COHEN & STEERS

The commercial real estate debt market: Separating fact from fiction

Recent stress in the banking sector is not a systemic commercial real estate (CRE) debt problem, and the risk of loss to lenders likely will be smaller than many believe.

by **Rich Hill**, Head of Real Estate Strategy & Research

KEY TAKEAWAYS

Commercial real estate debt is not a systemic risk for banks

Banks outside of the top 100 based on total assets have financed 15–20% of all CRE mortgages, diversified across 4,600 institutions nationwide, significantly mitigating risks.

This is not residential subprime 2.0

Debt service coverage ratios indicate loan term default risk is low and underwritten loan values are low, especially after considering the rise in property values over the past 10 years. In fact, we believe CRE mortgages as a group are underleveraged.

Office sector is at risk

In our view, the greatest risk is in the office sector, where owners may need to inject ~30 to 40% more equity into their properties to maintain healthy LTV ratios upon refinancing.

Executive Summary

How big is the U.S. CRE mortgage market? The market consists of $4.5 trillion backed by income-producing properties and $470 billion of construction loans. Banks hold less than 40% of income-producing loans and around 45% of all CRE mortgages.

What is the banks' CRE exposure? The 25 largest banks by total assets hold 13% of all CRE mortgages, and their exposure as a percentage of total assets is small at ~4%. Regional and community banks hold 31.5% of all CRE mortgages, and their exposure is much higher at 20% of total assets.

How important are the smaller banks? The 4,600 banks outside the largest 100 hold 15–20% of all CRE mortgages. We believe this diversity is underappreciated and helps mitigate risk. They finance smaller properties in smaller markets rather than larger core properties owned by institutional investors.

How much CRE mortgage exposure is office? Office receives the most attention, but it represents just 17% of income-producing property loans vs. 44% for multifamily. 16% of loans mature in 2023, more than a quarter of which are office.

What is the outlook for property values? We anticipate a 20–25% decline as cap rates adjust from higher interest rates, tighter lending conditions and slowing fundamentals. Construction loans (less than 10% of all CRE mortgages) are likely to see the most severe pullback in lending. While this will impact GDP, construction companies and builders, it is a net positive for property valuations as it reduces new supply.

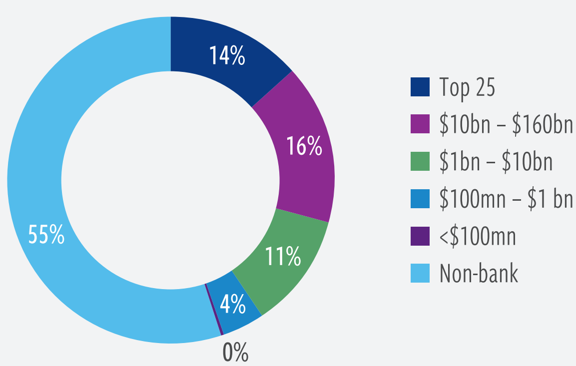
Do you expect lenders to take losses? We anticipate increases in delinquencies and distressed sales, but the risk of loss to CRE lenders may be smaller than many believe. Lending standards are more conservative than before the GFC, with loan-to-values of 50–60% and debt service coverage ratios of >2.0x. CRE property prices would need to fall 40–50% before the loans would realize losses.

What are the risks? Given the rise in property valuations over the past 5–10 years, we believe the CRE mortgage market overall is underleveraged. But there will be some restructurings and foreclosures. And some property types, such as office, will require borrowers to inject equity to refinance. Analysis of 3,000+ office loans securitized in CMBS suggests that the new equity could be 25–40%. Green Street, a CRE research firm, estimates office property values are down almost 30% from their peak. In other words, borrowers must put in additional equity consistent with how much property values have fallen. The most significant risks may be in loans originated in the past several years at peak valuations, especially if they were short term or variable rate.

EXHIBIT 1

Smaller banks hold a relatively modest share of total CRE loans

CRE loan exposure by bank size (%)



At March 10, 2023. Source: Mortgage Bankers Association, Cohen & Steers. **Data quoted represents past performance, which is no guarantee of future results.** There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend might begin. See end notes for additional disclosures.

How big is the CRE mortgage market?

