Finding the Silver Lining in Commercial Real Estate

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Anu Rajakumar: Real estate plays an essential role in the global economy. And while its inflation-hedging properties are attractive in diversifying a balanced portfolio, real estate also faces a number of headwinds. These have been exacerbated by the recent stresses in the banking sector, particularly on important areas such as office and retail. With severe pressure on commercial real estate, investors are wondering where the opportunities lie and how they can take advantage of potential dislocations. My name is Anu Rajakumar, and joining me from the Chicago office is Jose Pluto, portfolio manager for Securitized Strategies, to discuss the challenges facing one part of the current real estate market, commercial mortgage-backed securities or CMBS, and the outlook going forward. Jose, thank you for joining me today.

Jose Pluto: It's a pleasure, Anu. Thanks for having me.

Anu: So to dive right in, Jose, let's start with just a broad definition of CMBS, followed by some quick thoughts on the overall commercial real estate market at the moment.

Jose: Sure. So CMBS are securitized products that are secured by portfolios or individual commercial real estate loans. There are two main areas of the CMBS market that we focus on. One is what we call the conduit CMBS market, which are security secured by a broadly diversified pool of commercial mortgage loans that are diversified by property type and geography. And the second are single-asset/single-borrower, or SASB CMBS, which represent property-specific exposure to individual properties or portfolios of properties secured by one loan.

Anu: Perfect. And just to give our listeners a sense, what's the size of those two areas, the conduit CMBS versus SASB CMBS? Are they kind of relatively similar size markets?

Jose: Yeah. So the total CMBS market—private label CMBS market—has about 700 billion outstanding today. Approximately half or just slightly more than half, around 350 billion give or take, is in conduit CMBS. SASB CMBS is the next largest sector with about 250 billion outstanding. And then the third in the remaining roughly 100 billion outstanding is predominantly commercial real estate CLOs representing about 85 billion out of that 100.

Anu: So how does the CMBS market look right now, and what are some of the key challenges that you think you're facing at the moment?

Jose: So today there's been some really well-advertised challenges, as you alluded to, around the performance of commercial real estate. These have been mainly driven by tighter financing conditions and concerns about the fundamental outlook; namely, things like work from home and the impact it could have on the future of office properties. The new interest rate environment that we've entered and some of these concerns about an outlook for, slowing macroeconomic conditions have resulted in declining commercial property valuations. We're seeing tighter financing conditions by virtue of higher interest rates. That said, many of these concerns are now being, what we think are indiscriminately priced into CMBS markets through much higher expected default rates and potential for loan extension risk, that have manifested themselves in the post banking crisis period. While we think those challenges are quite evident, when looking past some of those broad challenges, there are some interesting opportunities being created. And it really ultimately depends on property-specific and story-specific considerations, for what we think the ultimate outcomes will be.

Anu: Thank you very much for that, Jose. You know, you mentioned a couple of times tighter financial conditions due to the interest rate environment. Obviously, the banking crisis has also exacerbated that problem. Could you just describe the impact of the recent regional bank crisis on the CMBS market?

Jose: Yeah. So the regional bank crisis really created a disruption to CMBS markets due to concerns about credit availability to commercial real estate broadly. The commercial mortgage-backed securities markets are now trading at levels that have really seldom been seen outside of crisis-type periods, either the aftermath of the GFC or March and April of 2020. Why has this manifested itself? Well, a couple different things to note, in particular around banks. Banks are a notable source of commercial real estate funding. According to the Mortgage Bankers Association, they are the single largest source of commercial real estate finance to income-producing commercial real estate.

In addition, when looking at data that we've seen from Morgan Stanley, data suggests that regional banks represent about a quarter of the funding market for office. So, again, a meaningful contributor to overall lending for that specific sector. When you combine that with expectations for a slow economic environment and potential recession, that's really translated into fear that commercial real estate credit performance will deteriorate going forward.

Anu: Perfect. So lots of hurdles facing the space, but let's take a moment to touch on some of the more intriguing parts of the CMBS market. Jose, where are you seeing potential opportunities right now?

Jose: Yes. As I mentioned earlier, we believe that the underlying risks to the commercial real estate outlook are being uniformly priced in somewhat indiscriminately across CMBS markets. That said, there is significant dispersion in underlying collateral quality that we believe affords some attractive security selection opportunities.

There are two main areas that we've focused on. The first are investment grade mezzanine, conduit CMBS that we think at current spread levels, remain very elevated given uncertainties around the transition to that slower macroeconomic environment. And some of these future use case concerns that we discussed earlier that we believe are being, again, universally or indiscriminately priced into markets that when accounting for those risks, still offer attractive, risk-adjusted returns.

