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A Commercial Real Estate Update

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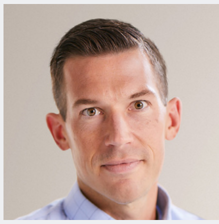
We recently sat down with our banking analyst, John Loesch, CFA, and our real estate analyst, Josh Barber, CFA, to discuss the state of the commercial real estate market and what's on the horizon.

Josh Barber, CFA
Research Analyst



John Loesch, CFA
Research Analyst

What kind of exposure do small- and medium-sized banks have to commercial real estate?

John Loesch, CFA: Historically, small- and mid-sized banks have had moderate exposure to commercial real estate loans since one of their core services is lending money for buildings in their communities. In fact, it's not uncommon to see small- and mid-sized banks have anywhere from 30% to 50% exposure in their loan books. But it's important to differentiate the type of exposure: owner-occupied (e.g., lending to a dental practice to buy the building out of which they operate) vs. non-owner occupied (e.g., an investor owns the building and leases to the dental practice). Owner-occupied has historically performed like a traditional commercial loan rather than real estate, whereas non-owner occupied typically comes with greater risk as tenants can decide to leave when leases are up, leaving property owners with vacancies.

Underwriting is key. With loan-to-values in the 40% to 60% range today, there's a decent amount of cushion before banks would experience any losses. Recent media commentary suggests that commercial real estate is in trouble with massive losses pending. I believe that sentiment is overblown. Will there be losses? Yes, but I don't think it will cripple balance sheets at this stage. Other considerations are the type and location of real estate. There's a big difference between an office tower in a central business district versus a medical office practice in a suburb. The loss exposure would be very different.

One thing to note is a lot of assumptions are being made about commercial real estate, e.g., losses and failures are going to happen all at once creating an acute problem. If you look at banks' portfolios, this is a multi-year situation as loans mature. Purchasing rates could be lower at maturity, and the ability to refinance and cash flow characteristics of those properties will be different than they are today. It's unfair to lump all commercial real estate into one bucket and say that the outlook is poor.

There is a lot of talk about the "maturity wall" with loans coming due in the next couple of years. What is your perspective on those risks?

John Loesch, CFA: If we consider the next 7 to 10 years of commercial real estate debt maturities, over the next two years, 2023 and 2024, much of the debt coming due is commercial mortgage-backed securities (CMBS) debt, not bank debt. Most of the bank debt comes due in 2026 and 2027 – supporting my point earlier that this is going to take time to play out. So, even though some banks have CMBS in their investment portfolios, it's almost exclusively AAA-rated debt, and there would have to be significant losses before banks would experience any capital impairment.

Can you give us an update on the Real Estate Investment Trust (REIT) market?

Josh Barber, CFA: The first thing to note about REITs is that they aren't real estate in the traditional sense. They include real estate, but conditions in the broad real estate market are different than in the REIT market. First, REITs generally have low-levered, long-term fixed rate balance sheets — so a lot of the rate sensitivity does not affect a REIT's daily business, which is a good thing. Second, REITs tend to have much higher quality portfolios than what exists in the market. Third, REITs have access to what's commonly known as the four quadrants of capital — public and private, debt and equity. For example, if you own a building in downtown Columbus, Ohio, you pretty much have just private equity and private debt. You don't have the ability to do public bonds or joint ventures. On the other hand, REITs have the ability to tap into all four quadrants of capital, which tends to diminish their risk profile.

Finally, every property sector responds differently to these sorts of market events. For example, shopping malls and even some strip retail malls were badly impacted by the expansion of e-commerce. While malls have held up okay, the true winner from the e-commerce explosion has been industrial warehouses and related property types. Today, the office sector — especially central business district office space — is facing challenges, but suburban offices are starting to do well. As the work-from-home (WFH) trend continues, it may not be positive for office space overall, but other property sectors can benefit. One that comes to mind are data centers — more remote workers mean businesses have more remote data needs.

Can you elaborate on the status of the office space?

Josh Barber, CFA: No doubt office space is in the eye of the storm as it faces a secular change with the WFH movement. At Diamond Hill, we have had very limited investments in office over the years because it's a tough business and tenants have a lot of leverage.

The secular shift to remote working has been quick but it will take time to see the long-term effects. Even if companies choose to eventually reduce or eliminate office space, they are still committed to their leases. Most companies are not abruptly giving up 75% of their leases; perhaps instead they will change how they use the space in the interim.

Small tenants usually don't want to hop around from building to building, and they don't have the wherewithal to negotiate high capex packages. Additionally, most landlords don't enjoy dealing with small tenants because it's a labor-intensive business to lease out 5,000 square feet of a million-square-foot tower. That said, there are property owners who have the platforms and know-how to make it a good business model, especially in supply-constrained markets.

Another trend we might start seeing is a rise in office conversions to housing. For example, in big coastal cities such as New York, Boston, Washington, Seattle, San Francisco and Los Angeles, availability has been one of the biggest constraints on the housing side. Now you have a lot of empty office towers, and people need more places to live. While the conversion process is expensive and time consuming, and there isn't a ton of government support for this shift, it could be something we see down the road, assuming the exodus of city residents due to tax and crime issues slows down.

How is multifamily housing holding up in this environment?

Josh Barber, CFA: Multifamily housing is doing well, though more so on the public side than private. In 2021, for example, private players could buy multifamily properties using floating rate debt at very low cap rates (sub 4%). The assumption at that time would have been to invest, refinance in a few years, fix the property, improve your net operating income and then sell. That group is facing some challenges now because they are likely upside down on their current cash flows – their debt yield is higher than their asset yield. That isn't a problem on the public side where investors use long-term bond-backed financing and have low-cost, long-term financing on their balance sheets. So public investors are going to be in a good spot, especially because their balance sheets have low debt levels putting them in a good spot to buy as properties come to market.

What other real estate areas are holding up well today?

Josh Barber, CFA: The data center sector is doing reasonably well now, and the hyper-scalers also continue to grow their businesses.

Oddly enough, hotels are doing quite well. Hotels don't tend to be a defensive property type, and they've been very defensive for the last year. Perhaps it's a delayed pandemic effect. Or maybe it's just that finally some of the bigger hotels can flex their muscles from a branding perspective, but it's been interesting. I'm not saying to rush out and buy a lot of hotel investments today because, in my opinion, I still can't see how that sector is doing well in a weaker economic environment, but that's been the case so far.

And then there's self-storage, which has been the opposite of office. It has low capex and economies of scale, which means tenants don't have much leverage. It's a good business with solid franchises and low balance sheets. If the economy weakens their net operating income will weaken, but that's a phenomenal business to be in long term.

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