DRC savills investment management

US Commercial Real Estate Debt: the land of opportunity

Navigating the convergence of cyclical Real Estate Debt and ESG opportunities in the US Market

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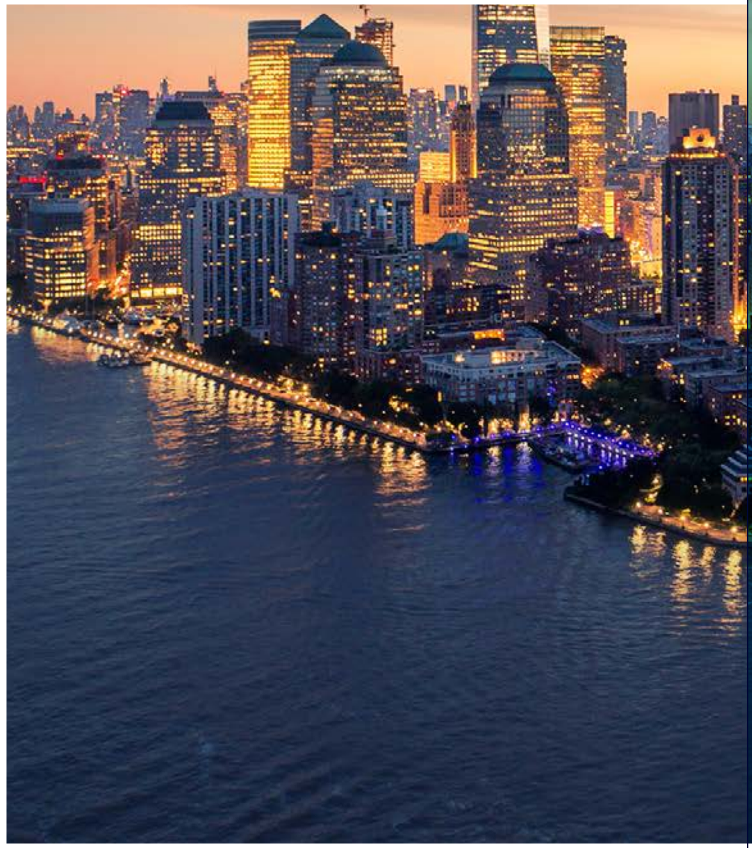

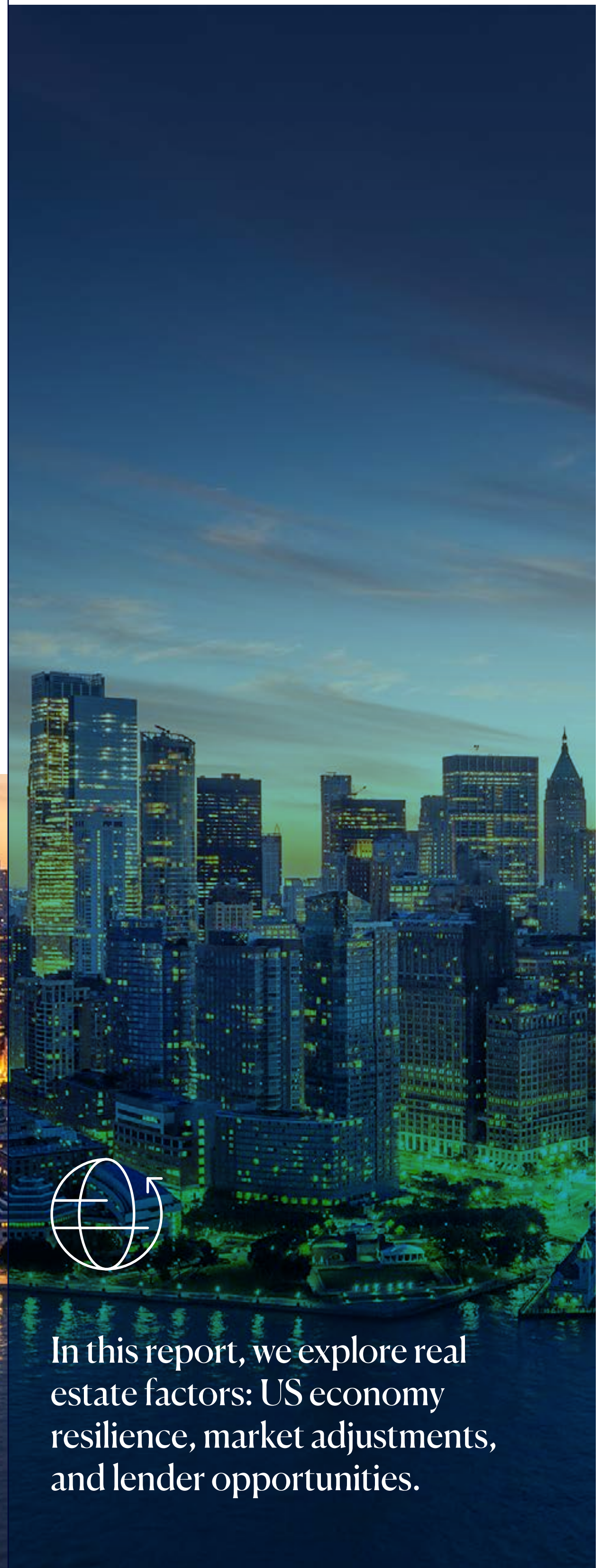

Introduction

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KEY POINTS

The US economy has proven surprisingly resilient during the recent rapid rate-hiking cycle. US real estate fundamentals are robust, with the notable exception of the office sector, whilst the escalating impact of climate change looms large across the real estate landscape.

Real estate capital markets are going through a period of adjustment as they adapt to an era of markedly higher interest rates. Indeed, the cost of capital and the low availability of debt were key drivers of the commercial real estate market in 2023. Investment activity has been muted while market participants wait for clarity on pricing, and gain confidence that the economy is strong and inflation under control.

As the cost of floating rates bite and loans mature, more motivated sellers will emerge. This is likely to bring more liquidity to the market through a downward adjustment in prices. The market is braced for a degree of dislocation.

Against this backdrop, active lenders are in a favourable position. Firstly, commercial mortgage-backed securities (CMBS) issuance is very low and banks and insurance companies have reduced their activity markedly, leading to a squeeze in the availability of senior debt.

Active lenders can negotiate favourable terms, including attractive spreads, when lending on assets that have already repriced substantially. The withdrawal of small and mid-sized banks from the market is likely to open space for non-bank lenders who can deploy capital through stretch senior and high yield strategies and be well compensated for taking on risk given that spreads have widened.

Secondly, given the fundamentals are broadly robust, risk-free interest rates are higher today than they have been in several years, properties have been revalued downward with some further reduction in value on the way.

Finally, climate change is making a pivotal change in real estate dynamics, and has led to a surge in impact investing. This has presented lenders the opportunity to lead in the sustainable transition and capitalise on the growing demand for green initiatives, thereby enhancing asset values and future-proofing investments.

