A Difficult Year For CRE, But Future May Be Brighter

By **Sally Davis, Michael Allen and Pete Scherer** (December 20, 2023)

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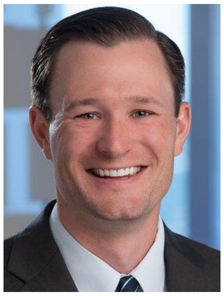
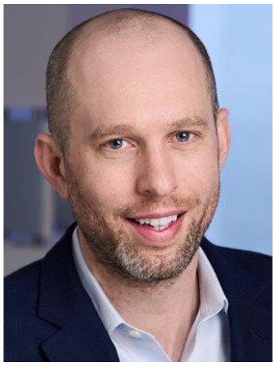


Michael Allen



Pete Scherer

2023 was, to put it mildly, a challenging year for the commercial real estate industry, marked by participant patience in the face of various headwinds ranging from shifting asset class-specific demand trends to more macro drivers like evolving regulatory landscapes, war and geopolitical realignment, and a whipsaw shift in fiscal policy.

Yet despite the obstacles, business continues, and some of the noteworthy events and trends from 2023 leave us cautiously optimistic for the year ahead.

The primary theme of 2023 was interest rate uncertainty.

While the majority of interest rate hikes undertaken by the Federal Reserve during its current era of fiscal tightening occurred in 2022, contrary to some dovish predictions, in 2023 the Federal Reserve either increased or held the federal funds rates flat at each of its meetings, resulting in an overall shift in the Federal Reserve's target rate from 4.25%-4.50% at the start of 2023 to 5.25%-5.50% today.

2023 also featured heightened scrutiny by bank regulators on commercial real estate lending, which was exacerbated by the collapse of Silicon Valley Bank and Signature Bank in March and JPMorgan Chase & Co.'s acquisition of First Republic Bank in May.

This scrutiny, in turn, caused banks to tighten their commercial real estate lending practices significantly, including constrictions in the availability of warehouse lines that provide back leverage to nonbank lenders, which led to fewer and more onerous financing options for borrowers.

The challenge of obtaining acceptable third-party financing terms, coupled with the ongoing interest rate uncertainty and lingering effects of inflation, left buyers, sellers and lenders at an impasse, unable to agree upon property valuations.

Complicating matters further were various political and geopolitical events with tangible impacts on deal making across the U.S. real estate market that left some market participants unsure of the road ahead. And the normal drivers of market uncertainty, namely the vagaries of consumer preference and asset-specific demand drivers, remain ever present.

Looking forward to 2024, our expectation is that interest rates will continue to be the 800-pound gorilla dictating the overall commercial real estate climate, but as those rates start to level off, or potentially drop.

And as borrowers come to terms with the new normal of "higher for longer," our view is that market participants will once again have sufficient confidence to resume more normalized investing activities, whether through financing, selling, acquiring or foreclosing, or a combination of all of the above.

We caution, however, that interest rates weren't the only story in 2023, and we do not anticipate they'll be the only story in 2024. That specter of asset-specific demand trends, political and geopolitical events affecting regulatory climate, supply and demand, and investor base, continue to loom large, and we anticipate will continue to have direct impacts on real estate investing in the year to come.

Financings

The financing bazaar that created strong returns for buyers and developers in 2021 and the early part of 2022 closed abruptly in the second half of 2022 and into 2023, when borrowers found themselves thrust into a new era in which fewer lenders were extending credit, and those that were demanded highly lender-favorable terms and pricing.

The doldrums that beset the financing market in 2023 were driven by several factors, including rising interest rates that resulted in increased costs, intensified regulatory scrutiny on lending — including capital cushions and reserves — particularly for riskier loans, and the regional bank collapses of March, which were driven in large part by the Federal Reserve's rapid increasing of borrower costs and, in turn, lenders' cost of capital as compared to their asset base.

Construction loans have been particularly difficult for borrowers to secure over the last 12 months, with some lenders pausing their construction loan origination programs entirely for periods of the year.

For borrowers with existing debt outstanding, 2023 saw its share of short-term workouts and modifications of troubled loans.

Consistent with the historical trend of banks being reluctant to take real estate owned assets onto their balance sheets, lenders have been open to negotiating workouts where there is a reasonable commercial case to do so and in doing so, have also been scrutinizing nonrecourse carveout, completion and carry guarantees for possible opportunities to enforce against guarantors in the event workout negotiations are unsuccessful.

But given the volume of distress in the market, especially in the case of office buildings, this year was also marked by more borrowers making the decision to hand back the keys to their lender. This, in turn, has directly informed how parties are approaching new financings, with a renewed focus on negotiating upfront comprehensive tender and deed-in-lieu terms.

Given the constriction of the traditional mortgage lending industry — coupled with the excess of troubled assets in the markets — alternative financing structures, such as mezzanine debt and preferred equity, are becoming more popular.

These structures, with their higher yield and shorter path to enforcement, are attractive to lenders and opportunistic investors and solve an immediate and pressing need for borrowers looking for capital, albeit at a high cost.

For loan originators — whether banks, mortgage real estate investment trust, or private credit funds — 2023 saw a noticeable slowdown in the availability of back leverage, e.g., repurchase facilities and note-on-note financings, as compared to the frenzied activity of prior years.

Despite that slowdown, there were some interesting new trends this year that we expect to gain traction in the coming months. For example, 2023 saw major banks provide increased flexibility in financing nonperforming loans, including providing continuity of financing upon a real estate owned property.

