Q&A

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Commercial Real Estate Investment Q&A: What Insurers Need to Know

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A decline in commercial real estate valuations has been exacerbated by rapidly rising interest rates and the failure of several larger regional U.S. banks. Tom Cloutier, Conning's expert in commercial mortgage-backed securities (CMBS), discusses the commercial real estate market, the firm's due diligence process, and the enhanced investor protections in CMBS. Despite the current challenges, Conning remains confident that the CRE market will not experience a crisis similar to 2008-9.

1. What is happening in the commercial real estate (CRE) market?

Tom Cloutier: The CRE market is experiencing a liquidity crunch and tightening credit conditions, and now there is discussion of greater regulation that could lead to tighter capital constraints after the failure of two regional U.S. banks. In total, these may adversely affect CRE development, the supply/demand balance, the availability of refinancing, and new origination opportunities. Conning anticipates a significant commercial real estate repricing during the next few years, affecting banks with real estate holdings, CMBS, insurance companies, real estate investment trusts (REITS) and real estate equity sponsors. Smaller and regional banks with outsized or concentrated exposures are likely to encounter more difficulties versus their larger counterparts, where losses may be more manageable.

Despite challenges at the beginning of 2Q 2023, we are not seeing signs of distressed selling and liquidations. For the balance of 2023, a relatively light maturing loan schedule poses less near-term risk. For 2024, expected demand for refinancing of maturing loans increases but appears manageable. However, the maturity wall picks up significantly in 2025 - 2029.

Banks and thrifts are significant financiers of CRE as they hold the largest share of CRE debt among market participants and are facing a significant repricing and decline in collateral values. Meanwhile, rapidly rising interest rates are challenging their operations with downward pressure on property incomes and increasing expenses.

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2. What are the immediate challenges facing CRE investors?

We have seen a prolonged window of weak transaction volume, which has led to lower CMBS origination and issuance. There are large differences now between buyers and sellers on property valuation and pricing, leading to declining liquidity for real estate investors. While the lack of distressed selling has limited losses thus far, the market needs rate stabilization to enable buyers and sellers to establish prices and clearing levels. Rate stabilization and lower volatility should allow for increasing transaction volume, a restart of the loan origination machine, and the transparency needed to restore market confidence.

Given higher interest rates and slower economic growth, Conning expects higher loan delinquency rates and further pressure on CRE fundamentals during the coming quarters. In our view, properties that were performing well pre-pandemic and have largely sustained or recovered will be best positioned for tighter refinancing/lending conditions. Properties at the margin that were underperforming pre-pandemic and have not improved will have very limited alternative workout strategies and will likely be the largest contributor to increasing losses in CRE over time.

3. **What is the outlook for the office sector, generally a 30% component of most CMBS?**

In the office sector, Conning expects that many of the pandemic-driven policies, including more work-from-home, flexible and remote/hybrid arrangements, will remain. Longer-term lease structures with staggered tenant expiration dates will help sustain office properties in the near term with these secular changes likely to play out over several years.

We expect the office sector will have winners and losers, much of which will depend on borrower/sponsor willingness and ability to inject equity into properties to sustain or transform them to compete in the new environment. Office performance is highly correlated with the unemployment rate, and we anticipate company downsizings and reconfiguration of space are likely to create a shift in normalized occupancy rates down about 10-15% from pre-pandemic levels.

In our view, Class A office space – generally newer, post-2000 construction and/or upgraded since 2010 – will be the least impacted. Class A and higher, or "trophy," space is where a lot of companies want to be, and while we have seen several firms lose office populations in the last few years, there have been many not in Class A spaces that are taking this opportunity to improve their workspace, known as the "up in quality" trade. We expect this trend to continue.

The challenge will be in Class B and C properties, which are generally older structures, usually pre-2000, and those that have seen no updates/remodeling. They may lose out as cities, in general, are facing declining demand for office space, and A space will be preferred. The impact varies by city; for example, New York City is still a major office destination but it has many aged 1970s-80s structures that may not be well positioned for the transformation in office space needed over the coming years.

4. **What does Conning view as the most important trend in the short term?**

During the next two years we will watch maturing loans and refinancings. Borrowers looking to refinance an existing loan or originate a new loan face higher borrowing costs and reduced credit availability that will translate into loan terms that are more restrictive for borrowers and more favorable to lenders. While term defaults are likely to increase in the next 24 months as economic growth slows, we expect a greater number will occur at maturity date to the extent that markets have repriced. The lenders want to make loans to customers with solid business plans for this challenging environment, as that's how they make money. They do not want to foreclose on the collateral property – being landlords is not their business model.