Background

Chris Urwin
Founder
Real Global Advantage

The US is the largest commercial real estate market in the world, accounting for approximately a third of the global market.

According to JLL's Global Real Estate Transparency Index, the US is the second only to the UK, aided by a mature REIT market.

It is estimated that there is $6 trillion of debt outstanding on commercial real estate loans, which has grown by 6.9% between mid-year 2022 and July 2023[1].

The total commercial real estate debt outstanding is split into circa $4.5 trillion of income producing properties, approximately $0.5 trillion of construction loans and the rest in owner-occupied property loans. Given the different risk profiles for construction and owner-occupied property loans, this paper will focus on the opportunities available in the larger income producing property market.

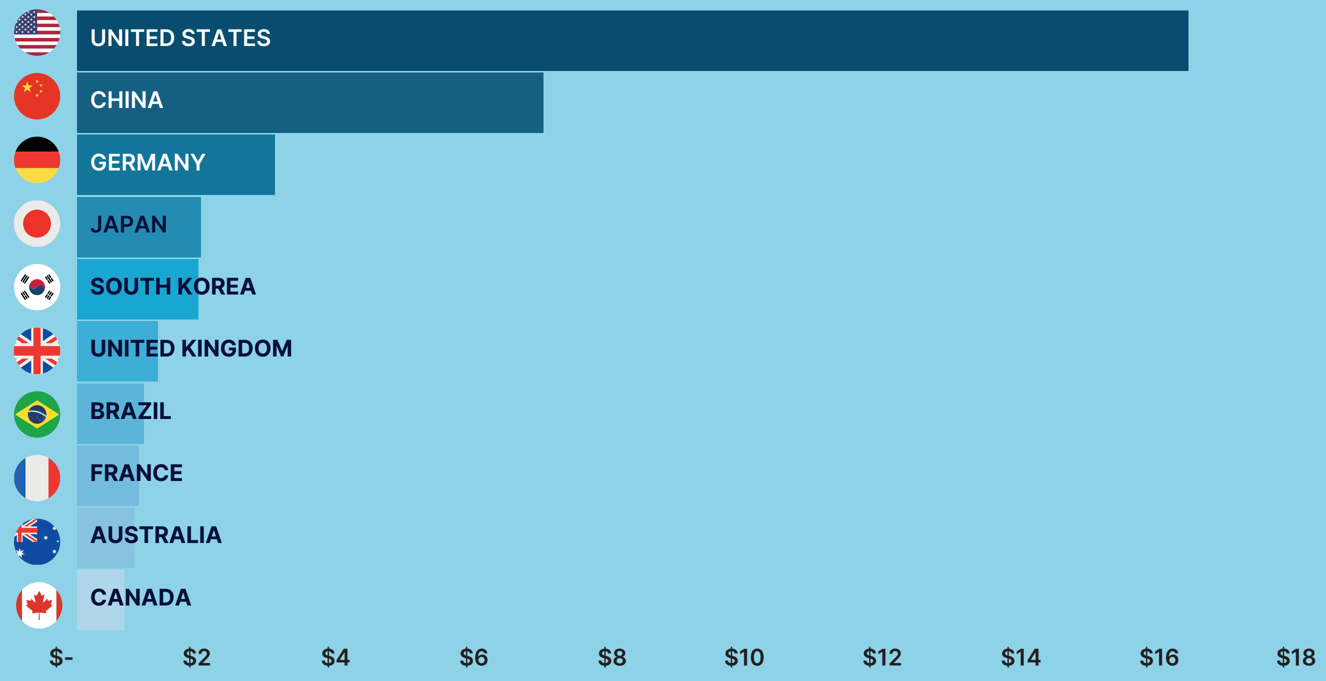
The largest lenders are banks who account for around half of all outstanding debt. Uniquely, the US has a large and deep CMBS market, including government agency-backed securities in the multi-family sector. Insurance companies, mortgage REITs and private funds are other significant players in the US commercial real estate debt market.

US commercial real estate went through a painful period of deleveraging in the aftermath of the global financial crisis. Since then, flows of debt into commercial real estate have been in line with overall economic growth. In general, there has not been widespread use of excessive leverage, although examples of risky leverage strategies can be found. Notably, the rate of growth in debt issuance was markedly faster in the multi-family sector.

$6 trillion
in US commercial real estate debt outstanding on commercial real estate loans.

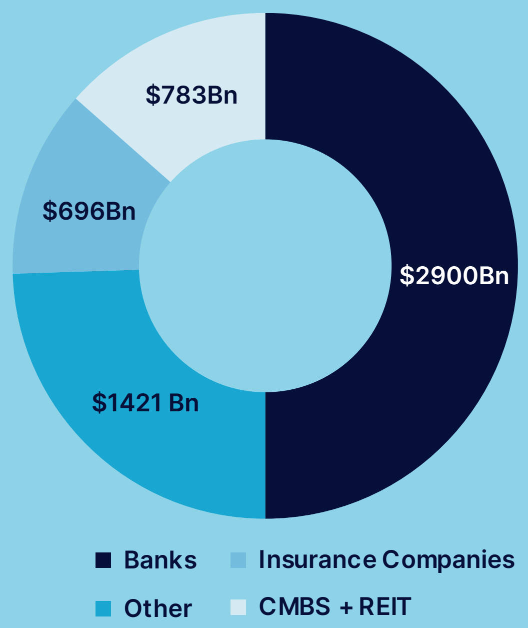
1 Trepp – Commercial mortgage sector faces another wall of maturities as $2.75 trillion rolls by 2027 (July 2023).

FIGURE 1:
Top 10 countries by real estate value
Value of real estate (USD, trillions)



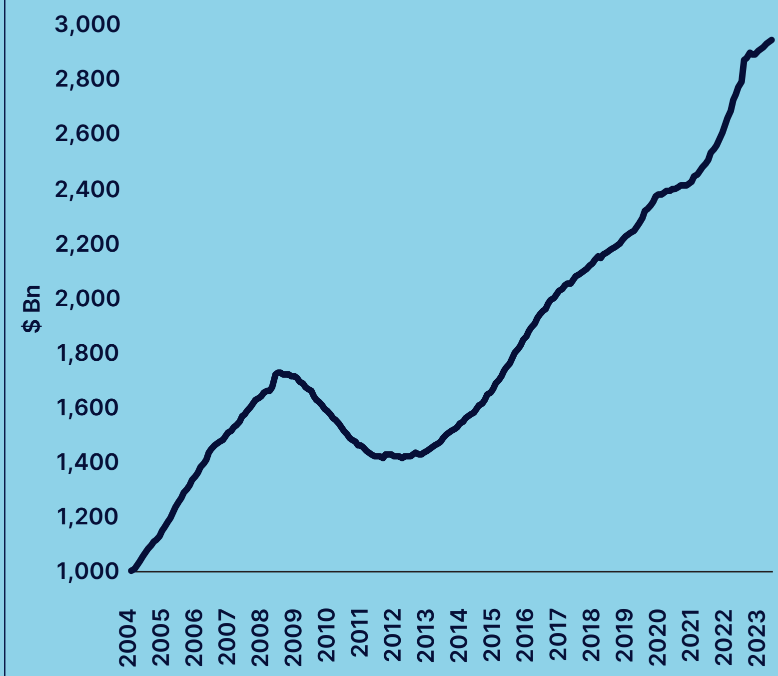
Source: Savills Research (December 2023)

