From Storyline to Strategy

The Growing Commercial Real Estate Debt Opportunity

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In 2017, seminal research from the University of Vermont confirmed what Kurt Vonnegut proposed in 1995: stories "have beautiful shapes."[1] Using artificial intelligence to parse through an exhaustive set of fiction novels to score their emotional content, the research quantified and methodically charted the narrative arcs within stories. Moreover, it discovered a mere six main narrative arcs exist.[2] Time and again, the stories we know follow well-trodden paths classified as: "rags to riches" (rise); "riches to rags" (fall); "man in a hole" (fall-rise); "Icarus" (rise-fall); "Cinderella" (rise-fall-rise); and, "Oedipus" (fall-rise-fall).[3] In other words, stories are told and retold in content and detail, but not in form.

The details of COVID and its implications on multifamily ("MFAM"; and, commercial real estate, "CRE") are certainly unique, but its unfolding narrative arc is likely to play to a familiar storyline. Valuation, interest rate and financing dynamics are set to intersect over the near-term in dramatic fashion. All of which – *spoiler alert* – suggest an emerging supply-demand mismatch within capital markets is probable, where demand for debt appears likely to outstrip constrained traditional lender capacity and interest, specifically amongst smaller community and regional banks. A dilemma that, in short, suggests an imminent financing void and budding opportunity for new non-traditional lenders to provide debt and capital solutions, chiefly in the vacated smaller-loan space community and regional banks occupy.

At the heart of the matter is a tsunami of looming CRE and MFAM debt maturities. Almost $1.7T of CRE mortgage debt matures between 2024-2026 (37% of all outstanding debt), including $669B of MFAM debt (32%).[4,5] The gravity of which is not just related to its sizeable figure, but the totality and interplay of various COVID-fueled factors that are set to intertwine to create distinct conditions and new financing opportunities ahead.

To best understand the forthcoming chapter though, context into the timeline setting today's dynamics is imperative.

CASCADING EVENTS

In 2021 and 2022, the cascading effects of $4.4T in COVID-era stimulus[6] and a synthetically low interest rate (and cap rate) environment[7] emerged in large part, "super-charging" CRE and MFAM valuations in their wake. MFAM valuations increased by as much as 23% and 29% from pre-COVID and early-COVID lows, respectively,[8] with the aid of 'cheap' and readily available debt as annual transaction volume more than doubled over 2021-2022 ($209B annual average) against its three-year pre-COVID average (2017-2019).[9]

The synthetic dynamics underpinning those valuations (and gains), however, were unsustainable. Persistently high inflation emerged, prompting the Federal Reserve to abandon its accommodative policy and hike its benchmark rate from 0-0.25% by +525bps in aggregate while tapering quantitative easing. Interest rates and financing rates climbed correspondingly with, to date, the UST10y roughly +375-400bps higher than its mid-COVID low of 0.5% and MFAM financing costs more or less doubling (excluding construction financing).[10]

The result: MFAM valuation diminution from "super-charged" highs with prevailing market pricing down roughly 1/3rd in 2Q'24 from its mid-COVID peak.[11] An outcome unrelated to the underlying property-level performance of the sector, which otherwise had "healthy" overall fundamentals with double- and, more recently, single-digit annual rental growth with occupancy in the low-to-mid 90% range despite a historic 585k net units delivered in 2023 nationwide.[12]

DIFFICULT MULTIFAMILY DEBT AND FINANCING DYNAMICS

As a result of retrenched valuations, a fair portion of MFAM investments encumbered by the $386B of debt originated since the onset of COVID with maturities between 2024-2026[13] may have only a portion (or none) of its original equity still intact, assuming 55-65% loan-to-value ("LTV") leverage at acquisition. In fact, it's estimated that $241B of maturing debt during that time period is "Troubled" with senior debt LTV of 80% or greater (with a total of $1.3T "Troubled" CRE debt overall).[14]

Valuations aren't the only issue. Even properties with palatable LTVs and

strong operations face higher interest rates that may require debt paydowns upon debt covenant/extension or refinancing tests to meet debt-service-coverage-ratio ("DSCR") or other lender requirements. As it stands, and using securitized MFAM debt maturing between 2023-2025 as a proxy for wider MFAM conditions given its relative transparency:

- 3/4ths of existing securitized MFAM debt is classified as either 'High Risk' ($58B; 47%) or 'Medium Risk' ($35B; 28%) with DSCRs of less than 1.25x or 2.0x, respectively – proportions also similar to those across CRE overall; and,
- roughly 2/3rds of fixed-rate securitized MFAM loans would become 'High Risk' ($71B) if prevailing financing rates were applied (i.e. immediate refinancing).[15]

