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SFA Research Corner

To Extinguish Post-Pandemic Fires We Needed Water, We Got Gasoline – A Look at CRE, CMBS, and Banking Turmoil

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To Extinguish Post-Pandemic Fires We Needed Water, We Got Gasoline – A Look at CRE, CMBS, and Banking Turmoil

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Banking turbulence is expected to worsen lending conditions for the embattled $5.6 trillion commercial real estate (CRE) market. Already wrestling with declining values and decreasing demand for retail and office properties, brought on by dramatic shifts in consumer behavior, the sector now faces refinancing challenges as maturities loom and lenders pull back. Sources of funding, including banks (the largest lender by far), the securitization market, and now insurance companies—which altogether are responsible for over 75% of all CRE lending—have retreated to varying degrees. At the root of the problem is the unfavorable financing conditions brought on by higher interest rates and wider spreads. Commercial mortgage rates have moved from about 4% to over 6% in the past year, casting a universal pall across all property types, according to Deutsche Bank Research. Below we focus on credit trends in office, retail, multifamily, and hotel properties. Using the data compiled by the bank's securitization research group, we also look at the impact these trends have had on private label commercial mortgage-backed securities (CMBS) and CRE CLOs, which hold many of these loans.

Office: The success of pandemic-related work-from-home policies and a shift to hybrid work continues to pressure demand for office space. According to the National Association of Realtors the office vacancy rate at the end of 2022 was 12.5% with Washington DC, San Francisco, Dallas-Fort Worth and Houston experiencing rates above 15%. This is well above the 9.54% average between 2018 and 2019. Office sales reached $84 billion in 2022, 28% below the 2021 level of $116 billion but 50% above the 2020 low of $56 billion. The 60+ delinquency rate for office properties in non-agency CMBS currently stands at 2%, an increase above the 2020 level of 1%.

Retail: A shifting preference for online shopping resulted in lower demand for retail properties even prior to 2020. The pandemic hastened this slide. Thirty retailers, including J.C. Penney, Neiman Marcus, J.Crew and Brooks Brothers, filed for bankruptcy, closing more than 9,500 brick and mortar stores. In 2020, the 60+ delinquency rate for retail loans in CMBS portfolios spiked to 10%. Today, 60+ delinquency stands at 6%, well above the historical pre-pandemic norm.

Hotel: The hotel industry was one of the hardest hit by the pandemic. The 4-week average occupancy rate dropped to 20% from a historical average of 66% as rooms remained vacant during widespread stay-at-home orders. As travel sanctions were lifted, however, hotel occupancy bounced back almost as quickly as it had fallen, propelling this sector into recovery. By the end of 2021, this metric had returned to its pre-pandemic norm, where it remains today. In 2020, the 60+ delinquency rate for hotel loans in CMBS portfolios spiked to a high of 19%. Today, 60+ delinquency stands at 5%.

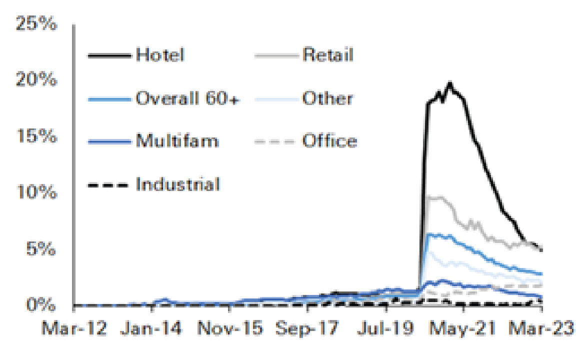
Multifamily: Representing 40% of the CRE loans held across all CMBS products, this property type is by far the largest held in securitizations. In fact, multifamily loans make up over 80% of the collateral held by CRE CLOs.