FIGURE 2:
Commercial Real Estate debt outstanding by lender



Source: Trepp (Q2 2023)

FIGURE 3:
Bank outstanding commercial real estate debt



Source: Federal Reserve (December 2023)

US Macro Economy

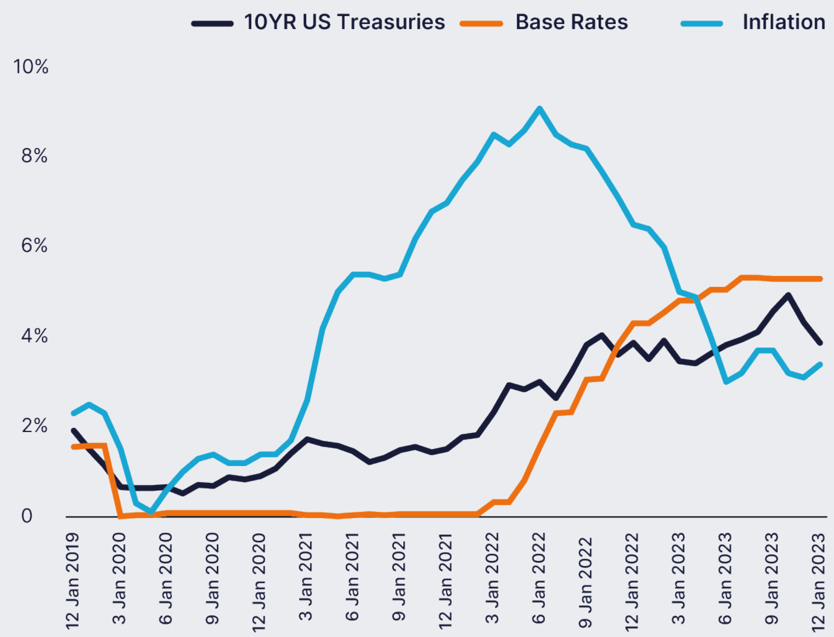
A defining feature of the US economy has been robust growth and strong labour market performance despite the sharp increases in interest rates. Between Spring 2022 and Summer 2023, the Federal Reserve (Fed) Funds Interest Rate increased from 0.25% to 5.5%, a markedly steeper increase in rates than seen in previous rate rising cycles.

Although inflation remains higher than policy makers would like, the CPI rate has fallen significantly, while growth and labour market performance has been robust. The Gross Domestic Product (GDP) in the US expanded by a healthy 2.5% in 2023, up from 1.9% in 2022.

Furthermore, the labour market is still growing.

The US economy added around 303K jobs in March 2024 and the unemployment rate remains low (by historical standards) at 3.8%.

FIGURE 4:
Significant fall in inflation



Source: Bloomberg (January 2024)

Commercial Real Estate

A strong economy but high interest rates means US commercial real estate is characterised by robust fundamentals (outside of the office sector) but weak capital markets.

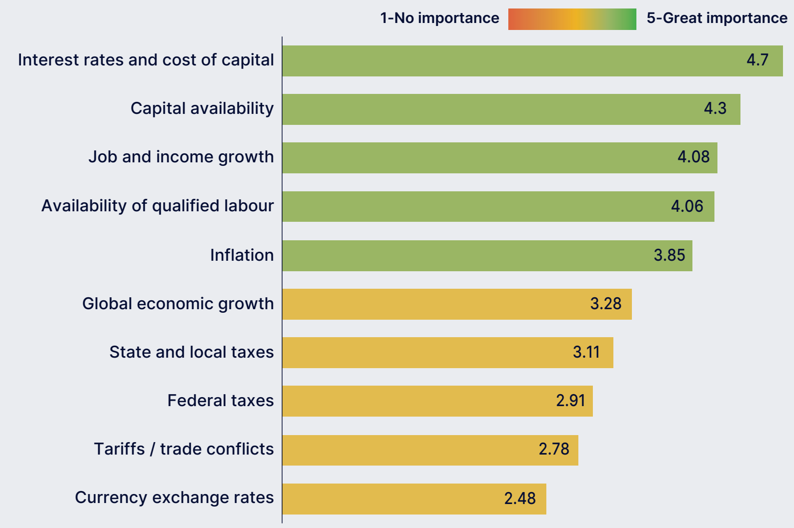
The office sector is experiencing particular challenges. In the US, the increase in people working from home has reduced office utilisation rates to a greater extent than seen in most other global regions. Data on office occupancy and the percentage of days in the office show remarkable stability, suggesting high levels of working from home are here to stay.

Consequently, when leases expire, many companies are reassessing how much floorspace they require given today's working practices. A clear trend towards downsizing and upgrading is emerging. While this is nurturing confidence in the very best offices, it is generating a lot of uncertainty about the value of a large proportion of office stock.

Despite challenges in the office sector, pockets of oversupply in certain multifamily markets and some self-storage markets struggling, operational performance has generally been robust and commercial real estate continues to deliver resilient income streams.

Key developments are taking place in real estate capital markets. It is high interest rates and the cost of capital that are key drivers of the commercial real estate market. The Emerging Trend in Real Estate 2024 Survey showed that this was the most critical issue for market participants.

FIGURE 5:
Importance of Issues for Real Estate in 2024



Source: Federal Reserve (December 2023)

Higher interest rates are leading to a repricing of real estate assets. The NCREIF Property Index declined for a eight successive quarter in Q1 2024. According to this index, real estate valuations have declined by approximately 16% since the start of the downturn. However, there is a widespread belief that valuations are significantly lagging the market. Green Street Commercial Property Price Index attempts to better capture market pricing in the transaction market. By the end of March, that had declined by 21% for the US commercial real estate market. However, there is significant variation in performance by sector. The office and apartment sectors have declined by around 37% and 28% respectively, while mall, retail strip and industrial have seen more modest declines of around 16-18%.

Levels of investment activity are low. Altus data suggests transaction activity continued to decline in Q1 2024. While private investors were net buyers, institutional, REIT and overseas investors were net sellers. Although activity levels are modest, they are not extremely low when compared to typical levels before the spike in activity in 2021 and 2022.

Capital for real estate investing is scarce, particularly for core real estate. Most open-ended funds, for example, have experienced redemptions and are more likely to be sellers than buyers. Further price declines are expected but the pace and scale of the adjustment is extremely uncertain. Much will depend on what happens in debt markets.

A large diversified debt market

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The US is the largest and most established real estate debt market in the world, with state level legal framework and sophisticated borrower, lender, and advisor base. In terms of lender diversity, the US market is significantly ahead of Europe.