Bank closures and aggressive moves by financial regulators to prevent contagion in the banking system have raised questions about the health of the U.S. commercial real estate (CRE) debt market. Our analysis suggests the magnitude of the problem and its implications have not been closely examined and are misunderstood.

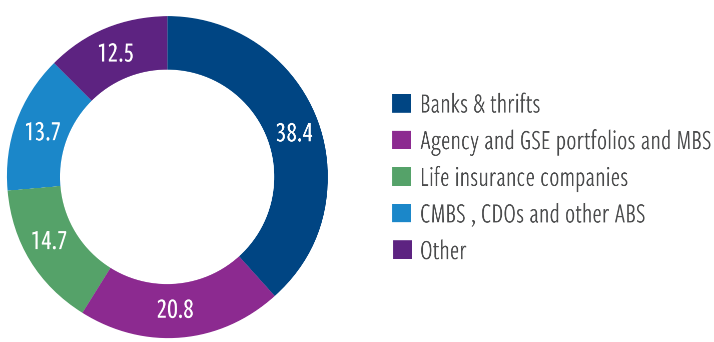
The CRE mortgage market for income-producing properties is roughly $4.5 trillion, based on Mortgage Bankers Association data analysis. There are also $467 billion of construction loans, and the FDIC classifies $627 billion of owner-occupied property loans as commercial mortgages. But we think these should be excluded given their different risk profile. Senior unsecured bonds, revolvers and warehouse facilities also are financing alternatives, but mortgages are the primary source of financing for commercial real estate.

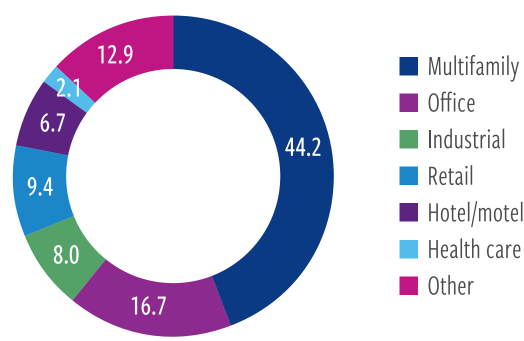
Various lender types provide capital to the sector, with banks & thrifts and government-sponsored enterprises (GSE) having the greatest share of the lending market at ~38% and ~21%, respectively. Although office sector loans (16.7% of the total) receive the most attention, multifamily loans represent the most significant exposure (~44%); other important sectors include retail (9.4%) and industrial/warehouse (8%).

EXHIBIT 2

Parsing the $4.5 trillion CRE mortgage market

Loan exposure by lender and property type (%)