Expected interest rate relief in the form of Federal Reserve cuts to its benchmark rate should alleviate interest rate pressures on refinancing, but the degree of relief doesn't appear like it will materially improve financing prospects within the timeline of impending maturities (and in conjunction with constraining LTV considerations). Market-priced expectations (as of this writing) peg an effective federal funds rate of 4.9% at Dec'24 and 4.3% at Jul'25, a decline of approximately 40bps and 100bps, respectively, from its current 5.33%.[16] Further still, any unwinding and "normalization" of today's inverted yield curve would put upward pressure on longer-dated interest and financing rates, offsetting or possibly erasing interest rate relief.

"TIGHTENING" LENDING STANDARDS

To the detriment of MFAM owners, as interest rates rose and valuations declined over the recent period, lenders also increasingly tightened their lending standards. Banks, which have historically comprised 40-45% of all CRE originations[17] – and held $1.8T of CRE debt at 4Q'23, including $1.0T of MFAM[18] – have regularly tightened their standards "somewhat" or "considerably" across CRE and MFAM quarterly for the past 2-years, generating a considerable cumulative quarter-over-quarter impact.

Conservatism amongst smaller 'non-large' banks has become more acute with a cumulative quarterly net tightening of 414% since 1Q'22 against 'large banks' 355% (excluding differentiation for "considerable" tightening versus "somewhat", of which small banks also had more).[19] An outcome likely resulting from smaller community and regional banks' poorer overall and relative health against larger banks.

BANKING INDUSTRY STRESS

Overall, CRE lending conservatism at banks appears to be a product of its own circumstance. Banking industry stress – highlighted by the failures of Silicon Valley Bank, Signature Bank and First Republic Bank in the first half of 2023 – still appears to be a concern with the FDIC warning in its annual '2024 Risk Review' that potential exists for some banks to "continue to experience heightened liquidity pressure"[20] and high exposure to CRE loans remains.

Banks' balance sheet liquidity declined by $873B over the course of 2023 (after falling $1.8T in 2022) to 26% of total assets, below its pre-pandemic average of 28% and its lowest level since at least 2013, as a combination of factors materialized over the year, including (a) declining deposits totaling $401B; (b) a significantly higher cost of funding as a result of higher interest rates (2.13% in 2023 vs. 0.55% in 2022); (c) a reduction of securities holdings, and (d) commitments toward obtaining contingency lines of credit. Community bank liquidity was more profoundly impacted, falling to 17% of total assets in 2023, its lowest year-end level since 2008, as many sold bonds and pledged a significant amount of bonds to secure additional borrowing lines.[21]

Community bank profitability also deteriorated with roughly 1 in 20 becoming unprofitable at year-end 2023 (up from roughly 1 in 33 the year prior) with mortgage-focused community banks the most likely to be unprofitable, reaching almost 1 in 5 banks (up from about 1 in 10 a year prior). Despite representing only 7.1% of all community banks, mortgage lending specialists represented more than 1/4th of all unprofitable community banks.[22]

BANKING EXPOSURE TO CRE; LENDING CONSTRAINTS

Banks, and particularly small regional and community banks, have saturated exposure to CRE and MFAM. At 4Q'23, median CRE loan concentrations at banks increased to 198% of Tier 1 risk-based capital and credit loss reserves, up +600bps year-over-year, toward the 214% historic high reached in 2008. Smaller banks with between $10-100B in total assets had even more exposure with a median ratio near 300%[23] – a level that subjects them to additional regulatory scrutiny.[24] In total, 28% of all banks reported a ratio in excess of 300%, near but below the 35% banks in 2008.[25]