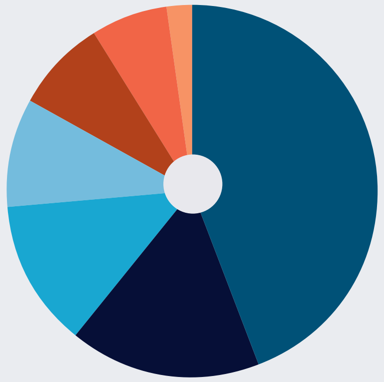
The current outstanding real estate loan exposure by property type is dominated by multi-family at circa 44%, while the remaining exposure is relatively evenly distributed across the other sectors.

The variety of different types of non-bank lenders in the US offers clearly the most choice for borrowers. Some of the tools available in the US such as agency lenders do not exist in the rest of the world. However, whilst banks' market share in the US is lower than Europe, their exposure to real estate lending is higher relative to their European counterparts.

Since mid-2021, US banks' exposure to real estate has grown by 15% while European banks' exposure grew by 3%.

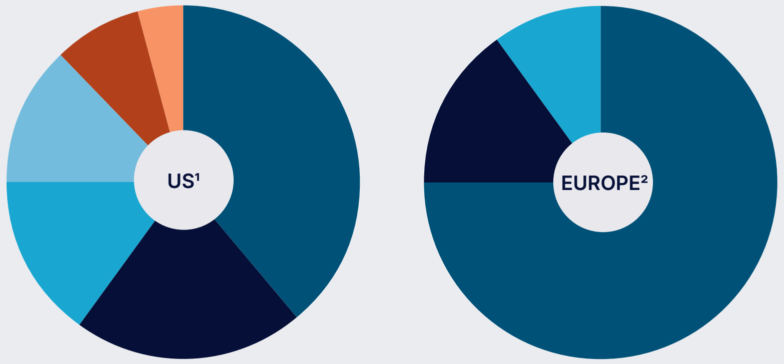
FIGURE 6:
US Real Estate Loan exposure by property type

Multifamily	44.2%
Office	16.7%
Other	12.9%
Retail	9.4%
Industrial	8.0%
Hotel	6.7%
Health care	2.1%



Source: Mortgage Bankers Association, Cohen & Steers (March 2023)

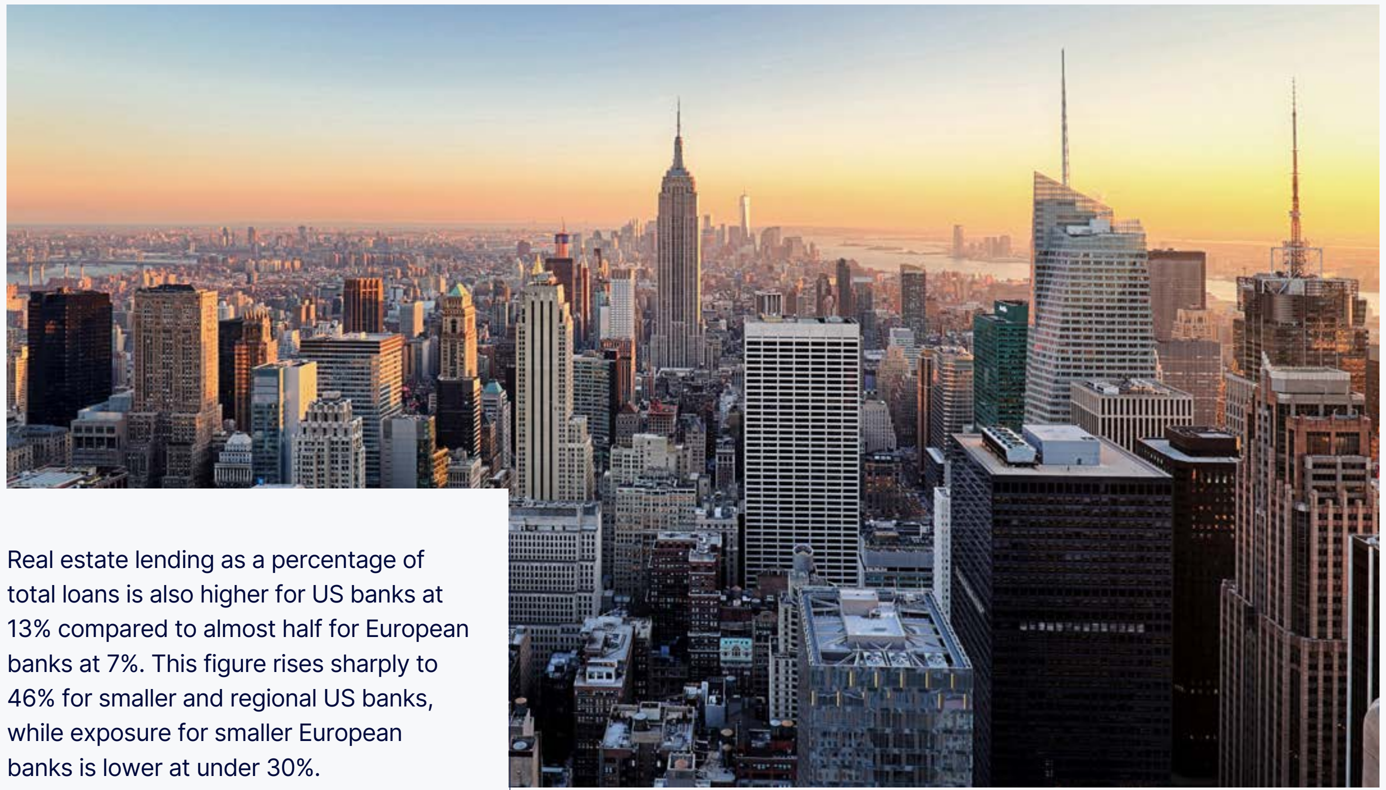
FIGURE 7:
Lender diversity across markets



US	
Banks	39%
GSEs	21%
Insurance Companies	15%
Securitised Debt	13%
Other	8%
Debt Funds and REITs	4%

Europe	
Banks	75%
Insurers	15%
Alternative Lenders	10%

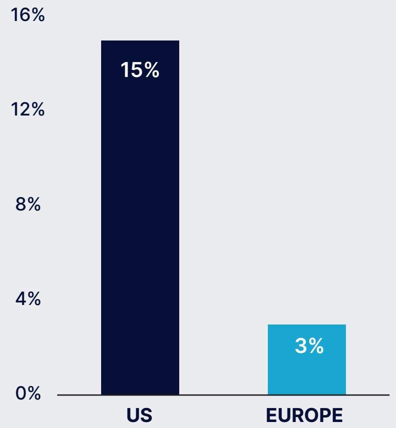
Source: (1) Mortgage Bankers Association (March 2023); (2) DRC Savills Investment Management estimates as at Q1 2024.



Real estate lending as a percentage of total loans is also higher for US banks at 13% compared to almost half for European banks at 7%. This figure rises sharply to 46% for smaller and regional US banks, while exposure for smaller European banks is lower at under 30%.

