CRE Debt Market: "Survive Until '25" Emerges as a Theme Among Lenders Facing Dual Threats of High Rates and Maturities

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A mounting list of uncertainties and risks has been piling up for CRE lenders, but one clear sentiment has percolated since rates surged in the second half of the summer: it will likely take the next year to work through current challenges until a recovery can fully take hold. In other words, for many, the mantra has become "Survive until '25." The data seem to support that sentiment, and 2024 looks to be a year of caution and delaying tactics for lenders.

Rates, volume, and capacity issues are at the heart of challenges. It has been a little over a year since the summer of 2022, when the Fed embarked on a campaign to fight inflation, partly through dramatic rate hikes. The most direct and immediate impact to CRE was, and continues to be, a gap in bid-ask spreads on property sales, which roiled transaction and lending volume. Meanwhile, a good chunk of CRE loans have matured or will mature over the course of 2023 and 2024, with mortgage rates between 100 and 200 basis points (bps) higher than in 2019. In addition, lending capacity is much lower given stalled trading activity and loan churn. Since the mini crisis in the spring, banks have some added pressure because of lower deposits and greater need for capital reserves.

Credit is stable so far. With gridlock in market activity, higher costs of capital, and softening property valuations, one would expect there to be credit issues with the $728 billion of CRE loan maturities in 2023 (16% of the US loan universe). However, about 75% of those maturity dates have passed. The credit issues so far have been relatively minor and limited to a few CRE asset types (mostly office), and those loans are in some stage of workout rather than liquidation. There has not been a broad rash of fire sales nor big jumps in loan delinquencies or charge-offs. In the vast majority of cases, strong property fundamentals helped borrowers find loans or various forms of bridge financing among a diverse set of CRE lenders and other capital resources.

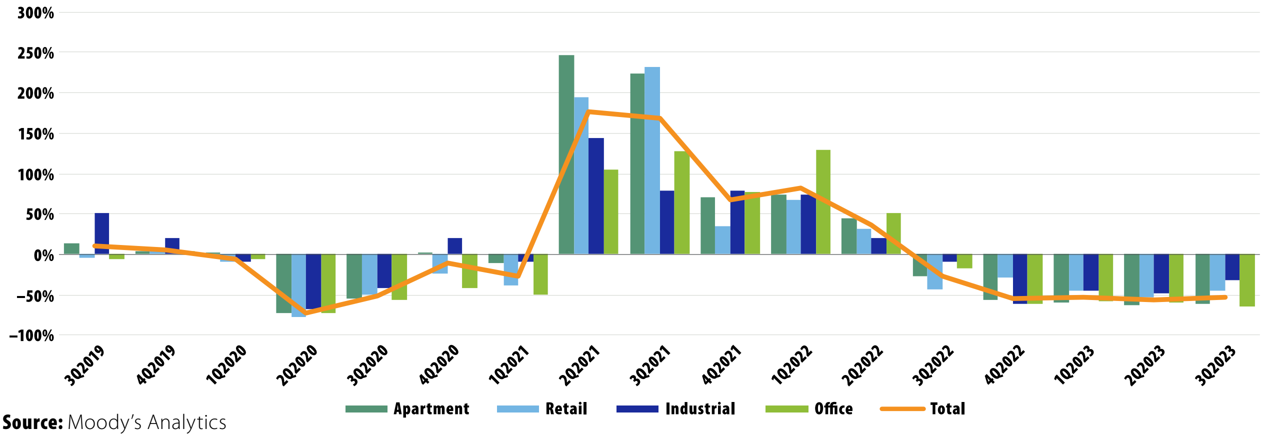
Sticky rates are a wrench in the gears, and things are likely to get worse before they normalize. Even though core inflation has been cooling steadily for a year, key segments of the economy have resisted the Fed's efforts. Stronger-than-expected recent economic data and lurking risks of renewed inflation have the Fed committed to a "higher-for-longer" stance on rates, even though the Fed is in a wait-and-see mode after the July hike. In addition, despite the Fed pause, prices have fallen in the long-duration bond market, pushing the ten-year Treasury to more than 5% on October 19. All this makes for less rate relief in 2024 than many had hoped. Many property owners who are able to will continue to push off selling or refinancing, and issues with volume and limited capacity will remain.

