Our Analysts' Take: Commercial Real Estate

Introduction to Commercial Real Estate

Before delving into commercial real estate (CRE), which will be the focus of this article, it is useful to provide an overview of the Real Estate Market. The Real Estate sector is expected to reach a size of $613.6tn in 2023, with the United States alone contributing $113.6tn.

Given the size of this market, we can divide it further into different areas. Residential Real Estate is the biggest one ($498.60tn worldwide) and includes any property used for residential purposes, such as homes, condos, and cooperatives. Commercial real estate ($115tn), on the other hand, includes all properties used for business purposes, such as gas stations, grocery stores, hospitals, hotels, restaurants, shopping centres, and offices. Other categories include Industrial, which encompasses any property used for manufacturing, production, distribution, storage, and research and development, land, and special purpose, which includes property used by the public, such as cemeteries, government buildings, and libraries.

Within commercial real estate, there are several subcategories, which were affected differently by the recent macroeconomic developments. Multifamily properties are a middle ground between Commercial and Residential RE but are mainly owned for investment, whether they are owner-occupied. Office buildings have taken the hardest hit and can be divided into Class A, B, or C, depending on the location of the building and the quality of the construction, with Class A being the highest level and C being the lowest. Other subcategories include retail properties, hotels, and mixed-use properties (which are usually a mix of office, multifamily, retail, and/or industrial).

Latest Trends in Commercial Real Estate

The Real Estate market is closely intertwined with the direction of central banks' policies, which affect, through interest rates, the rates which borrowers get when entering loans or trying to refinance their existing obligations.

Within Real Estate, CRE has been one of the most affected sectors. The hawkish policies of the main central banks caused valuations to plummet and investors to move away from the riskier real estate bets. If, on the one hand, hyperinflation allowed some landlords to pass a good chunk of this pressure to the tenants by increasing rents, others, especially owners of office CRE, also experienced a decrease in demand, which prevented them from doing that. The issue gets even more relevant if we consider that, especially in the US, most CRE loans are floating rate, which leaves borrowers vulnerable to movements in interest rates.

The turmoil in the banking sector we have been seeing recently, with the collapse of SVB and the deposit flight from smaller banks, is also having direct repercussions on the CRE market. In the US, banks represent 54% of the overall $5.7tn CRE market, with small lenders accounting for 70% of CRE loans, according to Citigroup analysts. More than $1.4tn in CRE loans will mature by 2027 and $270bn will mature this year, according to Real Estate data provider Trepp; the uncertainty pervading the banking sector will negatively affect the terms borrowers will get on new loans and whether these borrowers will be able to refinance at all. First, the interest rates that will be offered will likely be much higher than the ones they were able to secure during the pandemic, posing a threat of more and more borrowers defaulting on their interest payments. Secondly, even in the case in which landlords were able to absorb the worse terms by increasing rents in line with inflation, they may have trouble refinancing when their mortgage maturity date approaches. In fact, regional banks, which are the prime lenders for CRE in the US, are becoming increasingly risk averse and are lacking the actual liquidity from deposits to give out new loans.

Why Office CRE is different

While inflation helped to relieve some pressure from cashflows in CRE, the situation is very different for office CRE. After the pandemic, more and more workers are shifting to working from home, moving from High Cost of Living (HCOL) cities, and companies are resizing their office spaces consequently. This led to a decrease in demand for office spaces, which prevented landlords from raising rents and even forced them, in some cases, to offer better terms to fill vacancies. This puts even more pressure on borrowers, who are not only seeing the rates on their loans increase but will also have difficulties maintaining their current cash flows when lease contracts with companies expire.

Especially in the northern cities of the US, commercial office space supply is at record highs. This is also confirmed by vacancy rates, which make up for a good proxy for demand and supply of office CRE: for instance, the vacancy rate for office spaces recently reached 30% in San Francisco, which has been one of the most affected markets for office CRE. On the other hand, not all cities are in trouble, and markets in many parts of the south are thriving, experiencing fewer vacancies and a smaller impact overall. Outside of the US, the situation is not much better: in London, office values could decline up to 40% by the end of next year, according to analysts at Citi, and vacancies have risen significantly in the past year.