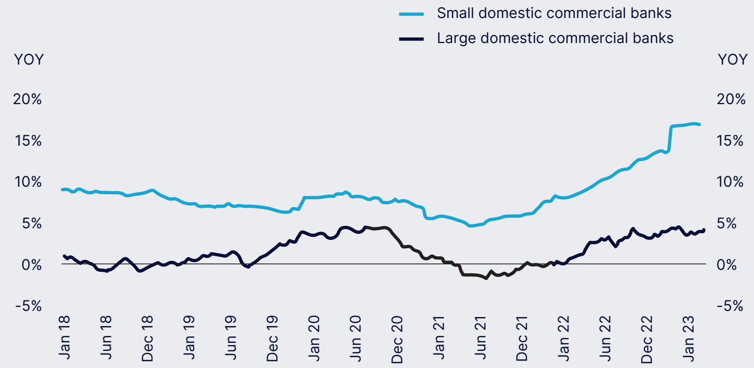
The huge difference between the small and large banks in the US is driven by the rapid growth in the exposure to real estate of regional and specialised banks over the last 20 years. By the start of 2023, small banks' share of real estate debt among all banks stood at 68%. Furthermore, against the backdrop of rapid interest rate increases from the Fed, small banks grew their real estate lending by nearly 20% in 2022. This compares to 5% increased exposure by large banks.

FIGURE 8:
Change in bank exposure to real estate since mid-2021



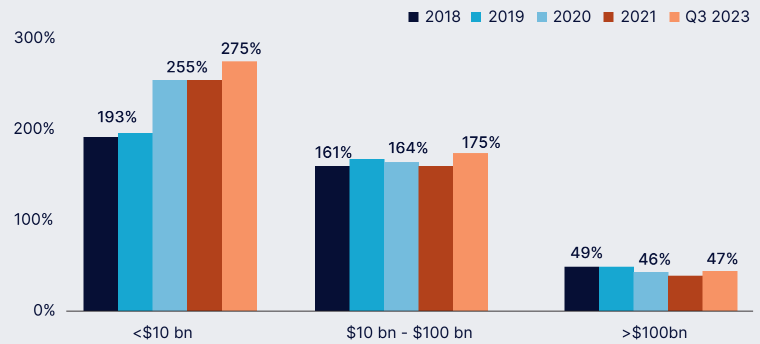
Source: Federal Reserve, European Banking Association (March 2023)

FIGURE 9:
Growth in real estate landing by bank size



Source: Mortgage Bankers Association, Cohen & Steers (March 2023)

FIGURE 10:
Significant growth in CRE exposure for smaller banks as a %age of capital



Source: Fitch Ratings (May 2023)

Smaller banks in trouble

The first quarter of 2023 saw several regional and specialist banks report liquidity issues and subsequent closures.Three banks collapsed in the space of a week in March 2023; Silvergate Bank ($11bn in assets) announced it would wind down and liquidate, followed by a bank run on Silicon Valley Bank ($209bn in assets) which collapsed and was taken over by regulators, and then Signature Bank ($118bn in assets) was closed by regulators citing systemic risks. In May 2023, First Republic Bank ($229bn in assets) also collapsed.

The underlying driver of these bank collapses was a liquidity crisis precipitated by the pace and level of interest rate increases by the Fed. As banks reported on their losses, depositors became spooked and withdrew funds, resulting in some banks becoming insolvent. The Fed, Federal Deposit Insurance Corporation (FDIC) and the US Treasury took extraordinary measures to calm markets by announcing all deposits at Silicon Valley Bank and Signature Bank would be refunded to depositors.

Whilst these actions have worked to calm markets, small to mid-size banks have experienced significant deposit flight which combined with concerns on current commercial real estate loan quality is likely to significantly slow lending from this sector. As the large volume of real estate loans held by small banks approach maturity in the coming years, smaller banks are likely to be selective on which loans to refinance or originate with recycled capital.

Large banks are not immune from the uncertainties facing markets. Over the last 12 months, US banks reserves for every dollar of delinquent commercial real estate loans dropped from $2.20 to $1.40, which is the lowest cover for banks against potential commercial real estate loan losses in over seven years[2]. Furthermore, the six largest banks average reserves dropped to 90 cents for every dollar of commercial real estate loan where the borrower is more than 30 days late for repayment.

These reserve requirements are set by the regulator for banks and are generally categorised by loan type and historical loss rates. These reserves are a drag on earnings, so banks typically aim to reduce the volume of reserves they hold. Using historic loss rates also poses a challenge for regulators as the decade before Covid was characterised by relatively low delinquency rates and would equate to lower bank reserves. Banks will need to take current higher delinquency rates and forward view on how persistent that is likely to be and take adequate reserves to protect against potentially higher losses. These factors are likely to result in more conservative lending from banks in the US.

2 FDIC (February 2024)

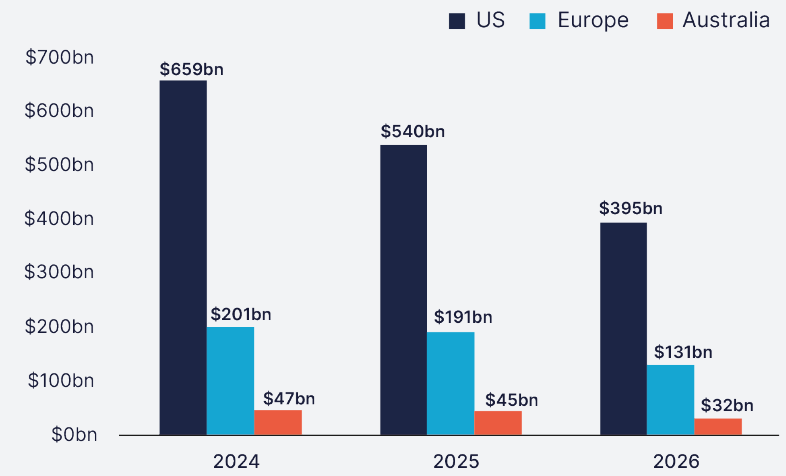
The opportunity for non-bank real estate lenders

Non-bank lenders are likely to grow into spaces where small to mid-size banks are forced to leave a gap in both acquisition and refinancing loans. The recent increases in interest rates and likely higher for longer environment will typically restrict banks to loan-to-values (LTVs) below 50% as they move to protect their liquidity. This space is typically dominated by the large banks as they focus on originating Senior loans, while the Stretch Senior and more specifically the High Yield space is dominated by the smaller and regional banks. As these smaller banks retreat from the Stretch Senior and High Yield real estate debt space and re-allocate to the Senior loans space, we are likely to see a funding gap appear for loans with LTVs greater than 50%.

The supply/demand imbalance is expected to be very much in the favour of lenders for the foreseeable future as a result of two key factors.

Firstly, the large volume of debt maturing over the coming years will need to be refinanced and given the contraction in credit from small to mid-sized banks hitting just as maturities are peaking, borrowers looking for loans in the Stretch Senior or High Yield segment are more likely to seek financing from the non-bank lenders with capital to deploy. Lenders catering to this segment can, in general, improve the quality and terms of their loans because of the reduced competition from the small to mid-size banks.

