Principal Asset Management℠

PRINCIPAL REAL ESTATE

How does the U.S. regional bank crisis impact commercial real estate?

Multiple banking failures, including the high-profile collapse of Silicon Valley Bank, have sparked concerns about an impending credit crisis in the U.S., and raised red flags around commercial real estate exposure within the broader financial system.

While the recent failures have justifiably caused concern over the health of the banking sector, as bank runs can happen quickly and spiral out of control, it is far more well-capitalized than it was before the Global Financial Crisis (GFC), thanks to more stringent oversight and capital requirements. Moreover, the Federal Deposit Insurance Corporation (FDIC) and Federal Reserve's (Fed) swift action following the bank failures have prevented a broader credit crunch, which would have had significant and long-term consequences. However, as investors and regulators scrutinize potential sources of concern to the financial system, the questions surrounding commercial real estate are bound to remain elevated.

Authors:

INDRANEEL KARLEKAR, Ph.D.
Senior Managing Director
Global Head of Research &
Portfolio Strategies

ARTHUR JONES
Senior Director
Real Estate Research

With contributions from:

KEITH BOKOTA, CFA
Portfolio Manager, Real Estate Securities

SCOTT CARSON, CFA
Portfolio Manager, CMBS

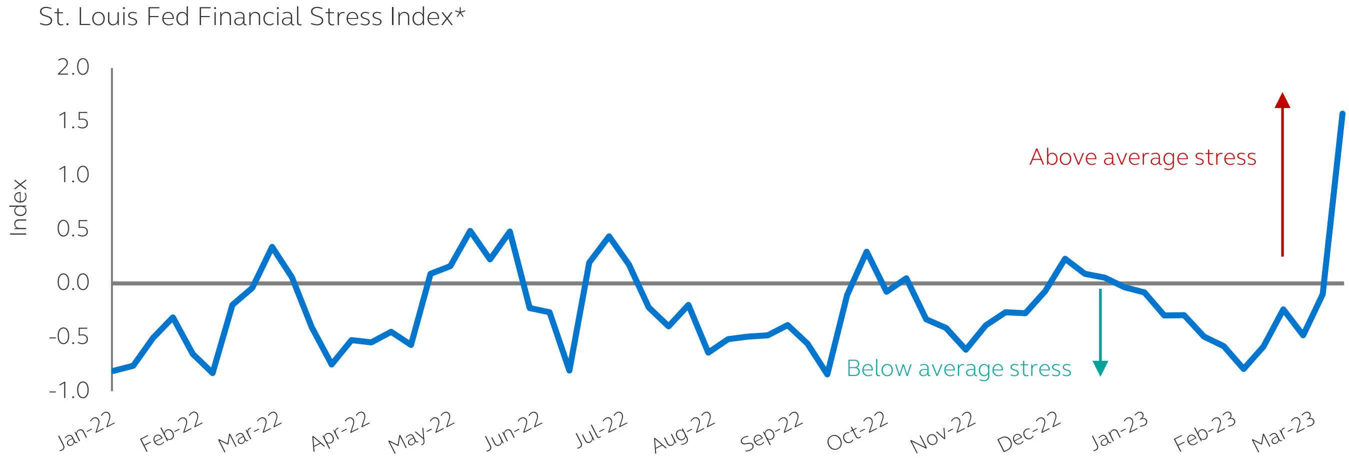
DAN DICKMAN
Portfolio Manager, Private Debt

An immediate and visible impact of the banking issues is a material tightening in financial conditions since early March (see Exhibit 1), exacerbating an already difficult environment for commercial real estate investors.

Capital costs had already increased substantially since the Fed began increasing short-term rates in March of 2022, which has resulted in value declines in both private and public markets. Today, the fear of over-exposure to commercial real estate, particularly the office sector, has effectively placed smaller banks on the sidelines.

Although the market remains well-capitalized and the financial system is fully functioning, bid-ask spreads remain wide as both spreads and rates have increased since the beginning of March.