The multifamily sector is the best performing of the major loan types held by CMBS. Rising rents and a continued housing shortage has pushed the national vacancy rate to 5.8% in 2022, the lowest level in 40 years. Vacancies were higher in the South, at 7.3% and lowest in the Northeast at 3.9%. Tighter lending conditions amongst banks will have little impact on this sector as Fannie and Freddie are the largest lenders with 50% of the market. The 60+ delinquency rate for multifamily loans in private label CMBS portfolios spiked to a high of 3% in 2020. Today, this metric stands at 1%.

As mentioned above, banks are the largest lender in this market, having funded 50% of the $5.6 trillion CRE loans outstanding. In 2022, faced with rising credit risks, banks began tightening lending standards across all CRE loans. Given the local nature of real estate, the CRE market relies heavily on loans from small regional banks. Indeed, small banks originated 2.2 times more CRE loans than large banks, $1.9 trillion versus $845 billion, according to recent Fed data. Some of these banks are now facing liquidity issues as higher-yielding investment products and bank collapses are slowing deposits and further dampening a bank's appetite to make loans.

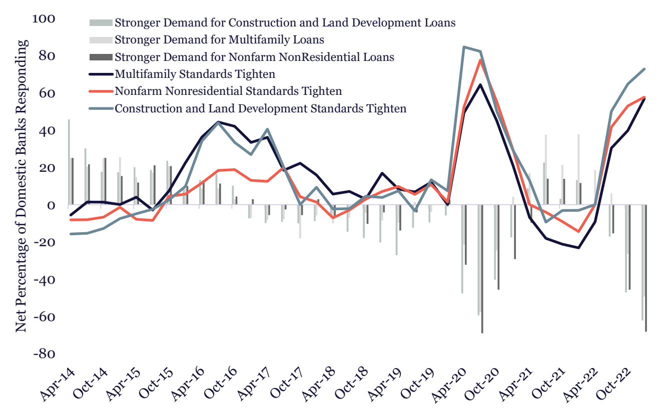
Other lenders have also pulled back. Issuance in the private-label CMBS market, which contributes 14% of CRE funding, has been downright anemic so far in 2023. Just $22 billion of new issue private label and agency CMBS came to market, a 73% drop from Q1 2022. The private-label market saw their "slowest quarter in more than a decade," according to Deutsche Bank Research, with $7 billion in new offerings, reflecting a drop of 83% year-over-year. To put that into perspective, the issuance low during the pandemic was $7.5 billion which, according to the bank, was reached in Q2 2020 when the country was at a standstill due to nationwide lockdowns. Agency issuance added $15.5 billion, 61% below its level one year ago. CRE CLOs saw two deals with a combined total of $900 million during the quarter.

60+ Delinquency Rate for CMBS across Property Types



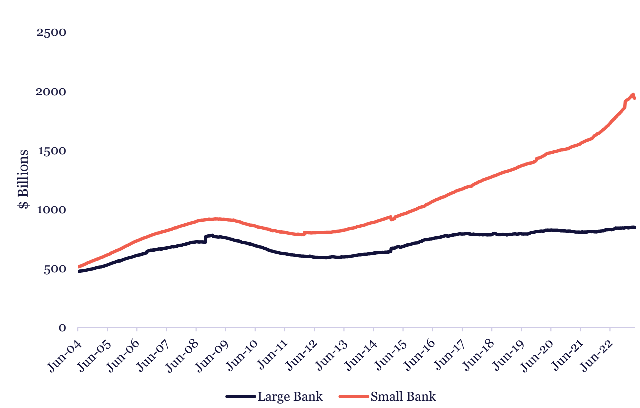
Source: Deutsche Bank Research CMBS Remit Tracker: CMBS 2.0 Monthly snapshot – March 2023

Banks Report Tighter Lending Standards for all types of CRE loans as Drop in Demand Accelerates



Source: [Senior Loan Officer Opinion Survey on Bank Lending Practices]

Small Banks Hold 2.2x More CRE loans than Top 25 Large Banks



Source: Board of Governors of the Federal Reserve System (US) - H.8 April 14 Release

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CMBS issuance has averaged $100 billion a year for the past twenty years, according to KBRA data. Trepp, a data provider for the industry, estimates that private label CMBS alone hold $784 billion total CRE loans. CRE CLOs hold another $85 billion.