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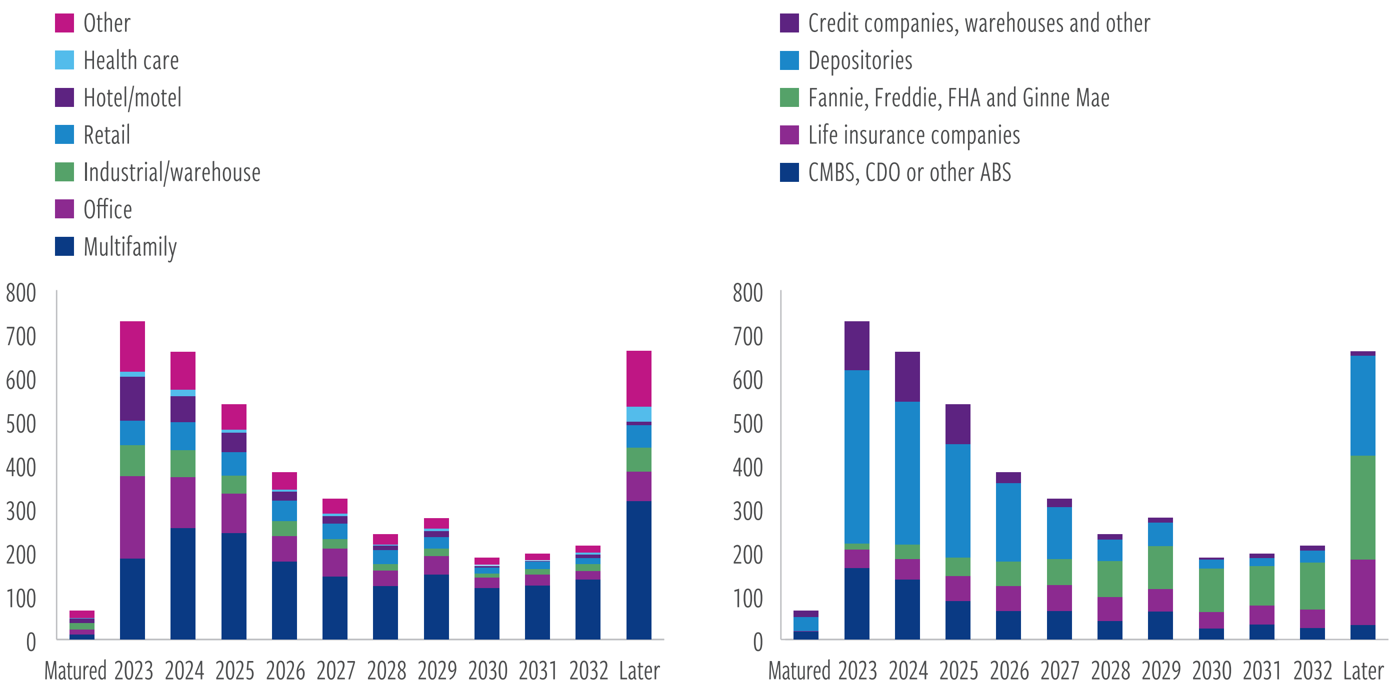
How much debt is maturing?

The Mortgage Bankers Association recently released a survey estimating the maturity profile of all commercial and multifamily mortgages, including those held by banks and non-bank lenders. They calculate $728 billion (16% of total loans) will mature in 2023, with another $659 billion (15%) maturing in 2024. Hotels/motels have the largest share of their loans maturing in 2023 (34%), followed by office (25%). Multifamily has the smallest share of outstanding mortgages maturing this year (9%). Among capital sources, 26% of the outstanding balance of loans held by credit companies, warehouses and other investor-driven lenders will mature this year, as will 23% of the balances held by depositories and 22% of those held in CMBS.

EXHIBIT 3

Office is the most exposed property sector in the near-term

Debt maturities by property type and lender type ($)



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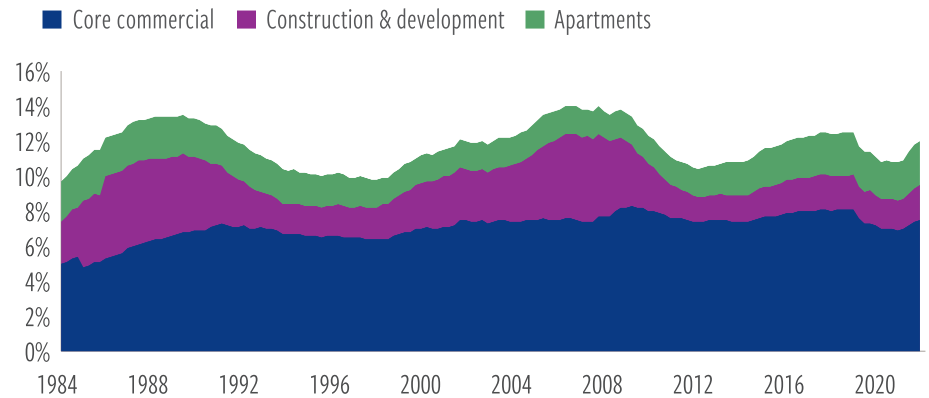
How important are the banks?

Based on the FDIC's Quarterly Banking Profile, at the end of 2022, banks had $1.8 trillion of core commercial loans, representing 7.5% of total assets (including $672 billion of owner-occupied loans). Multifamily residential loans stood at $598 billion (2.5% of total assets) and construction & development loans were $467 billion (~2%). While the total amount of CRE mortgage debt on bank balance sheets has grown over the past several decades, the percentage relative to total bank loans has generally remained in the 10% to 14% range.

