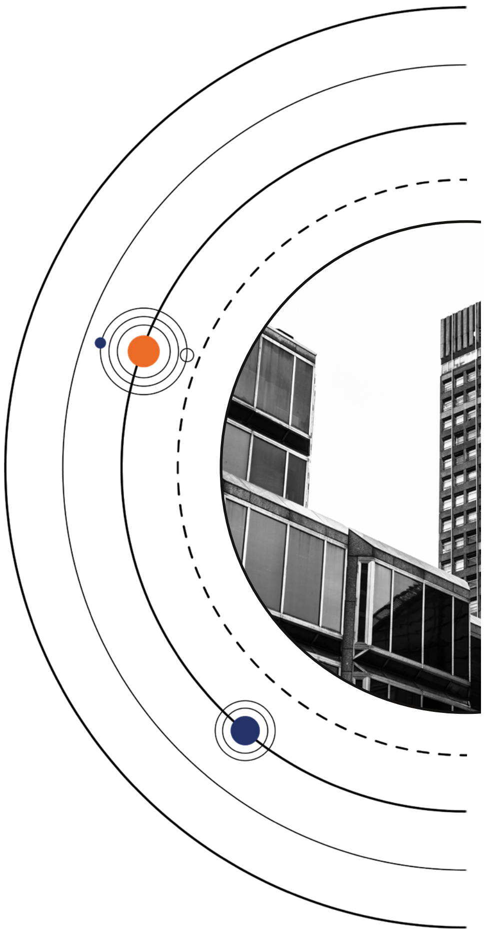
Eyes on the Horizon: Taking Stock of CRE's Short-Term Risks & Long-Term Outlook

SVN® RESEARCH®

EMERGING TREND REPORT | Q2 2023

Introduction



MARKET SIGNALS AND EMERGING RISKS IN COMMERCIAL REAL ESTATE

As borrowing costs rise and the US economic growth becomes less certain by the day, commercial real estate investors and consumers alike are searching for reliable signals of market directionality.

In recent months, banking system turmoil, which saw three mid-sized regional banks fail (including two of the largest failures in US history), became a flashing-red signal for market watchers. In this piece, the SVN Research Team looks at today's most pressing risks to make the case that while CRE may grapple with distress, the brunt of pain will likely be contained to a handful of major markets and shielded by long-term fundamentals.

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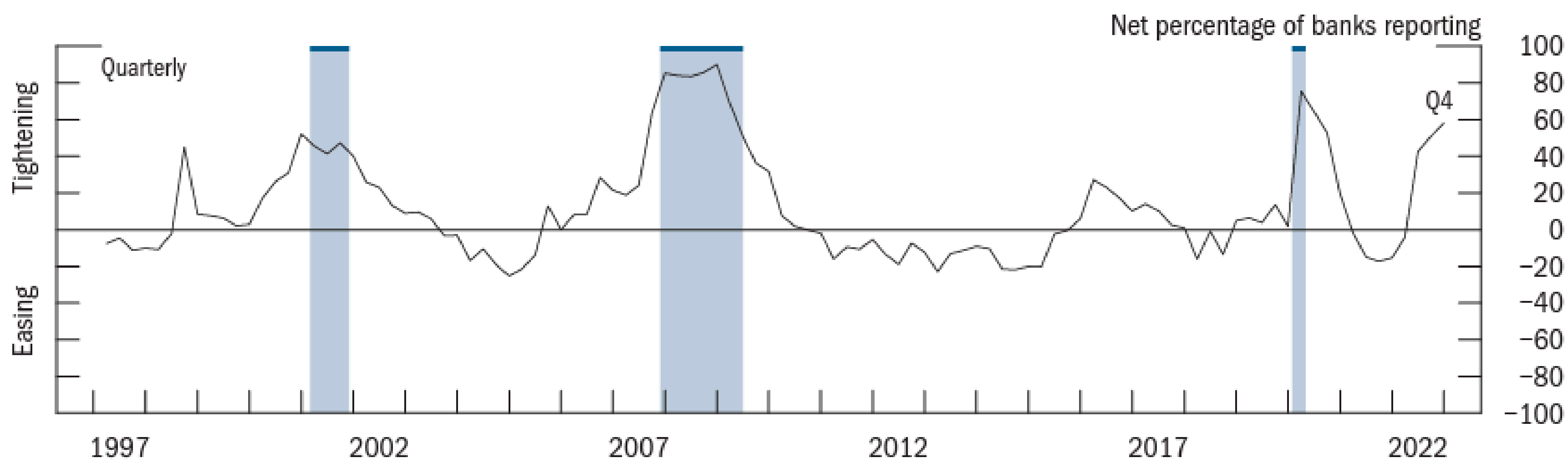
Rising Risks in CRE Lending