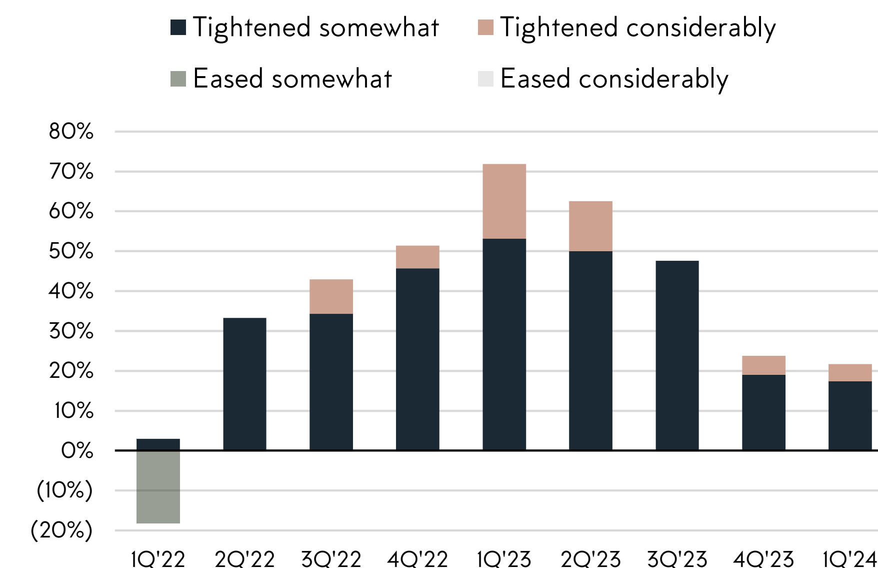
Moreover, banks hold $304B (45%) of the 2024-2026 maturing MFAM debt with an estimated $119B (39%) classified as 'Troubled' (with an LTV of 80% or greater).[26]

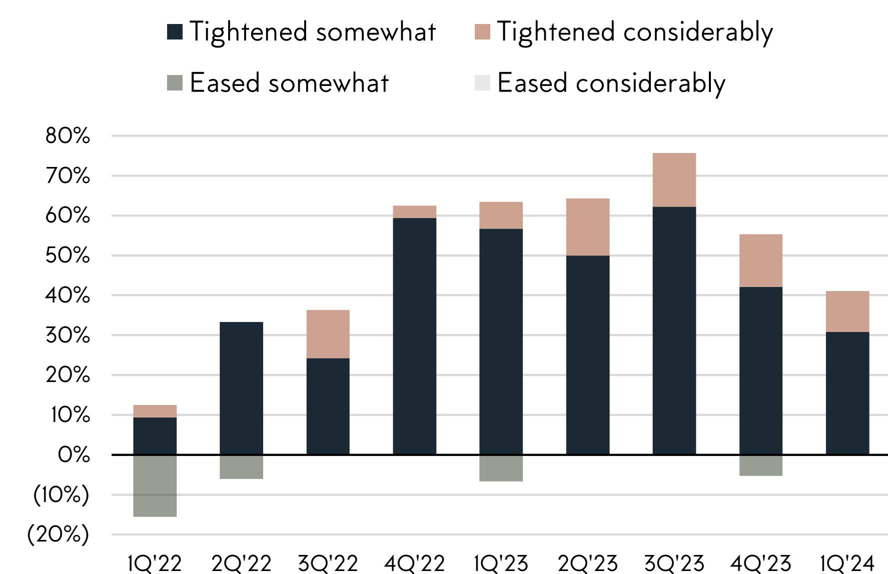
Unsurprisingly, given general banking health, including liquidity and mortgage-lender profitability, and exposure to CRE loans, bank CRE and MFAM lending has been on the decline. CRE and MFAM originations both decreased by almost half in 2023 year-over-year to a level about 60% and 75% of their respective three-year pre-COVID averages (2017-2019) – and, through 1Q'24, are on an annualized pace to decelerate further to about 50% and 60%, respectively.[27]

IMPENDING FINANCING VOID & NEW NON-TRADITIONAL LENDER OPPORTUNITY

Taxed by the MFAM (and CRE) distress aforementioned, the universe of active CRE lenders has declined by about 55% since its mid-COVID peak, or 798 lenders to 361 at 1Q'24 – an industry

TIGHTENING BANK LENDING STANDARDS
Senior Loan Officer Opinion Survey on Bank Lending Practices
Proportion of Respondents' Categorization of Lending Standard Changes over the Prior Quarter*





*Source: Board of Governors of the Federal Reserve System. *Figures reflect perceived lending standard changes over the prior three months, which generally correspond to the given quarter per the Federal Reserve.*

size not seen since 2015.[28] Yet, replacing the $669B of impending MFAM maturities between 2024-2026 (and $1.7T of CRE overall) would require a 2015-sized lending industry to originate 131% of its 2015 MFAM originations volume for three consecutive years. A task made more challenging considering the constrained status of smaller regional and community banks as previously discussed, and the difficulty other traditional lender types – like CMBS, Life Insurers or Agency – may have filling the niche of local banks in terms of flexibility, typically smaller overall dollar-sized loans and/or understanding of micro-climates of local markets.