EXHIBIT 4

Bank CRE loans generally backed by cash flow positive properties

Commercial real estate loans as a percentage of total bank loans (%)



At December 31, 2022. Source: FDIC, Cohen & Steers.
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Smaller banks hold the majority of CRE loans, but their diversity is underappreciated

The MBA recently released a study of CRE exposure across more than 4,700 banks. Our analysis of this data shows that the top 25 banks (as measured by total assets) own 65% of loans of all types, but only ~13% of the $4.9 trillion in total outstanding commercial mortgages, across all lender types (Exhibit 5). Only 4.3% of their total loans are CRE; we estimate only 50bp of total assets are office loans.

While regional and community banks own more than 70% of the loans held on bank balance sheets, they own only 31.5% of outstanding commercial mortgages. These smaller banks have an average CRE exposure of almost 20% of total assets, and only 3% of total assets are office loans. A handful of smaller banks have greater than 50% exposure to CRE, with some standing at more than 70%.

There is a long tail, as banks that rank 101 to 4,715 by total assets hold 15–20% of all outstanding commercial mortgages. We believe this diversity is underappreciated and helps to mitigate risk. They finance smaller properties in smaller markets rather than larger core properties owned by institutional investors.

EXHIBIT 5

Smaller banks have higher relative exposure to CRE mortgages

Loans as a percentage of total bank assets

Bank size	# of banks	% of total assets	CRE as % of total	Office as % of total	% of total bank CRE	% of total CRE mortgages
Top 25	25	64.9	4.3	0.5	30	13
$10bn – $160bn	135	20.6	16.2	2.0	36	16
$1bn – $10bn	829	9.7	24.3	3.2	25	11
$100mn – $1bn	2,965	4.6	18.3	2.6	9	4
<$100mn	761	0.2	7.2	1.1	0	0
Total	**4,715**	**100**	**9.3**	**1.2**	**100**	**45**
Region & community	**4,690**	**35.1**	**18.6**	**3.0**	**70**	**32**

At March 23, 2023. Source: FDIC, Cohen & Steers.
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How much will property prices decline?

Property valuations are driven by a combination of 1) demand for space, 2) supply of properties, 3) the cost as well as the availability of credit, and 4) investor return expectations. The first two factors influence net operating income growth and the amount of capital expenditures necessary to generate that growth, while the third factor influences the levered return.

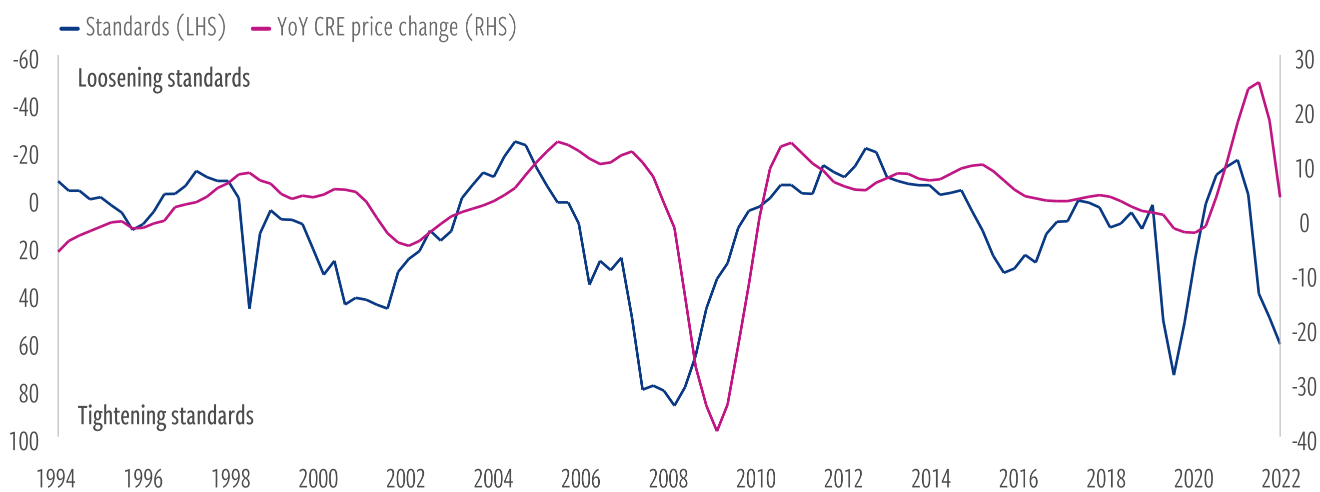
We expect a pullback in the availability and cost of credit, on top of higher return expectations, which will impact valuations. Indeed, a strong relationship exists between loan growth and CRE property prices (as measured by the NCREIF ODCE index). There is an even tighter relationship between lending standards (based on the Federal Reserve's Senior Loan Officer Opinion Survey) and the NCREIF ODCE index (Exhibit 6).