To make the situation worse, the biggest share of the maturing debt load is comprised of loans for offices. According to researchers at Barclays, the exposure of US banks to office CRE would be roughly 550bn, while the total exposure would amount to $900bn. Banks such as Bank of America and Wells Fargo bear the most risk, with respectively 27% and 22% of the loan book invested in the sector.

However, it must be noted that, while there is significant exposure to office CRE for banks, the composition of lenders varies between large and small offices. International banks, Commercial-mortgage-backed securities, and investor groups have a 71% share in the market for large offices, which are being affected the most, while regional banks have a more even exposure and smaller banks are mostly invested in the latter category. Furthermore, it's hard to understand how offices are performing. Although some cities, such as San Francisco, make for exceptions, office availability, which measures how much space is vacant and how much space will open in coming months, hasn't climbed too dramatically since Covid-19.

San Francisco: A Case Study on Commercial and Residential Real Estate

SF's Commercial Real Estate Crisis

Two years ago, the Union Bank Building at 350 California Street in San Francisco's financial district was worth $300m. This year, the building received final offers at a meagre $60m. It's evident that San Francisco, a critical hub of the tech industry, is trembling under the pressure of the work-from-home rise as it endures post-pandemic, leaving real estate analysts to question the future of the San Francisco market at large.

The Union Bank building is just one example of the city's office commercial real estate woes. Situated close by, the Wells Fargo building at 550 California Street is likely to take a similar hit, purportedly selling at a mere $40m, compared to an asking price close to $150m. These steep valuation drops are both the cause and the result of commercial tenants fleeing the once-bustling market of San Francisco. Roughly 30% of all downtown office space is now vacant in San Francisco, whereas, according to data from Coldwell Banker Richard Ellis, it was just 3% in 2019 before the pandemic.

The tech sector is contributing significantly to the vacancy rate in San Francisco. Both the rise of remote work and a sector-wide financial downturn are forcing cuts to big tech firms that include downsizing, relocating, and closing offices. Pinterest, for instance, is preparing to pay up to $125m to exit its lease at 505 Brannan St. in downtown San Francisco. The exit is just one of many decisions Pinterest has made to shed its corporate real estate holdings, opting out of renewing leases for some office locations while subleasing or terminating deals for others. Reddit is another social media giant downsizing from its current 78,000-square-foot office after its lease expires in September. Meta faces a similar fate, as it has listed its entire 435,000-square-foot downtown facility for sublease in January.

The real estate downturn has affected more than just the office sector, with even typically more resilient industries like retail facing similar exoduses. The recent closure of a flagship Whole Foods Market in the city, reportedly due to safety concerns and an increase in crime, is one example. Nordstrom pursued similar closings, shuttering two stores near downtown SF. While the city once touted some of the most exclusive and high-value commercial real estate spaces in the country, falling real estate values, coupled with concerns about crime and homelessness, has called its future into question. Not only is this a nightmare for commercial landlords, but the loss of commercial tenants has profound ramifications on the greater San Francisco economy, sapping the city of significant tax revenue.

SF's Unexplained Rent Pricing

The spill over effects of the CRE market on San Francisco's infamously hyper charged housing market is still an area of relative uncertainty. To date, it seems that the commercial real estate crash has affected mortgages but curiously, not rent. The Bay Area has seen a recent slowdown in home sales, with a decrease of 35.5% YoY as mortgages rise in pace with interest rates nationally. However, rent analysts like Jon Leckie report that rents as of May 2023 are up 2.5% YoY (0.5% MoM), sitting at a staggering monthly average of $3,715 for a one-bedroom apartment in the San Francisco metropolitan area. This trend defies the fact that, historically, rents have declined in periods of economic turmoil. For instance, rents fell as much as 70% after the burst of the dot-com bubble, and 30% after the 2008 financial crisis.

Some analysts are forecasting a return to a normal pattern of growth post-pandemic despite market conditions. Though demand is down, and landlords are having to compete for tenants, property owners have opted to offer incentives such as free months of rent and interior improvements to new tenants rather than reduce prices, according to real estate firm CBRE.