A RIPENING OPPORTUNITY FOR MULTIFAMILY DEBT AND CAPITAL SOLUTIONS

It is primarily these converging forces - like looming MFAM (and CRE) debt maturities, distressed LTV and DSCR refinancing metrics, and constrained lending capacity, particularly amongst small banks - that are creating the unique circumstances for an emergent MFAM capital markets 'supply-demand' void and developing lending investment opportunity. A situation strengthened because the opportunity is driven by broken underlying capital structures and the current interest rate environment, and not property-level fundamentals, where the MFAM sector is otherwise "healthy" overall despite recent record-levels of new supply that are expected to severely curtail below historic 'norms' after 2024. Moreover, MFAM still benefits from secular supply-demand "tailwinds" generated by a severe US housing shortage, the high cost of home ownership, and favorable demographic trends, including delayed marriage rates and more people living alone, contributing to household growth rates exceeding population growth.[29]

In fact, study of typical existing capital stacks of MFAM investments originated over the COVID-era with 60% LTV acquisition loans reveals a significant delta between existing debt and 'refinanceable' senior loans at 55% LTV (recalibrated from 60-to-55% LTV due to increasing lender conservatism). Or, in aggregate across CRE, a 'debt financing gap' estimated to be $400B[30] – an amount equal to about 9% of all $4.7T outstanding CRE debt.[31]

MFAM owners with smaller sized deals may sit in the most precarious position. Traditional lending sources, like regional and community banks, may have little capacity or interest in refinancing (or originating) a senior loan, and any financing "gap" should require additional equity or "rescue" capital from a third party. Yet, the size of any financing "gap" on a smaller deal is likely to become too small for larger private equity or mezzanine lending platforms at some juncture. One solution may be a 'hybrid' loan structure, where a senior secured 'A' tranche is combined with a 'B' tranche to retire and refinance existing debt while funding any financing "gap", particularly for ease of execution with one lender.

"EXTEND AND PRETEND" ILLUSIONS

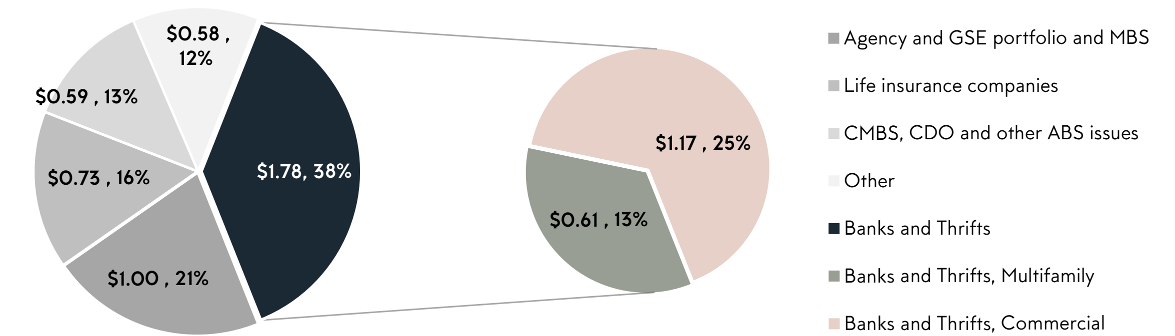
Given the perverse situation summarized herein, some lenders have recently turned toward "Extend and Pretend" practices (i.e. extending maturities and providing more time for refinancing or repayment), where (a) needed as a result of challenged refinancing or repayment dynamics, (b) sensible (on behalf of the lender), and (c) possible when terms are malleable. The extent of the practice is difficult to gauge given the lack of disclosure, but anecdotal evidence is mounting. As a proxy, $82.1B (50%) of the estimated $163B of CMBS maturities in 2023 remain outstanding, primarily via existing extension options.[32]

The "Extend and Pretend" practice has potential to delay large scale demand for financing and capital solutions – and, is one reason why such a scenario hasn't yet materialized – but, any further accumulation would ostensibly also intensify its eventual end (i.e. like a balloon being blown up until it bursts). By most measures, widespread "Extend and Pretend" practices are also an indication of the severity of prevailing dynamics and the scale of change needed to return to lending 'norms'. If or as loans accrue under "Extend and Pretend" scenarios, so does the extent of the fairytale ending lenders (and property owners) would likely try to convince themselves exists.