FIGURE 11:
Large volume of upcoming debt maturities



Source: (US) Mortgage Bankers Association, (Europe) DRC SIM estimates, (Australia) CBRE – Green Finance (June 2022) and DRC SIM estimates.

Secondly, many refinancings are going to be challenging as higher base rates mean property values are lower and debt costs are higher. The dramatic rise in base interest rates over the last year means actual affordability of interest in most cases is the limiting factor in the amount of sustainable debt a property can carry. This results in reduced availability of leverage for a given property and increases the funding gap. i.e., the difference between the existing debt on a property and what is currently estimated to be available for refinance. For example, between 2023-2025, office owners face a funding gap of $72.7bn[3], resulting in distress for some property owners while others will be forced to inject more cash into their properties.

Borrowers lacking further equity to pay down existing debt will have no other option but to seek alternative financing strategies such as stretch senior or high yield.

3 CBRE – The Office Sector Debt-Funding Gap is Likely to Increase (June 2023)

ESG – the challenges and opportunities

Michael Adjei
Junior Sustainability Analyst, ESG

The tangible effects of climate change are escalating, with the United States grappling with an upsurge in storms, floods, wildfires, extreme temperatures, and other climate-induced hazards. In the rapidly evolving real estate landscape, climate change has moved from a peripheral to a material issue. Many investors are now pledging to achieve net-zero carbon, spurred by emerging standards and legislation aimed at curbing emissions, and tenant demand for sustainable buildings.

Real estate lenders would be wise to assess and reposition their portfolios against these new realities, ensuring resilience (e.g. fortifying properties against extreme weather events, developing adaptive infrastructure to withstand changing climate patterns, and employing advanced technologies for real-time risk assessment and response) and sustainability (e.g. implementing energy-efficient building designs, investing in renewable energy sources, and adopting green construction practices).

Adaptation is key in facing climate change challenges

The true value

The confluence of economic shifts and climate-related physical risks have precipitated a widespread mispricing of real estate, spanning various markets and asset categories in America[4].

Evidence is mounting that climate-induced events are not being sufficiently integrated into property valuations. Consequently, real estate located in vulnerable zones is prone to overvaluation, with properties in regions lacking stringent flood-risk disclosure regulation being particularly prone to mispricing. A study from Nature Climate Change notes properties at risk of flooding are overvalued by an estimated $121–$237 billion[5]. Additionally, the National Flood Insurance Program (NFIP) has traditionally set premiums below the actual risk level, effectively subsidising the cost of owning property in flood-prone areas and skewing the perceived value.

Amidst these challenges lies opportunity: certain assets, by virtue of their low carbon footprint, geographic location, or the nature of their tenants, may gain value in a climate-conscious market. Conversely, others might experience a significant devaluation. The critical challenge is to discern which assets will be affected, to what extent, and to devise strategic responses accordingly. Investors may find reward in identifying and capitalising on assets that are currently mispriced, turning the tide of climate transition into a profitable venture.

$121–$237 billion

Estimated overvaluation of properties at risk of flooding, according to a study in Nature Climate Change.

4 McKinsey & Company – Climate risk and the opportunity for real estate (February 2022)
5 Nature Climate Change – Unpriced climate risk and the potential consequences of overvaluation of US housing markets (February 2023)

A Problem...

The frequency of billion-dollar weather and climatic disasters in the United States is surging - painting a disturbing picture of the escalating impact of a warming planet - with roughly a quadrupling of these events annually compared to 1980 (Figure 12)[6].

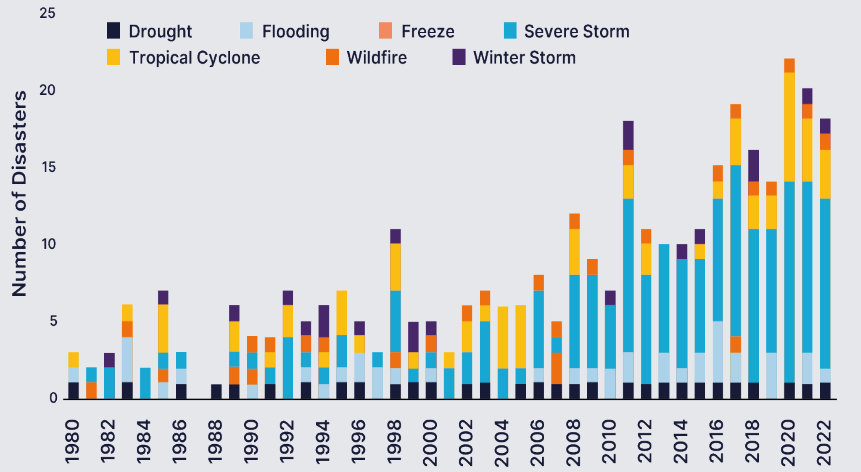
This significant escalation in both the severity and regularity of acute and chronic hazards has resulted in a cumulative cost exceeding $2.554 trillion between 1980 and 2022, as reported by the US Global Change Research Program.

Figure 13 correlates the level of risk of these events across the US with insurance cost spikes, with an emphasis on the acute vulnerability of southern coastal regions[7]. This is intensified by the geographic positioning of critical infrastructure, which not only impacts asset value but also significantly influences the cost of insuring against such escalating climate threats[8]. Since 2018, Florida has seen insurance costs jump by 440 basis points, while California has experienced a 370bps increase, both substantially outpacing the national average rise of 240 bps[9].

States with elevated risk assessments from Federal

FIGURE 12:

U.S. Billion-Dollar Disaster Event Types by Year



Source: U.S. Global Change Research Program (2023)

Emergency Management Agency (FEMA) typically face sharper increases in insurance premiums. However, Texas, Arizona, and Nevada stand out; although these states are rated at the highest risk level by FEMA, their insurance premiums haven't risen proportionally. Coastal cities such as Houston, which are prone to flooding—the leading natural hazard in the United States, responsible for 90% of such events—may see a significant surge in insurance costs in future. This projection underscores the need for a nuanced understanding of the relationship between risk assessment and insurance economics.