For more than a year, the Federal Reserve has employed a tightening interest rate policy aimed at curbing generationally high inflation. One consequence of monetary tightening has been a decline in bond values, causing the overall asset values on banks' balance sheets to decline, resulting in large unrealized losses for several banks in recent months.

In the immediate aftermath of this year's bank failures, financial markets remained liquid, and a potential crisis appeared contained. Still, the ordeal has generated heightened concern about the risk that rising interest rates may inflict on small and mid-sized banks — and whether lending and liquidity sources could dry up as a result.

The Federal Reserve's bi-annual Financial Stability Report, the latest released in March, quantified the commercial real estate market as the fourth-largest financial stability concern behind only rising interest rates, bank collapse risk, and heightened US-China tensions.

Figure 1.16. Banks reported tightening lending standards in commercial real estate loans



Source: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices; Federal Reserve Board staff calculations.

Source: Federal Reserve

According to the survey, the main risk to CRE is two-pronged:

1. Recent interest rate increases raise the cost of refinancing and encourage lenders to tighten credit standards, which risk drying up CRE financing sources.

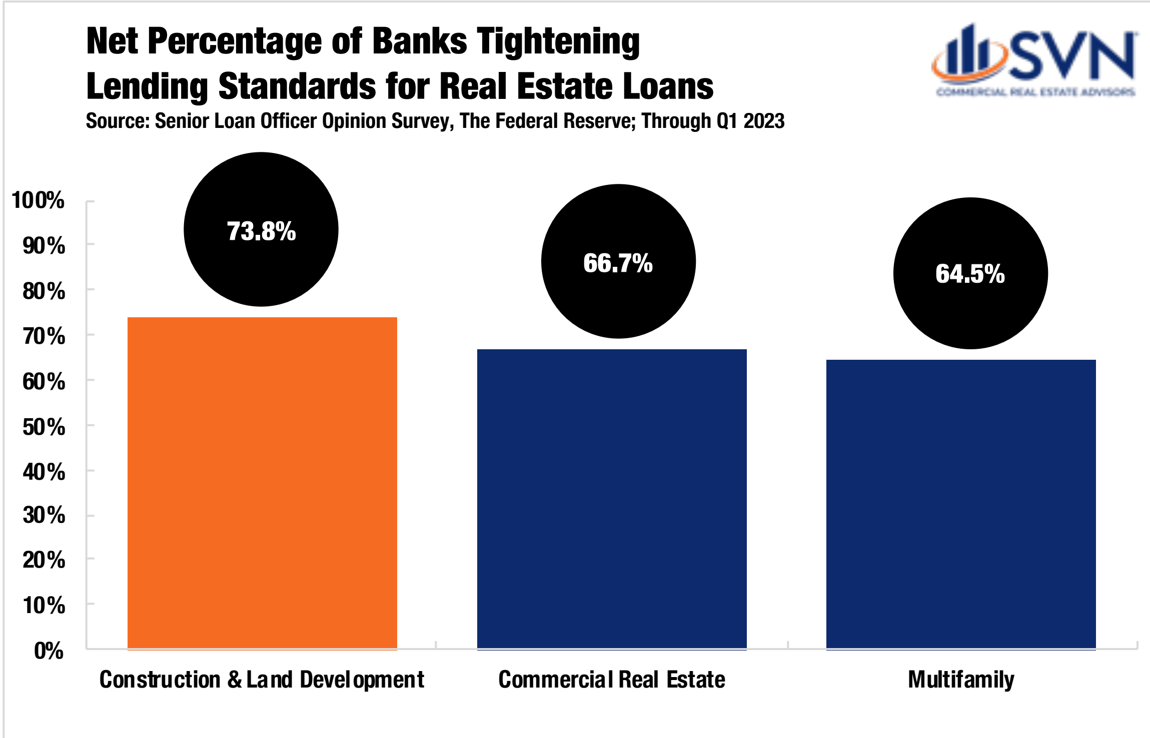
2. The shift to remote work, while more prevalent in some regions and some industries than others, has reduced office space and demand in several markets, which could lead to a correction in office building values and in downtown retail properties.