Yet, just as the grandeur of Cinderella at the royal ball was premised on magic that inevitably unraveled, MFAM (and CRE) should inevitably face a reckoning with the intersection of impending debt maturities, material valuation diminution and challenged refinancing dynamics, "tightened" bank lending requirements, constrained bank lending capabilities and appetite, and a shrunken CRE lending universe.

In other words, while different in content and details than stories before, MFAM is on an unoriginal narrative arc. One in which disorder leads to a budding opportunity with a "glass slipper" likely to emerge for MFAM debt as 'hybrid' loan originations – that is, unless MFAM (and CRE) can 'extend and pretend' its own "golden carriage" borne out of synthetic conditions past the stroke of "midnight".

(2.1) OUTSTANDING COMMERCIAL & MULTIFAMILY MORTGAGE DEBT BY LENDING SECTOR, 4Q'23 ($TRILLIONS)

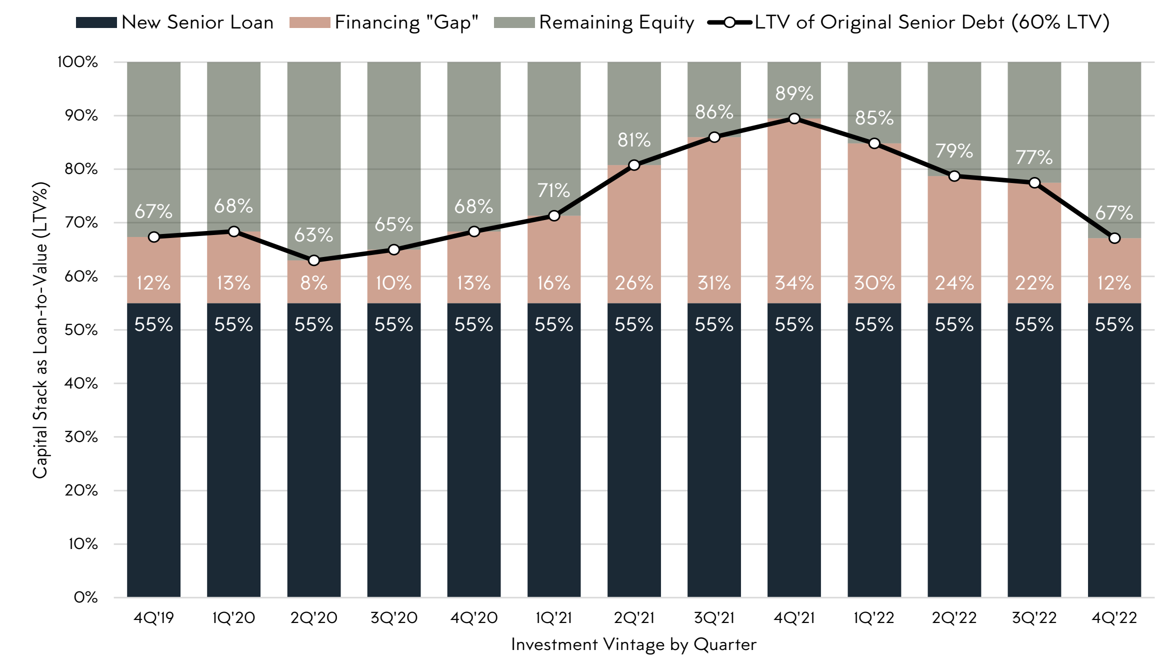


Source: Mortgage Bankers Association, Commercial/Multifamily Quarterly Databook, 4Q'2023.

(3.1) SIZEABLE MFAM REFINANCING "GAP" EXISTS

Hypothetical Capital Stack of COVID-Era Investments at 1Q'24

Valuations according to Green Street MFAM Commercial Property Price Index (CPPI); 60% LTV assumed on original COVID-era investments



Source: Green Cities Research, Green Street Advisors MFAM Commercial Property Price Index (CPPI). Assumes 60% LTV financing at the original COVID-era quarter of investment with hypothetical capital stack calculated at 1Q'24 with all valuation estimates corresponding to Green Street's MFAM CPPI.

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6. USAspending.gov. Total outlays in response to COVID-19 through Mar'24, including $3.9T of grants and fixed charges, with $4.6T of total obligations and $4.7T of total budgetary resources.
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8. Green Street Advisors' Commercial Property Price Index (CPPI) All-Property Index and Multifamily Index publication. CRE valuations increased as much as 15% from pre-COVID levels overall, and 24% from early-COVID lows.
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ALL DATA AS OF JUNE 12, 2024 UNLESS OTHERWISE NOTED.

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