The most severe pullback will likely occur in the riskiest lending, including construction loans. First, remember this represents less than $500 billion of the total outstanding mortgage debt. Second, the reduction in construction loans 1) will have a GDP impact, 2) impacts the range of the construction ecosystem, but 3) importantly, is not a negative for property values. In fact, we view it as a positive as it reduces the supply of new properties, which should help mitigate price declines.

EXHIBIT 6

Tightening lending standards are a leading indicator for CRE

Lending standards and changes in commercial real estate prices



At December 31, 2022. Source: NCREIF, Senior Loan Officer Opinion Survey, Cohen & Steers.
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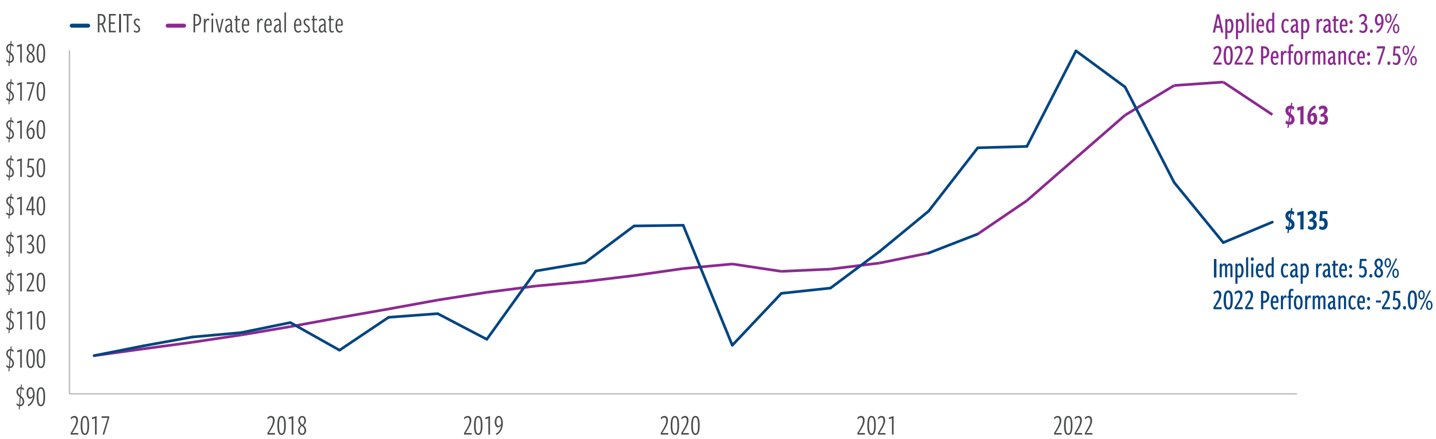
We previously argued that a 10–20% decline in CRE property prices was reasonable to expect, and we now believe it could be 20–25%. This was already in process prior to recent events in the banking system, as the NCREIF ODCE index fell nearly 5% in 4Q22, the first decline since 2009 and the second-greatest decline since 1978. While the NCREIF ODCE index was still up 7% last year, Green Street estimates that valuations are down 15% from their 2022 peak, and CoStar estimates a 7% decline.

We believe the listed REIT market is already pricing in this weakness, as the sector declined 25% in 2022 (Exhibit 7). The listed REIT market is trading at a 5.8% implied cap rate, 190bp higher than the 3.9% applied cap rate of the NCREIF ODCE index.

EXHIBIT 7

Listed real estate typically leads private valuations

December 31, 2016 = 100



At December 31, 2022. Source: Bloomberg, Nareit, NCREIF and Cohen & Steers.
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What is the risk of loss?

