Cougar Global Viewpoints

How commercial real estate may challenge regional banks

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- Commercial real-estate risks are known but not yet front-of-mind
- Regional banks dominate commercial real estate lending
- Offices, and their higher vacancy rates, remain the primary focus
- Apartment buildings aren't necessarily out of the woods
- Not a repeat of 2008 … but additional risks add to the wall of worry

Current risks in commercial real estate (CRE) should not be a surprise. In fact, well before the banking crisis in March, the fixed-income market already had priced increased risks for BBB-rated commercial mortgage-backed securities (CMBS). At the beginning of 2022 (long before a couple of regional banks failed), CMBS spreads over U.S. Treasuries moved from near 300 basis points to more than 600 basis points.

Bank failures have highlighted potential risks within sectors of the commercial real estate market, because regional banks punch well above their weight in this asset class.

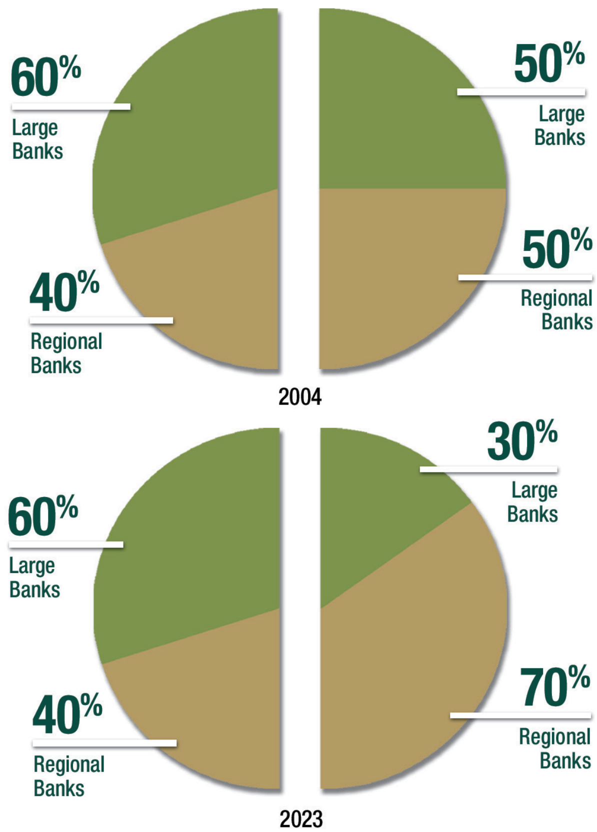
The U.S. Federal Reserve provides weekly data on commercial bank loans that dates back to 2004, and the total amount of loan volume has tripled over time, standing at a present value of more than $11 trillion. The top 25 banks by assets account for about 60% of total loan volume, while smaller banks account for about 40% of total loan volume. That ratio between large and small banks has remained fairly stable, but smaller banks have taken a more active role in CRE lending: Smaller banks were responsible for around half of this asset class activity in 2004, and that number is closer to 70% in the present day.

Most investors are focused on the capital values of office buildings rather than the entire CRE sector. Those values are likely to be lower simply due to loans that are refinanced at higher interest rates. Some research has estimated that capital values will fall around 15% on average from peak to trough, but one of our independent research providers is less pessimistic on the market overall, outside of a few major metro areas (e.g., San Francisco and Washington, DC).

U.S. Bank Loan Balances

Loans and leases in bank credit

Left side: breakdown of U.S. banks' total loan portfolios. **Right side**: breakdown of U.S. banks' CRE loan portfolios.



Source: U.S. Federal Reserve

Vacancy rates are another issue. Post-COVID workforce dynamics remain unsettled – at best – and investors are struggling to accurately assess vacancies. Most estimates of vacancy rates for major downtown metros are in the range of 15%, which could be light. Anecdotally, our own office building carries a 70%-75% vacancy rate on Fridays.

Regardless of the estimates for either values or vacancy rates, it seems reasonable to further haircut the values of office buildings as leases are renewed and loans are refinanced. Higher unemployment rates, and the potential of a deeper-than-anticipated recession, have also started to impact the value of apartment buildings.

On the bright side, the hotel, healthcare, and industrial sectors are in better positions; additionally, the residential housing market seems to be more insulated due to a lack of inventory and stabilizing mortgage rates. Lower inflation readings and a more dovish Fed could also reduce the debt-servicing costs for commercial loans, making the overall risks appear to be smaller and more well-defined than those of the 2008 global financial crisis. Investors already have enough risks on their on their plate right now.

It's notable that the 2008 recession was driven by brand-name banks that were too big to fail. Smaller banks should have their turn under the spotlight in the months ahead, when higher interest rates continue to expose previously dormant risks, such as values for commercial real estate.

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DEFINITIONS:

A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

A vacancy rate reflects the percentage of vacant or unoccupied units in a rental property, such as an office or apartment complex.

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