The Belt Tightens

It will take a few months to fully assess how the recent bank drama impacted lending, but bank lenders have already gradually tightened loan standards over the past year.

According to the latest Senior Loan Officer Opinion Survey by the Federal Reserve, surveyed in April, a net 73.8% of bank lenders indicated that they had tightened credit standards for Construction and Land Development loans in the first quarter of 2023. 66.7% of banks indicated tighter standards for CRE loans, while 64.5% of lenders indicated tighter standards for multifamily loans.

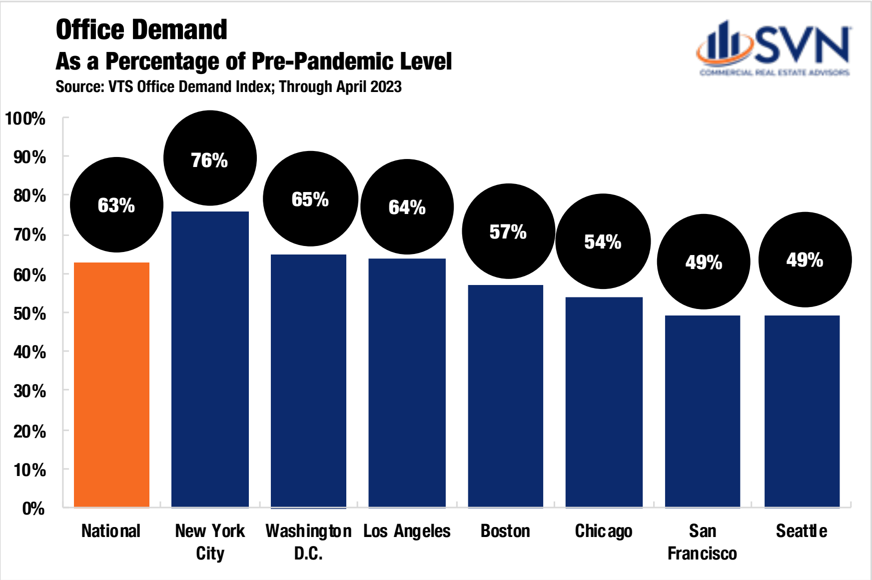
Demand has also fallen for each of the three loan types for three consecutive quarters, with the share of banks reporting falling loan demand increasing in each successive quarter. The slowing activity is showing up in prices.



According to the MSCI Real Capital Analytics Commercial Property Price Index (CPPI), all major property types posted annual declines in April, marking the first time that we've seen an industry-wide price drop since September 2010.