The risk of loss to lenders on commercial real estate may be smaller than many people think. This is because LTVs of 50–60% help mitigate the risk of declining property valuations, especially since the properties themselves are still generating cash flow. Said differently, if the valuation of a property declines by 40% and the LTV is 50%, then the loan still has a 10% cushion from loss. In fact, the entirety of the commercial mortgage market may be underleveraged, given lower cap rates, but also underappreciated annual NOI growth that averaged 4.5% during the past decade. The combination of these two factors has led to significant increases in property valuations over the past 5–10 years.

Exhibit 8 illustrates the cumulative change in property valuations from various periods to the present and the resulting impact on effective LTVs. When property valuations rise, the effective LTV declines and vice versa. For instance, commercial real estate valuations are up nearly 42% since the end of 2011, even after the 15% decline from their peak in early 2022.

EXHIBIT 8

Rise in property values reduces effective LTVs

Loan-to-value analysis assuming initial 50% LTV

	All properties	Apartment	Health care	Industrial	Lodging	Mall	Office	Self storage	Strip center
Cumulative property price appreciation									
Since 2012	41.9%	51.4%	34.2%	165.8%	32.0%	-16.2%	5.4%	195.5%	29.9%
Since 2013	34.2%	43.2%	27.9%	153.1%	23.7%	-24.4%	2.7%	162.7%	24.3%
Since 2014	25.6%	38.4%	21.7%	134.1%	11.7%	-31.1%	-2.3%	129.9%	13.3%
Since 2015	13.3%	27.0%	6.1%	115.0%	-2.2%	-37.3%	-15.6%	106.9%	6.5%
Since 2016	4.9%	11.7%	3.6%	98.5%	-7.4%	-44.0%	-20.1%	74.2%	-1.5%
Since 2017	2.6%	9.7%	2.4%	84.3%	6.2%	-45.6%	-22.9%	56.5%	-1.6%
Since 2018	1.6%	9.0%	-2.9%	68.6%	3.9%	-38.5%	-25.1%	60.5%	1.7%
Since 2019	-0.3%	4.6%	-3.8%	51.7%	-1.4%	-34.0%	-24.6%	56.1%	3.8%
Since 2020	-2.8%	-1.0%	-5.5%	34.3%	-1.1%	-25.7%	-27.0%	49.4%	3.2%
Since 2021	5.8%	2.5%	-1.6%	22.7%	31.9%	3.2%	-20.5%	50.5%	18.2%
Since 2022	-14.9%	-20.6%	-10.4%	-12.9%	0.2%	-18.6%	-25.0%	-9.1%	-9.1%
Effective LTV									
Since 2012	35.2%	33.0%	37.2%	18.8%	37.9%	59.7%	47.4%	16.9%	38.5%
Since 2013	37.3%	34.9%	39.1%	19.8%	40.4%	66.2%	48.7%	19.0%	40.2%
Since 2014	39.8%	36.1%	41.1%	21.4%	44.8%	72.6%	51.2%	21.7%	44.1%
Since 2015	44.2%	39.4%	47.1%	23.3%	51.1%	79.7%	59.2%	24.2%	47.0%
Since 2016	47.7%	44.8%	48.3%	25.2%	54.0%	89.4%	62.6%	28.7%	50.8%
Since 2017	48.7%	45.6%	48.8%	27.1%	47.1%	91.8%	64.9%	32.0%	50.8%
Since 2018	49.2%	45.9%	51.5%	29.7%	48.1%	81.3%	66.8%	31.2%	49.1%
Since 2019	50.2%	47.8%	52.0%	33.0%	50.7%	75.8%	66.3%	32.0%	48.2%
Since 2020	51.4%	50.5%	52.9%	37.2%	50.6%	67.3%	68.5%	33.5%	48.5%
Since 2021	47.2%	48.8%	50.8%	40.8%	37.9%	48.4%	62.9%	33.2%	42.3%
Since 2022	58.8%	62.9%	55.8%	57.4%	49.9%	61.4%	66.7%	55.0%	55.0%

At February 28, 2023. Source: Green Street, Cohen & Steers.
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If a property was financed in 2011 with a then-current 50% LTV loan, the effective LTV stands at 35% today. In contrast, effective LTVs have risen 59% since the beginning of 2022, considering the 15% decline in valuations over that period.