More pain is likely before the healing. Ongoing elevated rates will continue to put pressure on property values, especially on asset classes with very low cap rate risk premiums, such as multifamily. Loan delinquencies will rise, especially on the $659 billion more of loans set to mature in 2024. More troubles are likely than in 2023 so far, which were mostly concentrated in office and mall properties, although some distress has also been bubbling up in areas of the multifamily sector. More delinquencies, extensions, and modifications are likely in those segments, and depending on the general health of the economy and consumers, retail, hotel, and industrial may be impacted. The good news is that supply-demand fundamentals for CRE space markets remain steady, and so far, signs suggest that 2025 may be a healthy recovery year, with a still somewhat limited likelihood of major recession.

Interest Rates and Trading Activity Signal a Slow Return to Normal

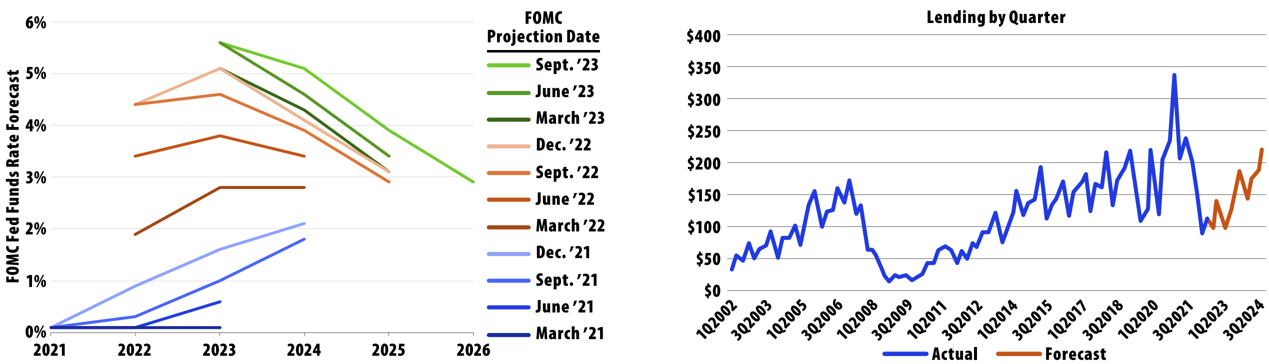
The bid-ask spread between CRE property buyers and sellers has not been this far apart for this long since the great financial crisis; the ten-year Treasury bounced from around 2% in the spring of 2022 to 5% in the fall of 2023. Buyers needed to reset their offers to accommodate 100 to 200 bps more of mortgage rates and a reset of going-out cap rates. Commensurately, Q3 is the fifth consecutive quarter of significantly lower year-over-year trading volume, as Exhibit 1 shows. As long as rates stay elevated, most sellers will continue to delay and suppress trading activity.

Exhibit 1: Year-Over-Year US CRE Transaction Volume



Source: Moody's Analytics

Exhibit 2: MBA Lending Volume Forecast and Fed Funds Rate Forecasts



Sources: Federal Reserve, MBA (October lending volume forecast)

Sales volume is of course a major driver of lending volume. Thus, alongside other frictions in the lending market, lending volume is also likely to have a big down year. As of October, the Mortgage Bankers Association (MBA) estimated that total CRE lending in 2023 will be $442 billion, down 46% from 2022.

Lending volume is also strongly tied to the rate situation. In July, the MBA forecast a strong 2024, with volume returning to $856 billion, 5% over the 2022 lending total. However, the ten-year Treasury jumped rapidly—about 150 bps higher right after the MBA's July forecast.