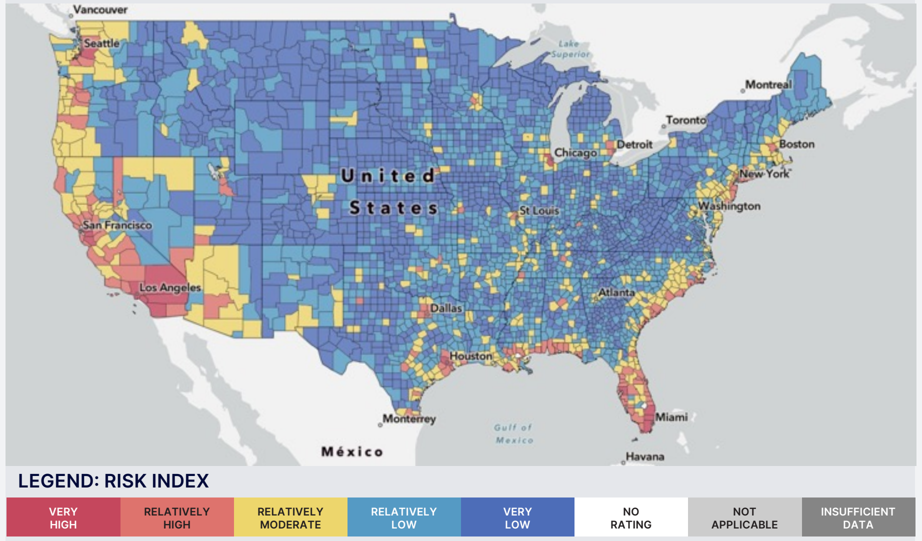
The impact is also stark in the multifamily housing sector, where insurance expenses vary dramatically across different metropolitan areas. For example, costs per unit per year range from $114 in Minneapolis to a remarkable $1,316 in San Francisco. The trend is clear: the most expensive metros premiums are those most exposed to natural calamities[10].

As insurance premiums escalate in response to the growing frequency and severity of extreme weather events, the direct effect on the bottom line is becoming more pronounced, presenting a significant challenge to institutional investors. Investors and lenders in the real estate market are now finding it necessary to adjust their strategies to accommodate these higher operational costs.

6 U.S. Global Change Research Program – Billion Dollar Disasters (2023)
7 FEMA National Risk Index (2023)
8 The Guardian – US sets new record for billion-dollar climate disasters in a single year (September 2023)
9 CBRE EA insights - Insurance costs heavily increased in climate sensitive states (November 2023)
10 PREA - Increasing Insurance Costs for Multifamily Vary By Location, Asset Type, and Affordability (Fall 2023)

FIGURE 13:

FEMA National Risk Index



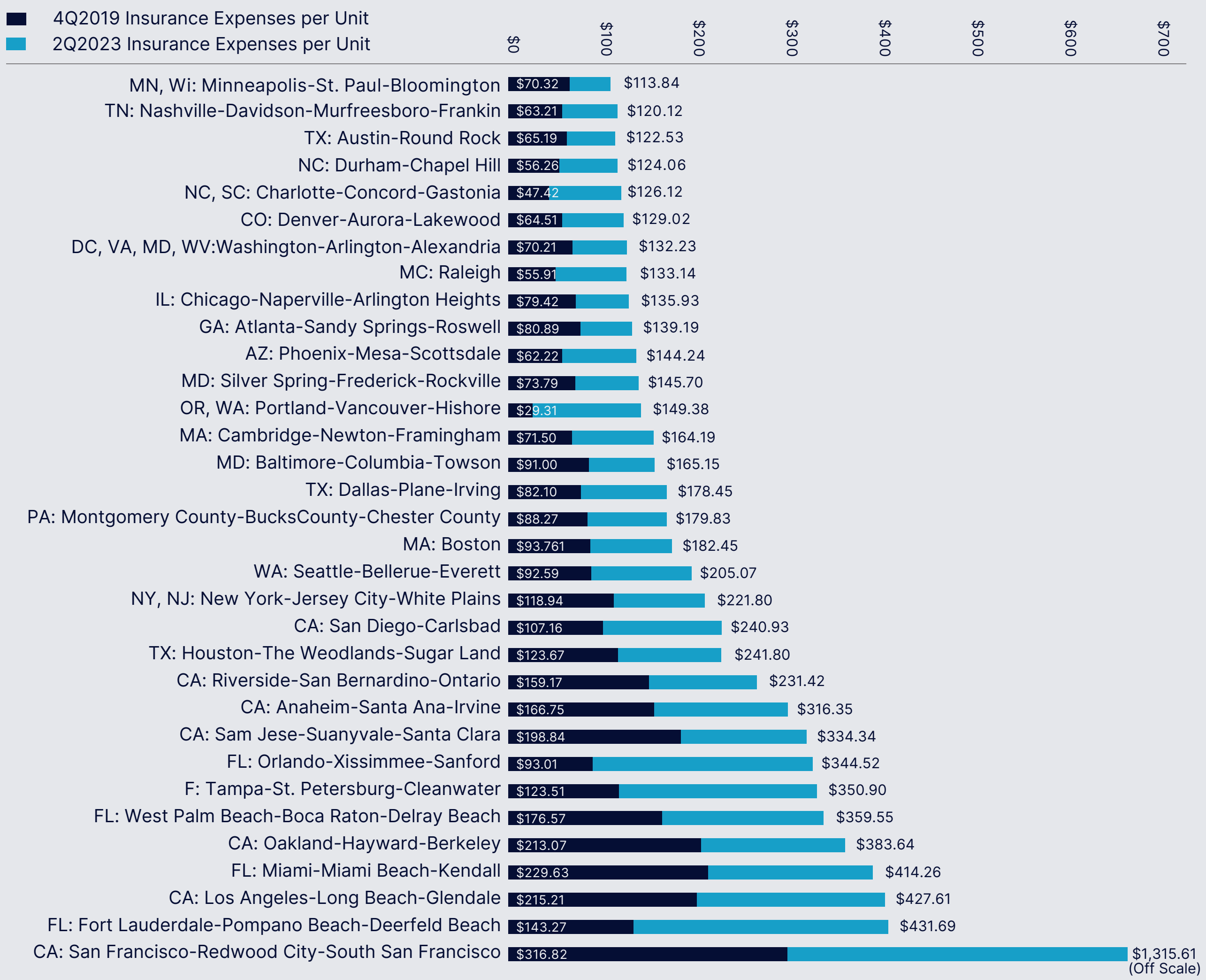
Source: FEMA Risk Index (2023)

$2.554 trillion

US climate-related hazards cost.

FIGURE 14:

Multifamily Insurance Expenses per Unit per Quarter



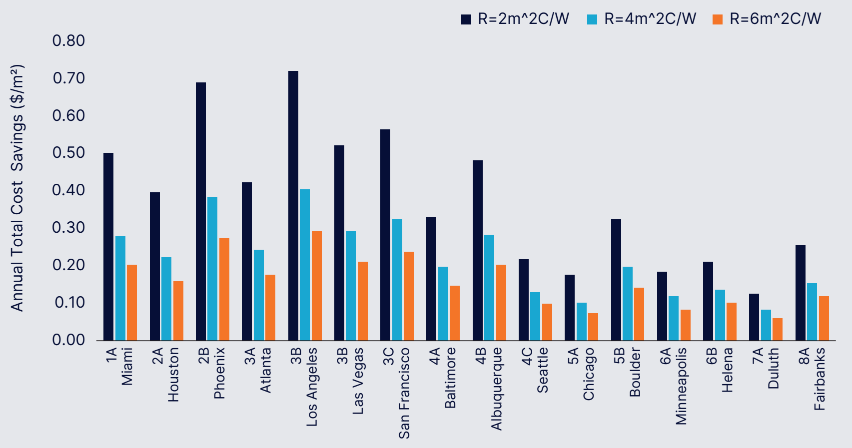
Source: PREA Research (Fall 2023)

Or an opportunity?