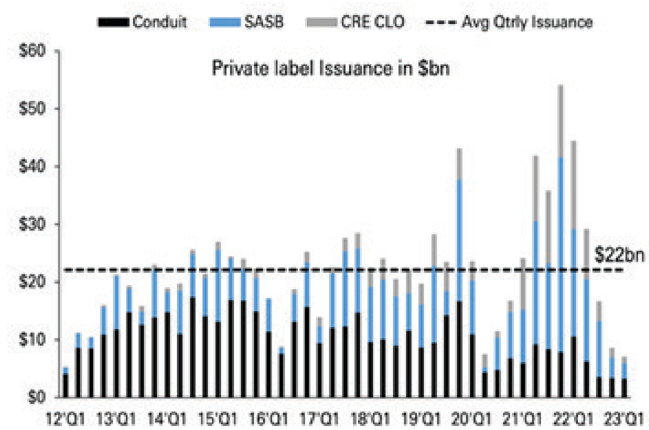
The pullback in credit comes at what could be a 'perfect storm' moment just as a tsunami of loans are scheduled to mature. Overall, an estimated $448 billion of CRE loans will mature in 2023 and an additional $2.1 trillion before 2027. Compare this to the relatively light maturity years of 2022, when $71 billion came due, and 2021, with $59 billion). In CMBS alone, KBRA expects about $50 billion to mature in 2023 and $90 billion in 2024.

What We're Watching

High interest rates, a looming recession, and tighter lending will impact the ability of borrowers to refinance a maturing loan. To track how and when these factors will affect CMBS performance we look at the rate of loans going to special servicing or loan workout, which in some cases is a precursor to default. While the special servicing rate has come down from pandemic-related highs, this metric remains elevated for hotel, retail and office properties. According to KBRA's March 2023 CMBS Loan Performance Trends Report, 53.6% or $328 million of the loans sent to special servicing were at risk for "imminent or actual maturity default." In February 2023 that percentage was 90%. Default is not always the end result of a special serviced loan if extensions or loan modifications are successfully negotiated. For example, in the same report, KBRA noted that delinquency improved for the retail sector as two properties reverted to performing loans after having missed their maturity dates.

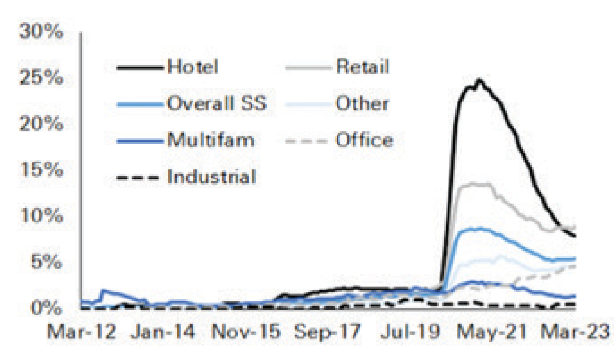
Other metrics to watch include the refi success rate. This metric is currently averaging 75% but with light maturity volumes. Deutsche Bank Research expects this metric to drop as maturities roll in, if too many refinances are chasing too few lenders. Despite the performance of multifamily and the recovery of hotels, and barring an unlikely cultural shift back to offices and retail or the return of historically low rates, the coming waves of refinances in CRE will bring significant changes to the sector.

Private-label CMBS Issuance: "Slowest Quarter in More than a Decade"



Source: Deutsche Bank Research, CMA

Special Servicing Rate Remains Elevated For Hotel, Retail and Office



Source: Deutsche Bank Research CMBS Remit Tracker: CMBS 2.0 Monthly snapshot – March 2023.