As the summer wound down and fall arrived, stronger-than-expected data on jobs, wages, and consumers came out; oil prices drifted higher to around $90 per barrel; the federal deficit continued to balloon; and the bottom fell out of long-duration bond prices. The Fed shifted its September forecasts to a resounding "higher-for-longer" stance (left-hand chart in Exhibit 2). The MBA followed suit and shifted its 2024 expectations to $559 billion, only 26% off a very low 2023 (right-hand chart in Exhibit 2).

This pushes a robust recovery out two to four quarters, which makes sense relative to the past two cycles. After the financial crisis, year-over-year lending growth was negative in the following nine quarters and five quarters after the COVID-19 pandemic. This cycle is about to record its fifth down quarter, and given the relative severity, it makes sense that it would be longer than the COVID cycle and shorter than the financial crisis cycle.

The Moody's Analytics baseline forecasts support the very gradual normalization of the ten-year Treasury over 2024, as illustrated in Exhibit 3. This was generally the case before the events of the past few months, but this view is now strengthened. If short-term rates are held at an elevated position, there will be less support for ten-year

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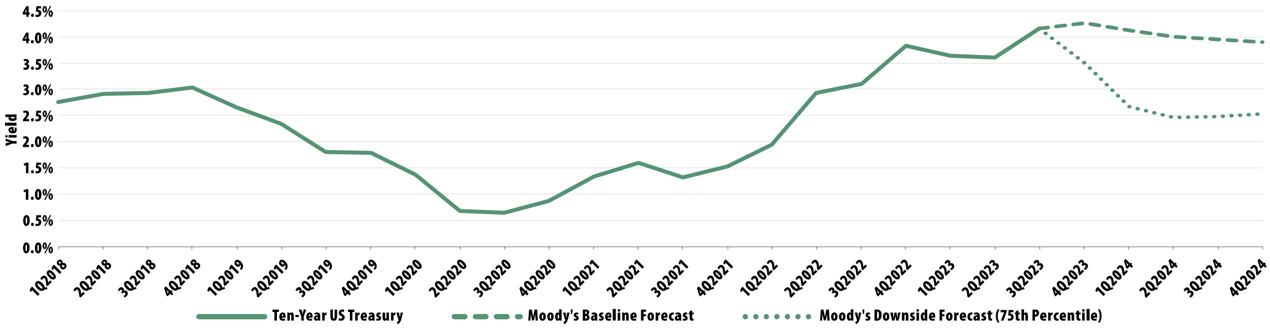
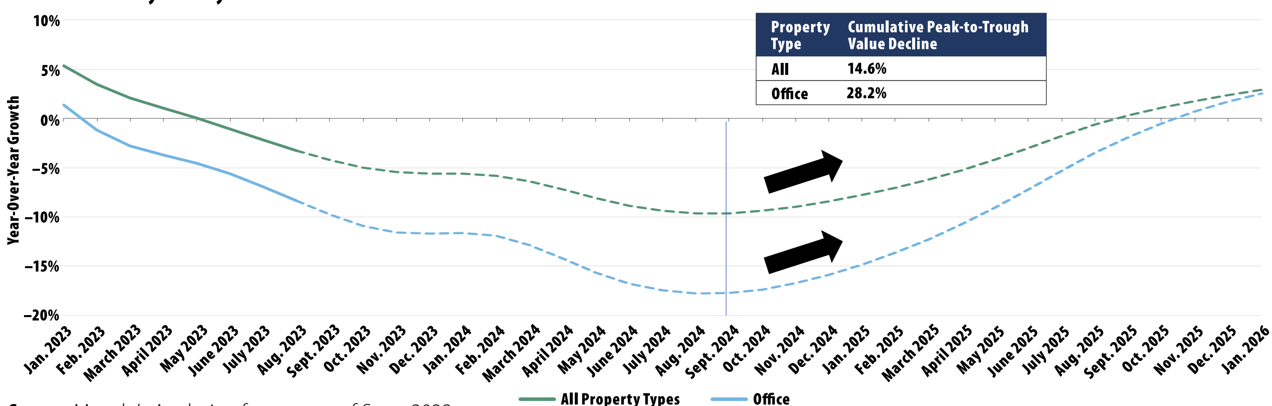
Exhibit 3: Moody's Analytics Ten-Year Treasury Yield Forecast Scenarios



Sources: Fed, Moody's Analytics; forecast as of Sept. 2023

Exhibit 4: Moody's Analytics CRE Price Index and Forecasts



Source: Moody's Analytics; forecast as of Sept. 2023

bond prices at yields much lower than they currently are in the near term.