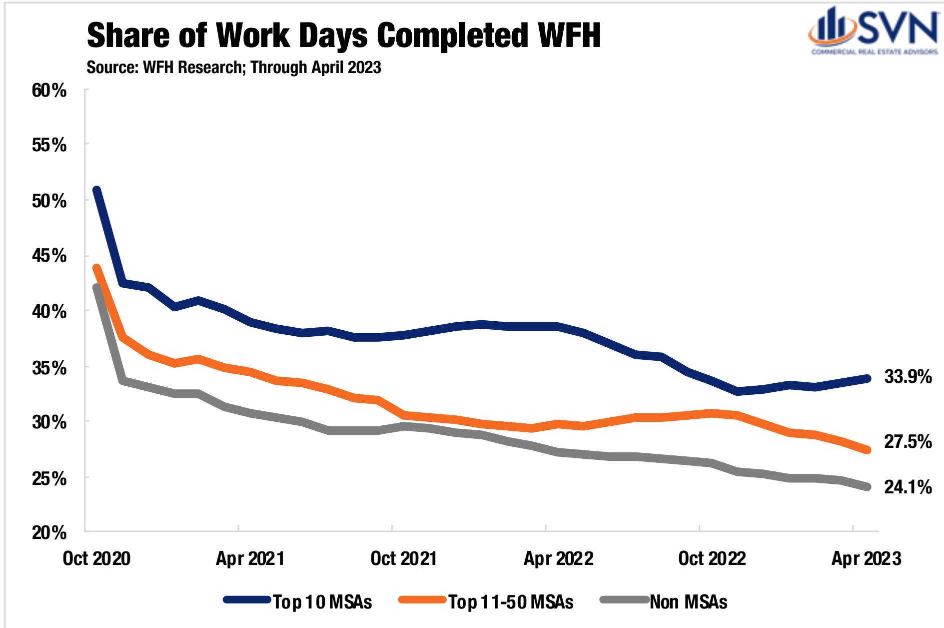
Further, as the Fed has backed off its quantitative easing measures, there has been a decline in demand for CMBS, leading to CRE loans occupying a larger proportion of bank assets. Some banks are preemptively preparing to offload property loans at a discount to limit potential exposure even as most borrowers remain up to date on payments.

Office Losses: Nauseous or Cautious?



The remote work revolution has dented office space demand, devaluing office assets and attracting the lion's share of CRE's over-arching anxieties. According to the VTS Office Demand Index, through April 2023, national space demand is just 63% of pre-pandemic levels. Of the seven major markets the VTS tracks, local performances range anywhere from a high of 76% (New York City) to a low of 49% (San Francisco & Seattle).

While the VTS data proves valuable for tracking some of the nation's most significant markets, it doesn't capture the varying impact that remote work has had on large metros versus smaller metros and non-metro areas. According to WFH Research, the share of workdays completed at home within the top 10 US metros has settled around 33% after falling to a post-COVID low of 32.7% in



November. However, in smaller metros (the top 11-50), the share of WFH days falls to 27.4%. In all other areas outside of the top 50 metros, the share sits even lower at just 24.1%.

The varying degree of remote work concentration explains why demand in smaller, tertiary office markets appears to be holding up better than in larger ones. In large metro areas, which see higher remote work adoption, office space demand continues to show nuanced patterns that reflect the diverse labor market compositions across cities. Metros like Seattle and San Francisco are experiencing a higher concentration of tech and IT sector layoffs compared to less exposed big cities, exacerbating the fall in office demand relative to available space.

Meanwhile, metros like Washington DC, New York, and Los Angeles, all of which have relatively high shares of remote work employees, maintain comparatively robust local labor markets, contributing to higher demand relative to other large metros.