One theory is that excitement over artificial intelligence and other innovations in tech are keeping workers or inviting new ones into the area. More likely, though, the situation reveals the stickiness of rent pricing in desirable metropolitan areas like San Francisco. The reality that rents have barely budged despite the reality of major shocks to real estate demand seems otherwise inexplicable—it is unlikely that the CRE crash will have absolutely no effect on residential real estate. Rather, the rent market should see the eventual effects of supply and demand over the course of the next few years as more and more companies abandon their vacant properties. What differentiates the current situation from prior economic shocks to office demand, which saw rents plummet overnight, is that companies are not suddenly disappearing, but instead allowing their leases to expire gradually. What's more, residential tenants in SF—even those committed to remote work—may be hesitant to immediately uproot their lives amid such macro uncertainty.

Long-Term Outlook on SF Real Estate

It's clear that the future of SF's real estate landscape is incumbent on the staying power of remote work trends, and as of now, it seems that work from home is here to stay. Both employers and employees see potential benefits from decreased time in the office: employees prefer the flexibility of working from the comfort of their homes, while some employers perceive remote work as a useful way to retain employees and trim labour costs in the face of recession. From 2019 to 2020, the percentage of full-time work that was done remotely ballooned from only about 5% to more than 60%. According to Stanford economist Nicholas Bloom, that share has declined to about 27% and is likely to stabilize around 25%—representing a 500% increase from pre-pandemic levels. The reluctance of tech workers to return to in-office work will mean many parts of San Francisco continue to struggle retaining commercial tenants. JLL, the leading commercial real estate services firm, has reported that even under their best-case scenario, one in five SF offices will remain vacant in 2026.

At the World Economic Forum earlier this year, real estate executives including the CEOs of JLL, and Cantor Fitzgerald warned that the financial burden of prolonged vacancies would force unused office buildings to be converted into residential properties or demolished. Indeed, this prediction may come to fruition in San Francisco's long term. San Francisco's Mayor London Breed recently introduced a new legislative effort to convert downtown San Francisco office buildings to housing, and the Board of Supervisors has moved this measure ahead with new considerations that seek to lessen costs and streamline the process. In particular, the policy aims at San Francisco's older and less desirable office buildings and retail spaces in the city's Union Square and would represent a much-needed step in rectifying the city's housing shortage.

While the legislation is still pending and is sure to be associated with exorbitant financing costs and years of red tape to untangle, these recent developments may signal the city's gradual movement towards solving both its real estate and civic problems. The crisis of the tech sector could wean San Francisco from dependence on tech, ushering in an era of a more balanced real estate market and more diversified economy at large.

European Angle

With year-over-year transaction value decreasing by nearly half by a widening bid-ask spread caused by declining CRE values in tandem with soaring interest rates, European commercial real estate investment fell to its lowest in 11 years during Q1 2023.

In terms of individual sectors, the projected fastest recoveree is also the most depressed in the previous year, industrials. Following rate hikes, major players such as Amazon pulling out of major warehouse projects, and, of course, Liz Truss' mini-budget, by EOY 2023, a Y-O-Y decrease of over 20% was recorded. However, this has been underscored by lenders not being afraid of the sector and believing that there are still easily sufficient tailwinds to allow for growth going forward, even despite last year's vacancies. In addition, due to inflation across Europe, there has been a nearly 25% increase in replacement cost, causing a sharp rent stagger. In terms of the heaviest hit sectors, the number of offices sold - Europe's largest real estate sector - fell to its lowest on record, while the volume of transactions slumped to a 13-year low of €10.8bn.

Overall, the denominator effect may be linked to a large portion of the sector's investment movement. Because the values of an investor's stocks and bonds portfolio have fallen rapidly in the last year (while real estate has been slow to revalue), allocations to the sector as a proportion of an investor's portfolio have risen, bumping up against the upper limits allowed by investment committees and frequently forcing withdrawals and sales. Some of the largest banks in the United States have identified commercial real estate as a source of worry, as evidenced by the recent banking contagion that has raised concerns about lease renewals. While European banks have less direct exposure to the sector according to International Monetary Fund estimates, in the UK especially there has been a flight to quality (in this case, meaning assets with strong ESG credentials and sufficient energy performance ratings). Lessees want updated buildings, not new buildings, and this concept becomes even more important when considering that 50% of all London offices will fall into non-compliance (i.e. lack proper ESG credentials) by 2027, making the modernization of old buildings paramount.