The current lack of price discovery has contributed to greater uncertainty in property valuations. Investors may face some large write-offs if they must sell at significant discounts. The lead times for defaults transitioning into liquidations and losses can be significant, often 24 to 36 months, so we expect the prevalent type of loan resolution will continue to be extensions, modifications, and forbearance to help bridge gaps in performance.

5. **Have you modified your due diligence process given market conditions?**

Our due diligence process remains consistent and focused on ever-changing market conditions. Conning views issue selection and credit priority as essential elements of our strategy irrespective of where we are in the credit cycle. We remain focused on higher quality positioning within the capital structure, generally, securities rated AAA – A. Conning targets a selective, diversified deal mix across property types with a focus on best relative value to pursue optimal risk-adjusted returns as well as downside protection across multiple real estate/economic cycles.

We have employed greater automation to monitor leading indicators that flag transitions in performance. Scenario analysis/modeling adjusts to rapidly changing economic conditions, rates and inflation. For example, our stress scenarios incorporate forward-looking higher cap rates to capture potential property price depreciation and declining cash-flow growth. The modeling process flexibly adjusts to rapidly rising interest rates, inflation, and economic growth scenarios. Qualitative and quantitative loan-level credit analysis drives relative value and enables us to build a diversified portfolio and provide a stable foundation for risk management.

6. What protections does CMBS offer investors?

CMBS are "structured securities" and Conning relies on the structure as well as our credit positioning – we are mainly in AAA to A securities – for protection against potential loss. In the CMBS structure, the highest-rated securities are paid first while losses accrue starting from the bottom of the structure.

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There were also significant structural protections and enhancements implemented after the financial crisis of 2008-9. There are greater credit enhancements – i.e., more cushion - for the higher quality securities (AAA – A) versus comparable pre-2008-9 levels. A pre-crisis AAA-rated security had a credit enhancement average of about 12%, meaning the deal would have to see a 12% loss among all the lower quality securities before the AAA-rated debt would be impacted. Credit enhancements for these same securities today average about 21% and run as high as 30%, offering greater protection against potential losses.

CMBS deals post 2008-9 have been more conservatively underwritten with less leverage (i.e., lower loan-to-value [LTV] ratios), higher debt service coverage ratios (DSCR) and the absence of projected/forward-looking cash flows. Where we saw 65% or more LTVs pre-crisis, they are now closer to 55% so the deals have considerably less leverage. DSCRs – the amount of monthly income from the property compared to the monthly debt obligation - are higher so the deals have more cash flow to meet coupons, although DSCRs are being pressured by rapidly increasing rates. Lastly, the supply and demand of commercial properties is more balanced now than pre-crisis as developers have been more disciplined in delivering supply to meet existing demand, helping lower concentration risk.

In addition, since 2016, security issuers must maintain a risk-retention stake in the deal to better align their interests with investors. And the past decade of low interest rates has benefitted older properties by allowing for some significant deleveraging, cash-flow growth, and property price appreciation. Multifamily and industrial properties grew by double-digits through the pandemic while some office properties also had significant price appreciation in the past five years.

We expect slowing growth across CRE property types, with the office sector expected to bear the largest burden, as a result of the secular changes it faces in the coming years. However, Conning does not expect another crisis a la 2008-9. A great deal has happened in the market since then and it has led to better protection for investors.

Tom Cloutier, CFA, is a director and structured securities research analyst, responsible for CMBS research and serves as a backup CMBS trader. Prior to joining Conning in 2011, he was responsible for research, analysis, and trading for CMBS portfolios at Goodwin Capital Advisers. Mr. Cloutier earned a bachelor's degree in finance from the University of New Hampshire and an MBA from Western New England College.

ABOUT CONNING

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including insurers and pension plans, with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

Commercial Real Estate Risk Factors

Systemic and /or Idiosyncratic Risk: significant deterioration in economic conditions can fuel diminished liquidity and increase overall default and downside risk.

CMBS/CRE may experience a higher beta/spread volatility during periods of heightened volatility which may impact demand for these assets.

Interest rate risk and inflation can have adverse impacts on commercial real estate valuations.

Regulatory and Political Risks: specific regulatory or political initiatives may have an adverse impact on commercial real estate development, the supply/demand balance and availability of financing opportunities.

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