The second place we focus has been in single-asset/single-borrower CMBS, where there are opportunities available across a broad variety of different property types with strong value retention characteristics, be they traditional sectors such as multi-family, retail, industrial, lodging, or office, as well as emergent sectors that have strong underlying trends. Things like data centers or life sciences and biotech research facilities. In all cases, there's opportunities here to take exposure to some of these stories at levels that we believe are quite attractive, and again, seldom seen outside of periods of extreme market stress.

A couple of other things to note about our underlying views on the CMBS markets and where these opportunities are manifesting themselves: CMBS collateral quality and deal structure today is significantly stronger than prior periods in the past, the things like during the GFC era. There's much lower leverage on properties and lower leverage on the underlying loans, as well as significantly more structural protection than existed previously.

We've seen a pretty significant drop off in the amount of CMBS issuance year to date that we think could start to create some amount of scarcity. Issuance volumes are down about 85% year over year and are running at the slowest pace we've seen since 2012. And it really largely reflects the drop in commercial real estate transaction volumes that has been seen more broadly with estimates as high as 75% year over year through the first quarter.

Final thing to note is that, when thinking about commercial real estate in a CMBS context, it's worth noting that office represents only about 30% of the overall loan exposure. In that other 70% are non-office property types. Things, like I mentioned before, such as multi-family, retail, industrial and lodging, all of which are more tied closely to things like consumer spending trends and a shift toward onshoring and last-mile distribution that are less sensitive to or relatively isolated from the work from home challenges faced by office.

Things to note on retail, which has in the recent past been a hot-button area for concern, we believe that due to the impacts of COVID accelerating the stress on tenants in that space, that you're left with a much healthier retail outlook going forward. Much of the retail landscape, involves things like grocery-anchored strip centers where there is a future use case for the underlying tenants that is, again, isolated from some of these dynamics like e-commerce and online shopping.

Anu: I was going to say, I've seen these cases where old shopping malls have been turned into apartment complexes. I don't know if you've seen this, but like very traditional, American shopping malls being innovated for where the need is in basically, like, multi-family apartment complex. Have you seen that? Or is that a trend that you'd think will continue to sort of be innovative in this space?

Jose: Yes, absolutely. We see evidence of that here locally. A number of-of older shopping malls, mid-tier quality ones in good locations have been redeveloped with that in mind, that mixed-use experience of having a combination of multi-family retail and entertainment. It's worth noting too that many of these mall properties are actually situated in areas that are quite attractive from both an accessibility standpoint as well as, underlying local demographic and socioeconomic income trends that can support a different use case for the type of property. And so we have seen that type of dynamic playing out. I think that's likely to continue going forward. You can't underestimate the creativity of property owners to extract and maximize the value of their holdings.

Anu: Absolutely. I totally agree. Um, now let's go back to office for just a moment because, you know, it feels like offices has become the ugly stepsister in the real estate conversations of the last, few years. And from my experience journey, it's partly because folks have such passionate feelings about being in an office: whether that's a five days a week situation—some people love it, some people hate it—whether it's hybrid…I was in a client's office last week, and he had very strong feelings about the introduction of hoteling at his company, which is, the elimination of assigned seating. All to say that the continuing popularity and the flexibility of work from home combined with the elevated vacancy rates, many are concerned about increased default risk in the office sector. Jose, how would you address that concern?

Jose: Yeah. I think it's very much a valid concern. The office sector continues to face challenges, as you mentioned, with high and rising availability rates. So not just vacant space, but also space being made available for sublet or for future release due to a tenant potentially exiting. That said, I think the sector-specific challenges are pretty well advertised and quite visible, as you highlighted. And there are many specific nuances around property use case, individual demand drivers, and then overall leverage from the amount of debt that the borrower has incurred on the property that we believe will be the determining factors for specific loan-level outcomes. So, you know, while those secular challenges are pretty well advertised, I think it's also worth noting that office today, in a CMBS context, is starting from a relatively stronger starting point than many of these headlines would suggest.

For starters, office has a much more diversified tenant base than other sectors like retail and the malls that we spoke about earlier. The top five tenants in office CMBS represent about 3% of the total exposure. Loans have a relatively healthy reported occupancy in aggregate. So about 88% of the loans in CMBS have reported as of the end of the year, or the most recent quarter, at least 85% occupancy.

And finally, leverage on properties is relatively modest; 86% of them have less than a 70% loan-to-value ratio, and about two-thirds have less than 65%. And so, they should have both modest leverage and adequate cash flow to manage the elevated interest rate environment that we find today.