Meanwhile, the Moody's Analytics downside scenario, which includes a recession, has risk-free rates falling to around 2.5%, which would be a mixed blessing because some money supply issues would be solved. However, there would be ramifications on the demand side for rental space and property acquisitions.

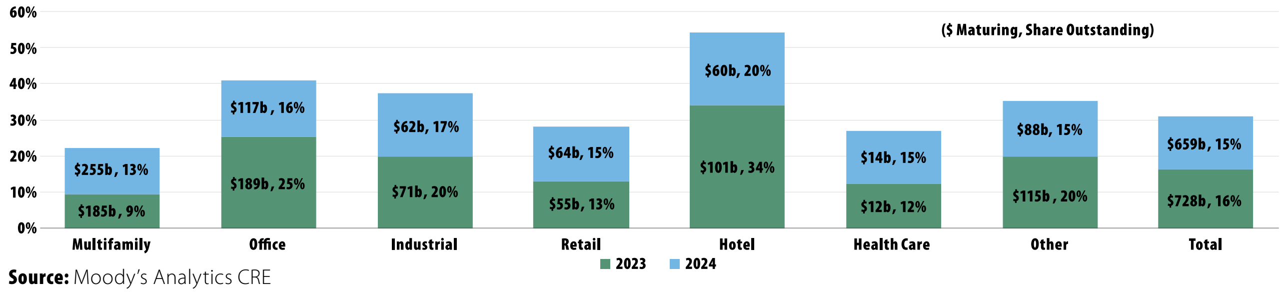
The inverted yield curve, in which short-term bond yields exceed those of long-term bonds, is worth mentioning in the recession conversation, although it's a symptom not a cause. The current inversion has lasted 19 months (on the two- to ten-year bonds), which is longer than all but one month (the one just before the financial crisis) since 1978. Recession isn't Moody's Analytics' baseline expectation over the next year, but the inverted yield curve has been eerily predictive, and if a recession is avoided before 2025, it would be the first time since the 1960s that a major inverted yield curve did not signal a recession.

The market turmoil has hit average property values to some degree, and we expect that to continue until roughly this time next year. Moody's Analytics' forecasts on the CRE Price Index show that declines for office properties are expected to hit their trough in Sept. 2024, after declining 28% peak to trough, as Exhibit 4 shows. There is less differentiation among the other property types; they are all close to a roughly 15% expected peak-to-trough decline. Again, the recovery is expected to broadly start for prices when rates slowly normalize to some degree.