The ECB's banking supervisor last year found deficiencies at most banks in how they assess prospective borrowers' ability to repay. CRE accounts for as much as 30% of non-performing loans across European banks, and tighter bank financing conditions reinforce the effects of higher interest rates, making refinancing tougher over the coming years. Refinancing timelines have been moved forward in droves with parties looking to wait until 2023 or 2024 deciding that a Q4 2022 refinancing was necessary due to Liz Truss' mini-budget. In addition, forced liquidation of real estate assets to meet investor redemptions has led and may continue to lead to downward pressure on CRE prices across the board.

Despite financial market turmoil, around £50bn in real estate debt was issued in 2022 in the UK alone, representing a 2% year-on-year decrease. Alternative lenders have been particularly affected, with over £35bn in debt and more than 12% of all loans in default or breach of covenants. In comparison, the current market average is around 3.5%. The most common hit asset class, as seen by all indicators, is office. Loan-to-value ratios have been skyrocketing, approaching unsustainable levels for certain investors, and creating a self-enforcing loop forcing investors into alternative CRE with stringer tailwinds, and less headwinds.

Overall, March appeared to be the beginning of a broad-scale recovery in commercial real estate across all classes. We continue to see office as the loss leader, despite robust growth in residential, industrials, and retail, with pressure from hybrid working posing a risk of obsolescence, especially for anything missing the requisite ESG credentials considering typical Super Core+ tenants (e.g. tech firms) wouldn't touch anything else. Given the massive refinancing scheduled for 2025, and the fact that the effects of equity markets (and other markets) downturns can often take up to a half-decade to be reflected in the real estate market, it remains to be seen whether the incremental gains we have achieved will continue to grow month after month.

Outlook on Commercial Real Estate

Despite all the challenges that the CRE market is currently facing, they are unlikely to pile up. Commercial real estate is a slow-moving market by nature, due to the intricacies of mortgage refinancing, defaults, and workouts. This characteristic is best explained through a typical situation faced in Real Estate: workouts. These usually take over a year, as first, after the borrower walks away, a special servicer appointed by bondholders takes over to officially foreclose the property. Then it goes into liquidation, which is a long, intricate process that is usually pursued in courts. The more parties involved in the workout, the longer it takes, making the rise in defaults on banks' balance sheets a slow bleed. Furthermore, subcategories of CRE such as logistics, hotels, rental housing, and data centres have been performing well lately, according to Blackstone president Jonathan Gray, making up for losses related to office CRE. Loans in the sector are also distributed broadly amongst big and small banks, insurance companies, government agencies and other agencies, making the rise in defaults unlikely to cause a systemic issue.

Now, the issue at hand is still a point of concern, as almost 50% of investors recently polled by Bank of America have identified CRE as the sector that is most likely to cause a systemic credit event. A combination of falling property values, tighter financial conditions and illiquid markets could result in a struggle to refinance a large stockpile of soon-to-be maturing loans. This depends on a series of factors, such as the extent of each bank's exposure, their ability to cope with losses from non-performing loans, but also the borrowers' willingness and ability to refinance or restructure loans. For now, it seems banks are bracing for larger losses, with Wells Fargo recently reporting a $643m increase in allowance for credit losses, mostly related to CRE loans, car loans and credit cards. This happened after Brookfield defaulted on $783m worth of loans linked to two Los Angeles buildings in February, with Wells Fargo and Citigroup being the initial lenders. Arkansas-based OZK, a regional bank with heavy exposure to office CRE has also increased its loan provision by 10% from last quarter. Smaller lenders are perhaps the bigger concern, as CRE loans account for 40% of smaller banks' total lending and only 13% for bigger banks.

All things considered; the most probable outcome seems to be a tightening of credit availability for the foreseeable future. A larger, systemic credit issue is less likely due to the broad distribution of loans related to CRE and the slow pace of the overall market. Nevertheless, a close eye should be kept on small lenders with high CRE exposure and default rates, especially in Class B and C office real estate, which have been far worse performers than Class A real estate this year.

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