Anu: Okay. Well, those are some very important points to take note of because, again, office really does get beaten up so much. So thank you for sharing that. Maybe just looking more broadly at the CMBS market, what is the default outlook looking like for the sector?

Jose: Yeah. So we expect current delinquency and special servicing rates—special servicing being loans that are in some stage of negotiation or potential workout—to increase over the next 12 months, due primarily to the impact of higher interest rates and lower property valuations. Those delinquency and special servicing rates stand at about 3% and 5% respectively today. It is worth noting that the bulk of delinquent and specially-serviced assets continues to remain to be retail and lodging properties that experienced stress during COVID and have not recovered post COVID. One of our sort of bigger concerns, or potential concerns, near term from a default and delinquency perspective, are floating rate single-asset/single-borrower, and CRE CLO deals, where interest costs today has risen dramatically and may actually exceed the properties underlying that operating income. There is approximately 200 billion of floating rate CMBS outstanding today. We think about a third of that is potentially negatively net cash flowing, so interest cost exceeding net operating income and has a maturity in the next, you know, call it 18 months, so between now and the end of 2024.

Traditionally, in those deals, borrowers are required to have interest rate hedges, but those interest rate hedges only cover the period of the initial maturity. And so these borrowers, when they reach that initial maturity period will face either a refinancing challenge or a debt service challenge at current interest rate levels, that could result in borrowers needing modification to their loans, or in some cases, borrowers exercising contractual extension options, which will allow them to delay refinancing, for another, call it two to three years.

Anu: Sure. And you know, Jose, just wondering if you could provide a few examples of some CMBS defaults that you've seen recently?

Jose: Yeah. So there have been a handful of notable CMBS, SASB CMBS-related defaults of floating rate loans, predominantly in the office sector, during the first five months of the year. In all cases, we believe the properties faced a combination of high-interest rates and current borrowing costs, due to the rise in the Fed funds rate and in SOFR, as well as a performance challenge on the underlying properties that resulted in negative net cash flow that the properties' owner was unwilling to support going forward. In nearly all of these cases, when evaluating the performance of the properties and looking at their historical operating performance, that these were generally properties that were performing what I would call below average even pre-pandemic, so prior to the challenges from work from home, and have really seen their fortunes wane through a combination of work from home dynamics as well as higher interest rates.

Anu: Yep. Understood. Thank you very much. Now, Jose, as we look ahead for the CMBS space, I just want to wrap up this conversation with maybe two or three key takeaways that you think our listeners should really walk away with as it relates to this particular sector.

Jose: Sure. There's really no doubt that there are significant challenges facing the commercial real estate and CMBS markets, and the CMBS markets are pricing in some pretty significant dislocations. That said, it's important to remember that outcomes will be driven by the specifics of the property dynamics, the leverage, and the underlying CMBS structures. And so we think there are really interesting opportunities that are being created by this dislocation.

Anu: Perfect. Thank you very much for that. Those are some great comments. Now, Jose, I cannot let you go without a bonus question. So for today, your last name is Pluto, so I have to ask: what were your thoughts when Pluto got demoted as a planet? I feel like you must have had some strong feelings here.

Jose: Yeah, it's a- it's a great question. So I was somewhat shattered.

Anu: [laughs]

Jose: Um, I'll have you note though that I have a three-year-old daughter who has a very strong interest in astronomy. And so, she finds it to her endless delight that she believes were named after a dwarf planet [laughs]. And so, [laughs] I do think there's a case to be made. I've learned quite a bit about dwarf planets actually over the past few years, and so being part of the largest of a different category, and the first discovered, gives us the opportunity to highlight and shine in our own right. So, I've moved from disappointment to optimism.

Anu: I like that. You know, big fish in a small pond, I think is the right outlook there.

Jose: Yeah [laughs].

Anu: Thank you so much for sharing that, and for just joining me today, Jose. You shared some great insights into the state of the CMBS market. Hopefully I'll summarize some of your key points that, you know, despite fear around some of the areas of commercial real estate, particularly office, and based on broader macroeconomic issues from tighter financial conditions, the resetting property valuations, there are indeed a number of really interesting opportunities out there, particularly in the sectors you had mentioned tighter consumer spending or housing, data centers, warehouses, et cetera. You mentioned investment grade mezzanine conduit CMBS, single-asset/single-borrower CMBS. So there are opportunities out there, and hopefully, our listeners will have appreciated some of your comments. So once again, Jose, thank you very much for joining me.

Jose: It's been fun. Thanks for having me.

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