EXHIBIT 1: Stress in the financial system is elevated and compounding difficulties for commercial real estate investors



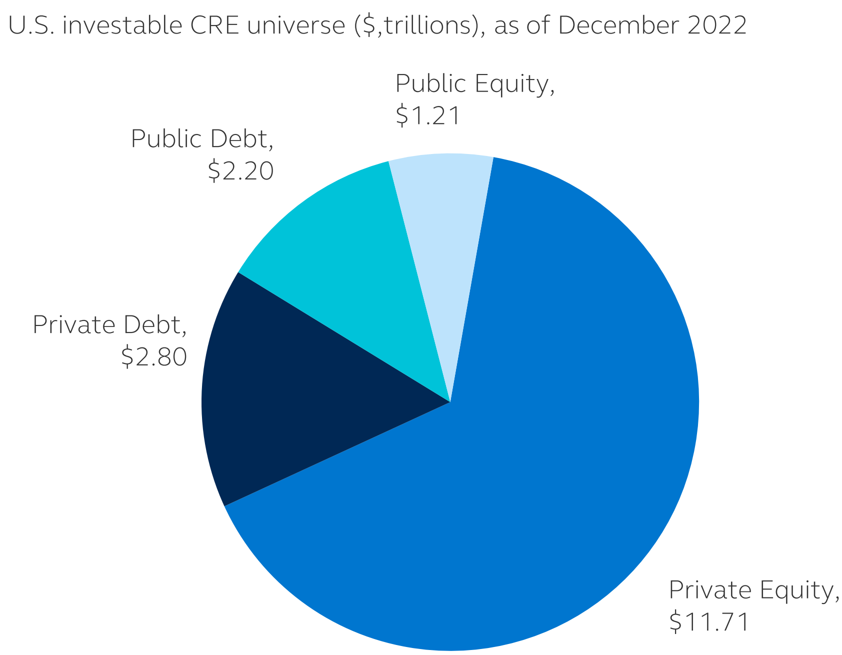
*The average value of the index, which begins in late 1993, is designed to be zero. Thus, zero is viewed as representing normal financial market conditions. Values below zero suggest below-average financial market stress, while values above zero suggest above-average financial market stress.

Source: St. Louis Federal Reserve Bank, March 2023.

Commercial real estate debt market

It is difficult to overstate the importance of a liquid and efficient debt market for commercial real estate as it provides a critical source of liquidity for the development, sales transactions, and capitalization of existing assets. According to data from the Mortgage Bankers Association and Citigroup, the size of the commercial real estate debt universe outstanding was nearly $5 trillion, as of the end of 2022. This represents roughly 28% of the entire investable commercial real estate universe (see Exhibit 2). Of that share, commercial banks and thrifts represent $1.7 trillion or roughly 35% of all commercial real estate debt in the market today—a sizable share of the overall lending universe.

EXHIBIT 2: Debt remains a sizable and important component of commercial real estate investment



Source: NAREIT; Mortgage Bankers Association, Federal Reserve, NCREIF, CoStar, Citigroup, Principal Real Estate, 2022

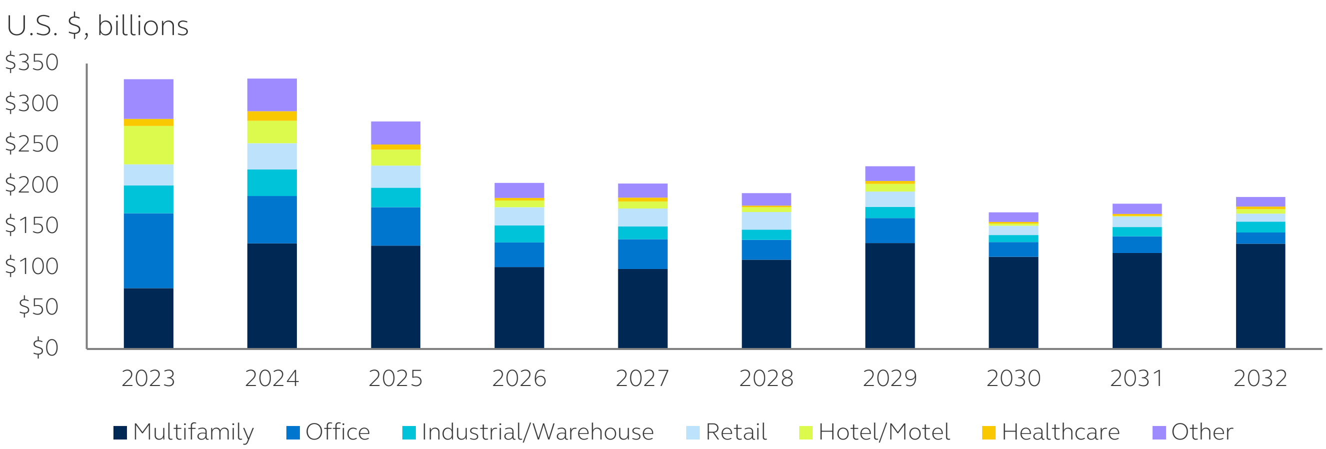
Implications for maturities/exposure over the next 12 months