With that in mind, properties that were financed prior to 2018 may have average LTVs of less than 50%. Remember that nearly 45% of commercial mortgage loans on income-producing properties are secured by apartments (where valuations are 51% higher since the end of 2011, even after a recent 21% decline from the peak). Industrial, where valuations are up even more, represents another 8% of all CRE mortgages.

We believe the greatest risk lies in loans that were originated over the past several years at peak valuations, especially if they have shorter maturities. Disclosure on this in aggregate is sparse, but we can look to the CMBS market for some answers. About 56% of all outstanding CMBS was issued from 2019 to 2023 YTD, consisting of less than 1% for the 2023 vintage, 14% for the 2022 vintage, 21% for the 2021 vintage, 7% for the 2020 vintage and 13% for the 2019 vintage. Given that CMBS market share was on the rise over this period (standing at 20% in 2021 vs. a 2015–2019 average of 17%, we believe these percentages are likely lower for the entire CRE mortgage market.

We estimate 60–70% of loans were originated prior to 2020 and the other 30–40% were originated over the past three years.

Bottom line: We view this as primarily an equity problem for some property types, but it is not a debt problem. This is much different than the subprime crisis during the GFC, where an individual might have taken out a 90% LTV loan on a single family residence (80% 1st lien plus a 2nd lien) and property values fell 40% while unemployment was high.

We do expect delinquencies and distress to rise, if for no other reason than idiosyncratic events as property valuations decline and the higher cost of refinancing. Distress almost must go up from here, given that it stands near a historically low level right now.

How much new equity will be required?

The CMBS market provides a case study on potential risks that borrowers may have to inject more equity into their properties. We analyzed more than 3,000 CMBS loans secured by offices, with a current loan balance of $372 billion. We focused on office as it is considered one of the most distressed CRE sectors.

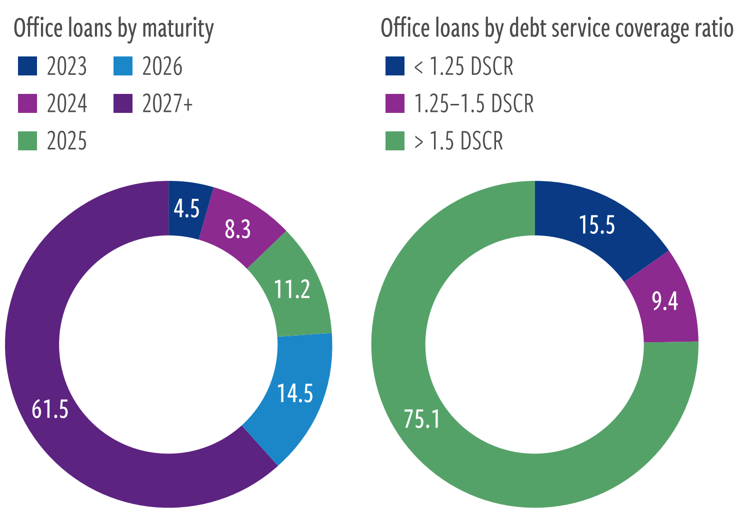
Notably, 61.5% of CMBS office loans mature in 2027 or later, compared with only 4.5% in 2023 and 8.3% in 2024. And 75% of CMBS office loans have a debt service coverage ratio (DSCR) greater than 1.5x (Exhibit 9). This helps to mitigate the risk of term default (i.e., a default prior to a loan's maturity) since the net cash flow on the properties sufficiently covers interest payments. Generally, term default risk is more of a concern when the DSCR falls below 1.25x. But only 15.5% of CMBS office loans currently have a DSCR in this range.

That said, we believe maturity defaults are a greater risk for CMBS office loans, as property valuations have declined (or will likely decline), requiring borrowers to put up more equity when they refinance.