In the commercial real estate sector, climate resilience and energy efficiency are gaining prominence as key factors in property value and tenant appeal. Take for example investment in infrastructure like cool roofs- mandated on new builds by Chula Vista's supportive legislation[11] - which are a direct response to this trend, offering a robust defence against overheating and a lure for prospective tenants due to their operating expense savings. Figure 15[12] illustrates the annual energy cost savings per unit of roof area when employing reflective roofs, compared to traditional black roofs, across various climatic zones. Reflective roofs offer benefits across all zones, particularly in warmer climates (zones 1–4). In these regions, the savings can reach up to $7,000 for a 10,000m2 building, as shown in cities like Los Angeles and Phoenix.

Initiatives like cool roofs are merely one example of an adaptive measure that has proven its value and contribution to asset future-proofing.

FIGURE 15:
Annual energy cost savings*



Source: Energies (November 2021)
* Annual energy cost savings (per unit roof area with a new reflective roof (70%) versus a black roof (6%) for the office building, with three roof insulation levels in all 16 climatic locations.

Other comprehensive climate adaptation strategies can include the integration of green spaces to manage flood risks, the utilisation of energy-efficient materials and systems through retrofit, and the implementation of water conservation measures. They represent a proactive stance in climate resilience, offering a dual benefit: potentially reducing insurance premiums through demonstrably lower risk profiles, and enhancing the sustainability and marketability of properties.

Implementing decarbonisation measures within commercial real estate stands as a powerful strategy for stabilising the climate given that the built environment is a significant contributor to greenhouse gas emissions. Moreover, the decarbonisation drive presents opportunities for real estate entities to leverage their assets creatively. They can reimagine their locations as hubs for generating and storing energy, for instance, by installing solar arrays and batteries, which support energy grid stability and reduce reliance on non-renewable sources.

In the US, where over 70% of commercial buildings are more than two decades old, retrofitting emerges as a critical component of climate mitigation strategy[13].

11 The Kresge Foundation – Climate Adaptation, The State of Practice in U.S. Communities (November 2016)
12 Energies – Cool Roofs in the US (November 2021)
13 U.S. Energy Information Administration – CBECS Survey Data (2018)

The Empire State Building illustrates the transformative potential of such initiatives. This landmark, constructed in 1931, underwent a $550 million renovation in 2009. The renovation encompassed several energy efficiency measures - retrofitting all 6,514 windows with high-performance glazing, upgrading the chiller plant, and installing a new building automation system. The results were remarkable: a 40% reduction in energy consumption, annual cost savings of $4.4 million, a 67% reduction in greenhouse gas emissions, and significant improvements in indoor air quality and occupant comfort[14]. This case exemplifies how real estate can pivot towards sustainability, with retrofitting serving as a nexus for increasing energy efficiency, bolstering property values, and fostering compliance with emerging regulations, such as New York City's Local Law 97- a stringent regulation requiring significant emissions reductions by 2030 and 2050. The Urban Green Council projects that to comply with such regulations, the retrofit market in New York City alone could demand an investment of over $24.3 billion by 2030[15] or risk asset stranding- the inability for commercial real estate to survive the low carbon transition. What's more, with the International Renewable Energy Agency's warning of a potential $7.5 trillion devaluation in real estate due to climate risks and economic shifts, the concept of stranded assets becomes a tangible double-edged sword.

Lenders, in partnership with owners, must carefully balance the risk of asset devaluation against the cost of retrofit at this critical juncture, being mindful that traditional valuation models underestimate the capital required to decarbonise, potentially straining investors financially. There is a real opportunity for forward-thinking lenders to offer the necessary capital injection, securing their stake in a greener future.

40%

less energy consumed after renovation, saving Empire State Building $4.4 million yearly.

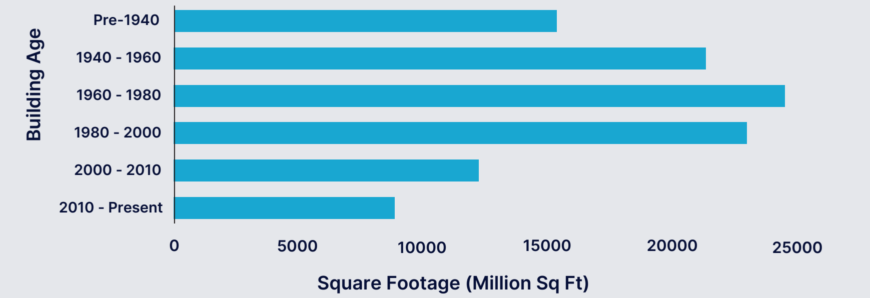
As such, lenders have a pivotal role to play in championing climate policy, encouraging investments in clean energy, and enhancing energy efficiency. Their influence can extend to supporting policy initiatives that aid borrowers impacted by climate change, ensuring a just transition. By actively engaging in these areas, lenders can help steer the sector towards a resilient and sustainable future, mitigating the risks associated with asset stranding and driving the industry towards comprehensive climate adaptability.

The imperative to retrofit existing buildings for decarbonisation in the US commercial real estate sector is both an environmental necessity and a financial opportunity.

It's a decisive moment for the lending community; a chance to redefine the parameters of responsible finance, exploring meaningful impact, in a way that aligns profitability with planetary stewardship.

Impact investing is witnessing a surge within the United States, signalling a strategic shift in the real estate market, and lenders are uniquely positioned to capitalise on this green transition and reap the benefits of early adoption. Those funding energy-efficient upgrades, renewable energy installations, and other sustainable building practices can expect to see their assets appreciate in value due to their enhanced tenant appeal and regulatory compliance. Lenders can establish themselves as leaders in this rapidly evolving landscape, leveraging their financial influence to facilitate the carbon transition, understanding that today's green retrofit is tomorrow's standard.

FIGURE 16:
U.S Commercial Building Space by Age



Source: Wall Street Journal - Trillions in Assets May Be Left Stranded as Companies Address Climate Change (November 2021)

14 Rocky Mountain Institute – Empire State Building Case Study (2010)
15 Greentech Media - After Pandemic, New York's Buildings Face Daunting Decarbonization Mandate (April 2020)

Conclusion

The evolving dynamics of the commercial real estate market, coupled with the challenges faced by traditional banks, create significant opportunities for non-bank lenders.

By embracing sustainable initiatives, lenders can not only enhance asset values and future-proof investments but also position themselves as leaders in driving the transition towards a more resilient and sustainable real estate sector.

As the interest rate environment remains uncertain, banks will remain risk-averse, allowing non-bank lenders to leverage their flexibility to take full advantage of the broad opportunity set. We believe the combination of the funding gap, the current level of risk free interest rates and the opportunity for impact investing make the US real estate debt space a compelling opportunity for institutional investors.

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