Credit Shows Resilience, but Working Out Maturities Will Take Time

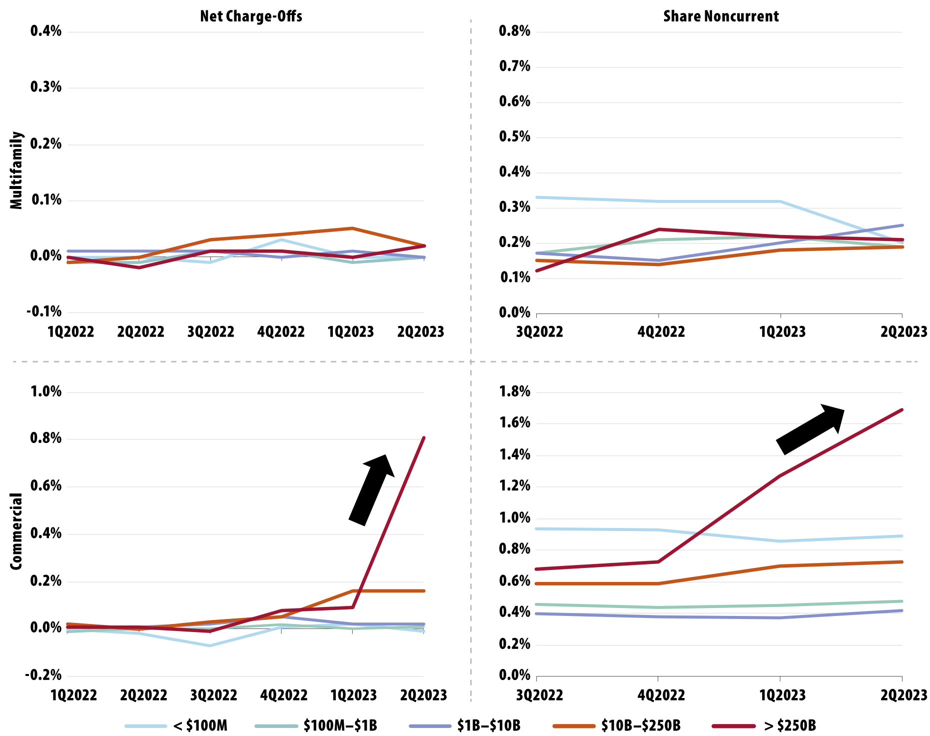
A significant amount of loan maturities still loom over the next year. We are now past the majority of maturities in 2023, and the credit performance of most loans has held steady, but as the high-rate environment and limited trading activity drag on, more troubles will manifest. Another $659 billion (15% of the total $4.5 trillion

Exhibit 5: US CRE Loan Maturity Schedule Through 2024 by Property Type



Source: Moody's Analytics CRE

Exhibit 6: Bank Delinquencies and Net Charge-Offs by Bank Size



Source: FDIC

outstanding CRE debt at the start of 2023) is coming due in 2024, as Exhibit 5 shows.

The maturity profile of banks roughly matches that of CRE overall, with a significant share of loans that already matured in 2023. As Exhibit 6 shows, that showed up in credit only in a limited way—commercial loan net charge-offs among large banks. Delinquencies didn't rise much, but larger banks that have more regulatory oversight and capital requirements moved more quickly to off-load certain loans, generally large office loans or portfolio loans.

CMBS were a somewhat different story than banks in that there isn't the same concept as charge-offs, and the maturities were more muted because of significant defeasance and the contractual ability of large-loan-floater borrowers to extend their loans past initial maturity dates. Similar to banks, most of the issues were centered around offices, and as Exhibit 7 shows, both the conduit and the single-asset / single-borrower loan office delinquency rates rose to around 5%. Although this isn't historically very high, more delinquencies are likely to come, with more loans maturing into an environment with higher rates, softer fundamentals, and a tight credit market.

Looking at the payoff rate of maturing CMBS loans shows where the refinancing troubles are. Payoff rates were on par with historical rates, other than for regional mall and office. The hotel sector, the most procyclical of CRE sectors, is starting to see some payoff issues, but the delinquency rates haven't risen demonstrably.

Maturing office loans in 2023 have had the lowest successful payoff rate of any asset class, at 31.2% as of September, as shown in Exhibit 8. Of those that haven't been paid off, roughly 40% are still meeting their contractual mortgage payments.