Traditionally, such real estate owned permissive financings had been limited to single asset facilities from middle market lenders. We have also seen an increase in major banks offering back leverage for warehouse facilities and note-on-note financings, i.e., financing another lender's interest in a warehouse or note-on-note facility instead of traditional loan assets, a trend we expect to continue given ongoing scrutiny of banks' direct real estate lending exposure.

The good news is that the tightening of activity by traditional banks has created an opportunity for other institutional capital providers, in particular, private debt funds, which have emerged as potentially the next great funder of real estate if the constriction in originations by banks continues.

While we expect this private lending activity to continue in 2024, we do note that there has recently been increasing attention paid to regulating these private lenders in light of concerns that private credit taking up the slack from more traditional lenders is merely a form of regulatory arbitrage masking, but not eliminating, systemic risk.

Increased regulation on private credit at this stage, however, is merely speculatory and will surely be affected by the upcoming federal elections.

Asset Trends

The headwinds suffered by the real estate industry in 2023 were not borne evenly across asset classes, with multifamily, industrial, data centers and retail performing relatively well as compared to other sectors that were hit hard by the pandemic and persistent work-from-home or hybrid models, e.g., office buildings.

In the case of multifamily buildings, higher interest rates for traditional residential mortgages coupled with depressed supply, also driven by high interest rates, pushed individuals out of the market for homeownership and toward renting, which helped to support multifamily demand.

Even in the multifamily sector, however, investors are moving cautiously given that pricing remains high and that a sense that consumer capacity for additional rent increases may have been reached.

In particular, we are seeing the multifamily sector slow down in certain geographies, e.g., San Francisco, Houston and Atlanta, where interest rates and financing costs have far outpaced rent increases.

In the case of the industrial sector, strong e-commerce demand has continued to drive the need for industrial logistics assets and recent policies from Washington, D.C., have fostered the near-shoring trend to further support pricing.

In the case of data centers, the artificial intelligence boom has driven a surge in demand, as have geopolitical trends placing ever greater emphasis on data security. Data center construction, however, is constrained by power availability, which may keep prices high and supply constrained in 2024.

We also saw steady deal activity in asset classes once considered niche, including marinas, cold storage, self-storage, RV storage and other outdoor storage models. We expect the market's interest in these assets to continue into 2024.

In contrast with the better performing sectors, office properties continued to see depressed demand and deal activity with sellers unwilling to sufficiently lower valuations to incentivize buyers, particularly given the elevated financing costs previously discussed.

Class A offices in prime geographies were the strongest performers suffering minimal impacts on tenant demand, while class B and C office space struggled significantly, especially in downtown areas.

While office-to-residential conversions were a hot topic of discussion at the beginning of 2023 — and seemed to offer a light at the end of the tunnel for some — such conversions have yet to gain significant traction and faded in appeal due to the expense and practical difficulties that most conversions present.

Life science facilities were another asset class that saw some softening in demand and deal activity. The life science slowdown was driven by a confluence of factors, including rising cost of capital across the industry, e.g., limiting available research and development dollars, waning pandemic-era demand, and significant new capacity coming online.

Equity and Joint Ventures

The headwinds felt across the commercial real estate market hit particularly hard for equity investors, many of whom found themselves with assets underwater and their equity fully wiped or significantly impaired.

Decreased demand for real estate in certain sectors, fewer loan originations, higher cost of capital, depressed prices in other sectors and general malaise about the U.S. real estate market led many market participants to conclude they were overallocated to real estate.

As such, equity investors and their operating partners were forced to turn inward, focusing on asset management and preservation in the hopes of preserving their most promising assets for better days and eventual exits.

We also saw some opportunistic transactions with existing joint venture partners providing rescue capital at preferential terms, and new partners investing to provide additional liquidity through co-investments and other hybrid models.

Of course, such a climate also lends itself to capital and operating partner disputes: As the saying goes, "the tide has gone out," with operating partners and their day-to-day management of joint ventures and exposure to loan guarantees now under a bright spotlight.

Given the tough fundraising environment, we have seen some capital partners seek to act as a safe harbor for operators by expanding their relationship beyond the narrow confines of traditional joint ventures.

This trend toward vertical integration has been driven by capital partners seeking to tie up first-class operators and their deal pipelines and improve alignment, e.g., by taking a portion of the operating partner's management vehicles or negotiating preferential terms to invest in the future either in, or alongside, operating partners.

Through these structures, capital partners can participate in their operating partner's full business, including from economic, reporting and governance perspectives.

These structures have not only improved capital partners' deal pipelines, but also improved alignment between capital partners and operating partners, with traditional limited partners (i.e., capital partners) now absorbing a portion of the general partner economics (i.e., promote and co-investment), which may have historically been syndicated to third-party investors.

Operating partners do give up a degree of control and economics when entering into one of these emerging structures as compared to a traditional joint venture, but having a deep alliance with a well-resourced and well-respected capital partner during times of market uncertainty and dislocation can provide meaningful protection and comfort to operating partners.

Conclusion

To sum up 2023 in a word, we would say "uncertainty."

While only cable news commentators will offer definitive predictions for 2024, we note that pressure is building for market participants to place their bets with pandemic-era loans continuing to face maturity deadlines, pandemic-era policies and drivers fading away, and recent signs that the Federal Reserve's cycle of interest rate raising may be nearing its end.

In short, while no one can predict with certainty 2024's winners and losers, we do offer a cautious prediction that the gridlock that marked 2023 will fade and deal volume will increase throughout 2024 and into 2025.

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