As mentioned earlier in this note, the commercial real estate market is already facing challenges from a difficult capital market environment. It is estimated that out of the nearly $5 trillion of commercial real estate debt outstanding, that roughly $448 billion is maturing in 2023, with 60% of that total held by banks.[1] Properties that are well-positioned from an occupancy and rent growth perspective should not face cash-flow interruption events and are unlikely to encounter issues in refinancing apart from a cost of capital increase. The key concern is around the office sector, as vacancy rates today in most major markets are at, or near, all-time highs due to low levels of utilization and weak leasing trends following the pandemic. Cash-flow interruptions and refinance stress are more likely in office than in other property types. Bank exposure to office loans is roughly 39% of all real estate (excluding multifamily), which compounds the issue for office owners and bank loan portfolios within the sector. Office lending has been limited over the past six to 12 months due to concerns over exposure and underlying property fundamentals.

Beyond the banking sector, conditions appear to be less challenging. The credit market from Life Companies, CMBS, and agencies remains open, although the cost of capital is elevated in the current environment. This is in stark contrast to 2008-09 during the GFC when credit markets froze. Moreover, loan-to-value ratios within the NPI, the public equity market, and CMBS are markedly lower than they were entering the last financial crisis. While maturities are moderate to elevated in 2023, loans coming due in 2024 and beyond may encounter more sanguine financial conditions, suggesting that the problem is immediate and may not cause long-term reverberations for commercial real estate. Maturities facing non-bank lenders are also evenly distributed across property sectors with an overweight to office in 2023, which presents a more focused area of concern.

One implication is that office owners will face more significant headwinds than those in other sectors as they encounter both capital and cash-flow events. Over the next two years, the high volume of loans that will need to be refinanced will intersect with weak market fundamentals. In our view the office sector will be the most significant pain point in commercial real estate over the intermediate term. And we believe private equity property values in office will experience the most significant declines across all sectors. Although a material increase in office occupancy would improve our outlook, there are many crosscurrents in the data—including slower economic growth and uncertainty surrounding the future of work that make the forecast somewhat opaque.

EXHIBIT 3: Non-bank commercial real estate maturities by sector



Source: Mortgage Bankers Association, Q4 2022

[1] JP Morgan. Commercial Real Estate Overview: Stressing Banks, Insurance and REITs for CRE Weakness, March 2023

Have markets appropriately priced in risk and will this create opportunities?

Recent regional banking failures and increased scrutiny over commercial real estate exposure have the potential to constrain an important source of capital. While this will affect pricing across quadrants and certain sectors, we believe the impact will play out over the near-term, rather than creating longer-term capital issues for real estate assets especially as we head to the end of the interest rate cycle. Of particular interest, however, is the office sector, which faces both cyclical and secular headwinds and, we believe, will be under the most pressure during the next 12 to 18 months.

The matrix below outlines the opportunities and challenges across the four real estate quadrants. We believe yields on debt are currently highly attractive across the credit curve and may remain attractive providing investors with opportunities to deploy capital. We also see buying opportunities within the public and private equity sectors. Cash private equity investors will be well served to look for buying opportunities towards the end of 2023 and in early 2024, as capital value declines may have played out. Inflection points often create stress for investors but also opportunities and 2023-24 could provide some interesting entry points for commercial real estate.

EXHIBIT 4: Near-term dislocations will ultimately give way to opportunities

Key:

- High impact
- Moderate impact
- Low impact

Sector	Regional bank impact	Cash flow risk	Credit risk	Pricing risk	Commentary
Private equity	High impact	Moderate impact	Moderate impact	High impact	Constrained credit environment over next 12 months quickens pace of capital value declines; creates buying opportunity in early 2024 as they have already priced in a decline in values ahead of private markets
Private debt	Low impact	Moderate impact	Low impact	Low impact	Lack of bank lending in near-term increases potential total return; office default risk remains elevated
Public equity	Moderate impact	Moderate impact	Low impact	Low impact	Low debt exposure; attractive relative pricing and sector exposure
Public debt	Low impact	Moderate impact	Moderate impact	Low impact	More exposure to cyclical sectors; but risk priced in; opportunity to fill in liquidity gap

Source: Principal Real Estate, April 2023

Risk Considerations

Investing involves risk, including possible loss of Principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate.

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