volatility can allow investors to lend at lower leverage points than prior to the dislocation, as well as at higher yields as shown in the chart below. Debt can currently be purchased at leverage points of 50-65% loan-to-value, which means more sponsor equity. As a result, we believe CRE debt remains investable through the currently volatile market environment. Further, deals today can be struck with more favorable structures, including lease rollover reserves that support underlying properties and tighter loan covenants (e.g., shorter amortization periods, yield and DSCR covenants).

We also continue to see an opportunity in transitional lending. Borrowers may look toward shorter-term lending in lieu of refinancing at higher rates amid reduced liquidity in CMLs.

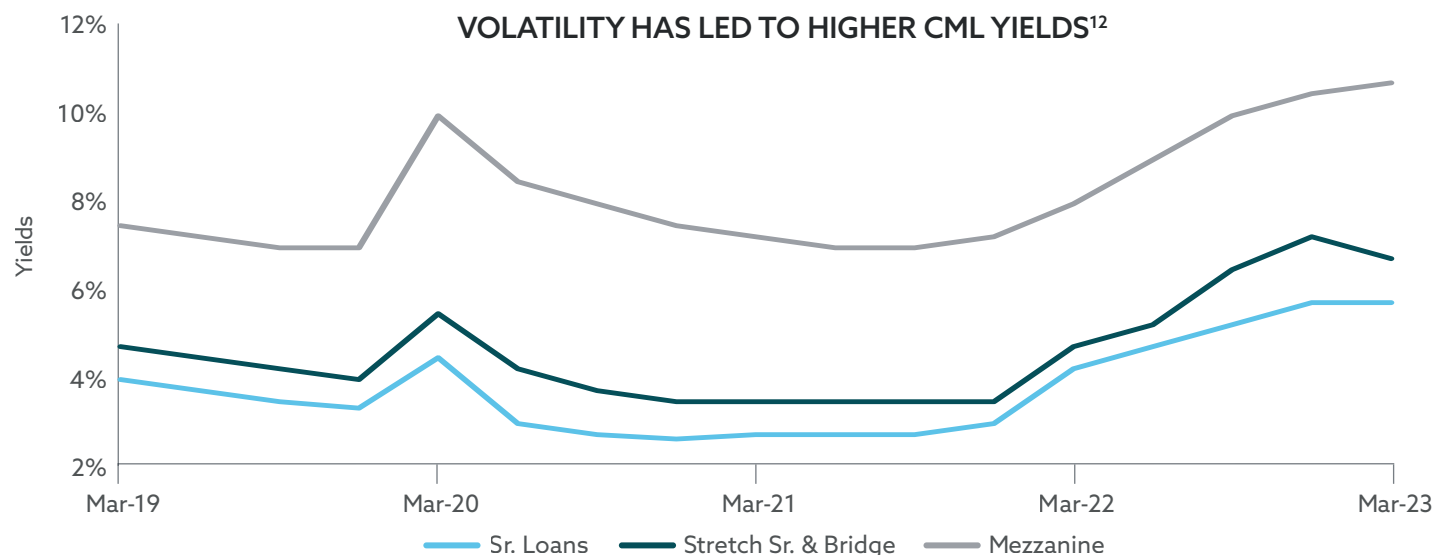
Meanwhile, private credit has been touted as an alternative liquidity source that can step into the CRE market while others have pulled out.¹¹ While a possibility, we would point out that, given the risk/reward profile of private credit, such investors are likely to look at the highest-yielding/lowest-priced loans. That would entail Office and distressed areas of other sectors – a much smaller opportunity set than the broader CRE market opportunity discussed above.

While deal activity has slowed, we expect it to pick up. We believe it is important for market participants to prepare now, as the upcoming CRE refinancing wave and improvements in deal pricing and structure present opportunities for institutional investors. They can move up the capital stack, transitioning from CRE equity to CRE debt, adding loans with potentially more attractive risk-adjusted terms.

OVER \$2.5T IN MATURITIES IN NEXT FIVE YEARS⁹



VOLATILITY HAS LED TO HIGHER CML YIELDS¹²



(11) Bloomberg. "Shadow Lenders to Bridge Real Estate Void Left by Banks, Bonds." 13 April 2023. (12) Cushman & Wakefield. Quarterly yields through 31 March 2023. CRE data is calculated by PPM using third-party sources, in particular Cushman & Wakefield. Past performance is no guarantee of future results.

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