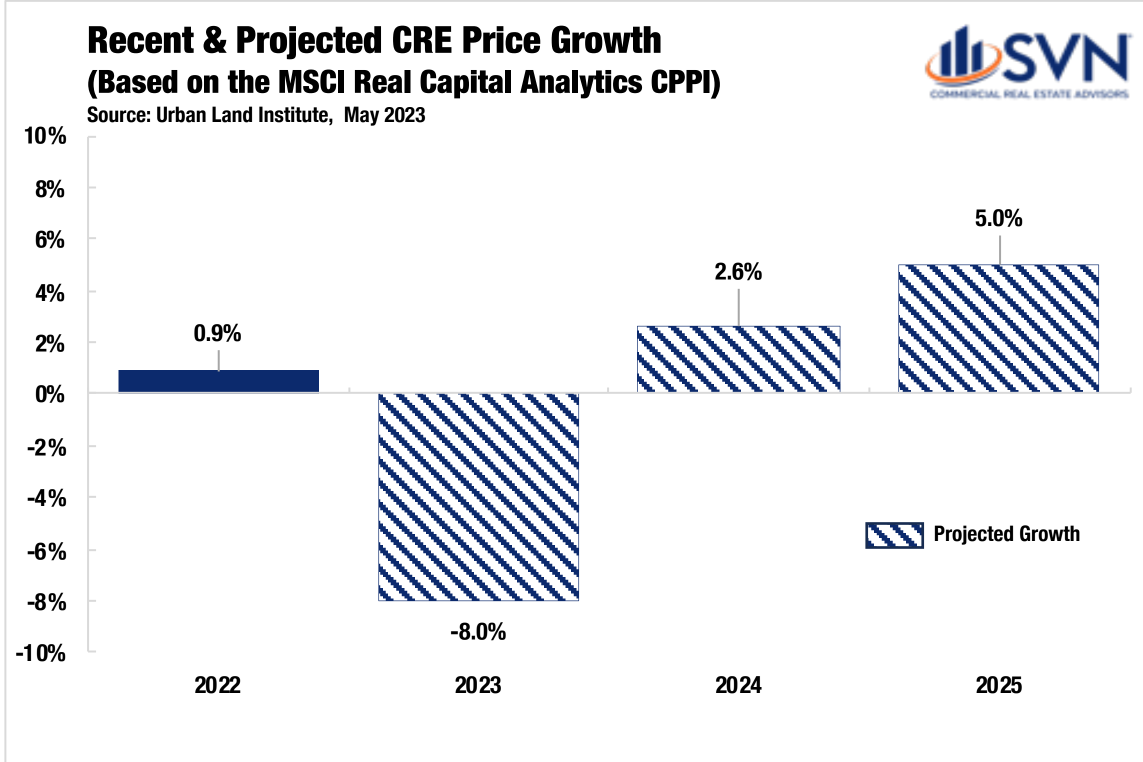
Near-Term Risks Meet Investment Resilience

Despite the widespread price declines seen in 2023, valuations still hover close to all-time highs. A combination of limited trades preventing new price discovery, a strong labor market, and limited investment alternatives, are all anchoring valuation in place and keeping investors looking toward the long-term.

According to the May release of the Urban Land Institute's (ULI) Real Estate Economic Forecasts, while a slowdown in CRE is likely in the short term, market forecasters expect a full recovery by 2025. Survey respondents expect national transaction activity to total $425 billion in 2023, its lowest level since 2013. However, in 2024 volume is expected to boomerang back to $525 billion and reach $695 billion in 2025. The expected recovery would well exceed the domestic long-term average volume of $445 billion annually.

As for prices, ULI projects that property values, as measured by the MSCI Real Capital Analytics CPPI, will fall by 8.0% in 2023, which would be the index's first annual decline since 2010. The index is projected to return to growth in 2024, reaching 2.6% before climbing to 5.0% in 2025.

As a consequence of negative short-term pricing pressures — alongside the expectation that rent incomes will remain fairly stable — cap rates have started to (and are expected to continue) edge higher. According to ULI, cap rates, as measured by NCREIF's Property Index (NPI), which is a weighted measure of industry-wide values and operating incomes, reached a low of 4.0% in 2022. However, predicted rent growth over the coming quarters is expected to push cap rates up to 4.8% by 2025.



Despite the increasing concerns surrounding the state of the commercial real estate sector in 2023, most analysts maintain that we are not entering a 2008-like scenario. By proactively looking to mitigate risks, banks and regulators have likely safeguarded financial markets from the worst adverse effects. Moreover, if widespread price declines continue, it will begin materializing within US inflation data, inching policymakers closer to a monetary pivot.

Investors will need to remain vigilant in the near term but should keep sight of the Fed's preferred endgame: lowering inflation and anchoring forward-looking inflation expectations. Should a correction in the commercial real estate (CRE) market occur, it would bring the Federal Reserve closer to achieving its objective and signal an imminent peak in interest rates—a first step in thawing a chilly real estate market.

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SVN International Corp.
185 Devonshire St, M102
Boston, MA 02110
www.svn.com