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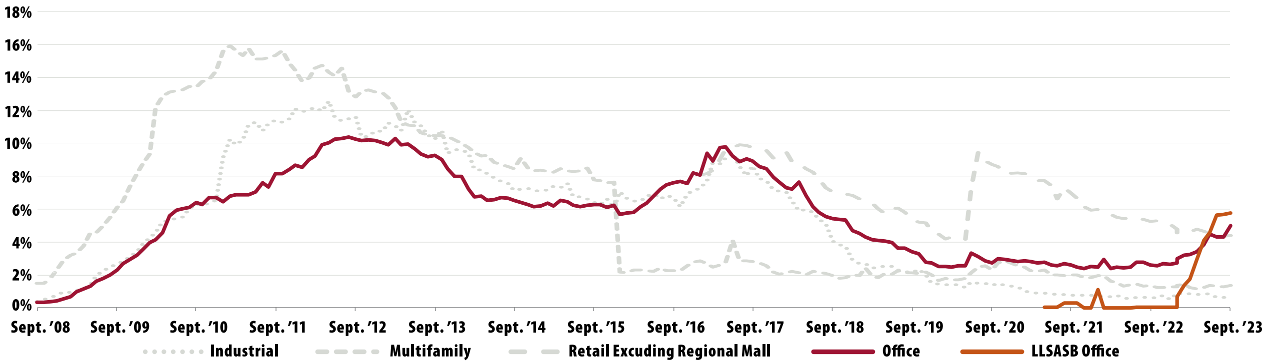
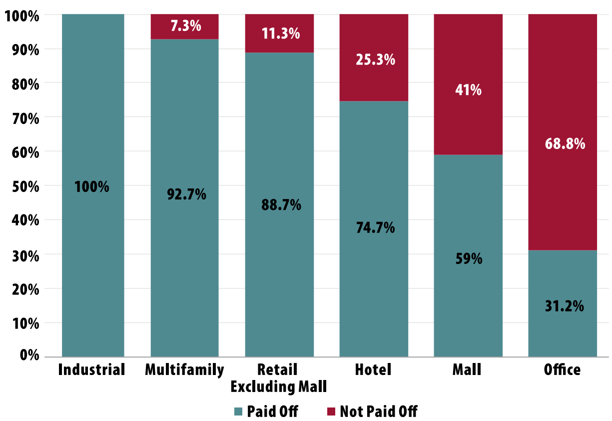
Exhibit 7: CMBS Loan Delinquencies



Sources: Trepp, Moody's Investors Service

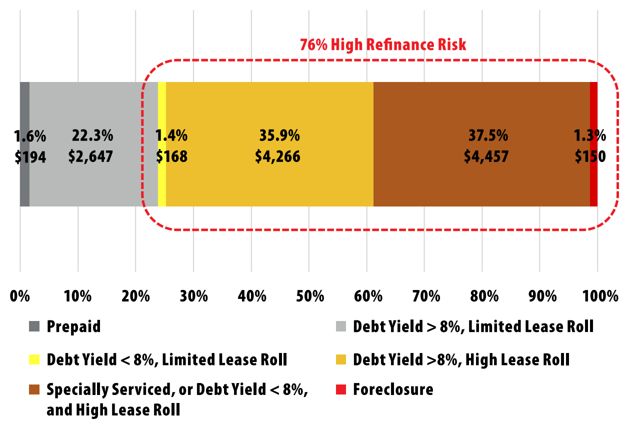
Note: All data shown are for conduit CMBS except the LLSASB Office series.

Exhibit 8: CMBS Loan Payoff Rates by Property Type



Source: Moody's Analytics CRE

Exhibit 9: Office Loan Maturity in Next 12 Months



Source: Moody's Analytics CRE

Few differentiating factors indicate whether an office loan will fail to refinance in this environment. First is the 8% debt-yield threshold. Generally, for anything below that level, a borrower wasn't able to find a takeout loan or buyer. Next is high near-term lease rollover. Lenders and buyers are weary of rent-roll risk, as the future of office demand remains unclear. Finally, size matters. Larger loans, such as those that may typically be held at larger banks, are less likely to find a takeout lender because of the concentration of risk, whereas smaller loans have had much greater success at refinancing.

Considering those factors, we looked at the next 12 months to see what's next for office loans. More than 75% have characteristics that put them at high risk of not being able to refinance, as Exhibit 9 shows.

Many of these maturing loans will see extensions, modifications, and various delay tactics as lenders wait for the CRE capital markets to stabilize. However, these loans will need to be worked out, and some will be sold into a soft market, further depressing prices. Whatever the scenario, 2024 will likely be rocky for lenders as they buckle up and "survive until '25." ■

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