EXHIBIT 9

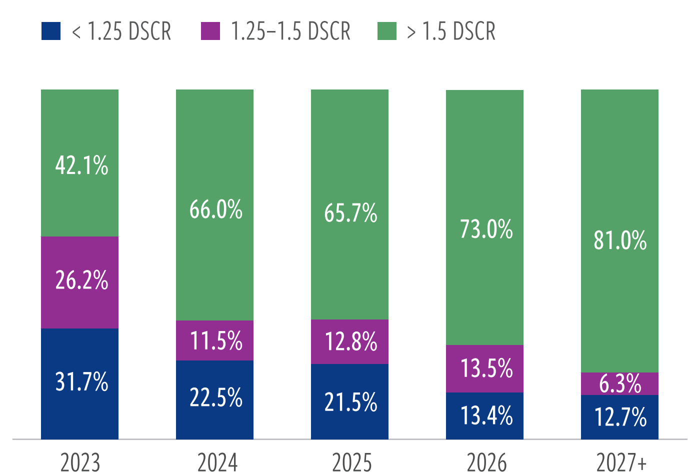
15% of office loans have inadequate cash flow

CMBS office loans by maturity and coverage ratio (%)



Near-term office loans are not performing well

CMBS office loan debt service coverage ratio



At March 1, 2023. Source: Deutsche Bank, Cohen & Steers.

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CMBS office loans currently have a weighted average debt yield of 10.7%. Debt yield (net operating income divided by loan balance, or cap rate divided by LTV) is a standard lender underwriting metric. We believe CMBS lenders will likely require a debt yield close to 14–15% when underwriting new loans secured by offices.

Our analysis suggests borrowers will need to inject 25–40% more equity into their properties depending on the cap rate and LTV. While this may seem like a lot, Green Street estimates office valuations have already declined 28% from their March 2020 peak. In other words, borrowers are simply being asked to put additional equity into deals consistent with how much property valuations have fallen.

We reiterate that some property types (such as multifamily and industrial) are likely underleveraged, given the rise in property valuations over the past 5–10 years. This may allow borrowers to take out equity. However, other property types, such as office, may require borrowers to put in equity. The question is whether these borrowers have sufficient capital to refinance the loans (and/or what the opportunity cost is).

CMBS case study: Office

Required equity assuming 8% cap rate and 55% LTV

	Debt yield		Required equity	
Maturity year	Current	New	%	$
2023	9.3%	14.5%	36.0%	3,709,298,941
2024	10.5%	14.5%	28.0%	6,104,543,593
2025	11.8%	14.5%	18.5%	6,155,685,920
2026	10.8%	14.5%	26.0%	10,971,178,965
+2027	10.6%	14.5%	26.5%	70,106,407,860
Weighted average / Total	**10.7%**	**14.5%**	**26.1%**	**97,047,115,279**

Required equity assuming 9% cap rate and 50% LTV

	Debt yield		Required equity	
Maturity year	Current	New	%	$
2023	9.3%	18.0%	48.5%	4,997,249,962
2024	10.5%	18.0%	42.0%	9,156,815,390
2025	11.8%	18.0%	34.4%	11,446,248,413
2026	10.8%	18.0%	40.4%	17,047,524,238
+2027	10.6%	18.0%	41.0%	108,466,517,822
Weighted average / Total	**10.7%**	**18.0%**	**40.6%**	**151,114,355,824**

At March 1, 2023. Source: Deutsche Bank, Cohen & Steers.
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About the author

Rich Hill, Senior Vice President, is Head of Real Estate Strategy & Research, responsible for identifying allocation opportunities in both listed and private real estate and related thematic and strategic research. Prior to joining the firm in 2022, Mr. Hill was a managing director and Head of Commercial Real Estate Research at Morgan Stanley, where he was responsible for public REIT equity research, CRE debt strategy and macro property research. Previously, he was a director at RBS Securities and a vice president at Bank of America Corporation. Mr. Hill has a BS from Georgetown University and is based in New York.

Index definitions / important disclosures

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment..

Listed real estate: FTSE Nareit All Equity REITs Index contains all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. **Private real estate:** NCREIF Fund Index–Open End Diversified Core Equity (NFI-ODCE) is a capitalization-weighted, time-weighted index of 36 private real estate funds pursuing a core investment strategy focused predominantly on U.S. assets.

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