

The Great Repricing: Commercial Real Estate Eyes the Abyss

The U.S. commercial real estate market, valued at \$20 trillion in 2021 by some estimates, touches nearly every facet of urban and suburban dwellers' lives – from where they live (multi-family housing or apartment buildings) to where they work (office buildings), to where they shop (shopping centers or malls), to where they receive health care (hospital buildings and doctor offices), to how their pension funds and insurance companies invest (commercial mortgage-backed securities). And we could be on the precipice of a historic repricing of this entire asset class.

For many years, the commercial real estate market was a safe investment. Banks were keen to loan to developers and owners because the loans were considered safe. This is because they were secured by a valuable asset – the underlying tower – which, unlike residential real estate, came with a stream of cash flows that a lender could direct to help pay the loan back. When the mortgage-backed securities market crashed in 2008, primarily residential mortgage-backed securities (RMBS) crashed in the form of subprime mortgages. Banks had created bespoke derivative securities based on pools of loans (i.e., mortgages on residential real estate) that were carved up into different tranches and sold at different prices pursuant to rating agency assessments of the risk levels associated with each tranche. The lowest-rated tranche was sometimes called sludge or toxic waste. These derivative securities were purchased by many different kinds of buyers but primarily by those searching for enhanced yield at a time when debt instruments were paying a less-than-attractive yield. While the RMBS market took it on the chin in 2008, commercial mortgage-backed securities (CMBS) barely trembled. So institutional investors searching for enhanced yield continued to buy the CMBS derivatives. Perhaps they should now be worried.

It appears the first cracks are developing in the commercial real estate market, and the consequences could be shattering. While there is rarely a sole cause of a collapse, whether for a building or a market, here we can posit at least two causes: COVID-19 and the rise in interest rates.

The effects of COVID-19 are well understood. Mayors of major cities nationwide have been begging people to return to the business districts. The virus caused a massive relocation of where work is performed. The digital nomad, untethered from a desk, is now real. Vacancy rates are troubling. In some cities, these are measured by the reduction in cell phone pings on cell towers in office districts. In San Francisco, cell phone pings are down by half. With apologies to *Field of Dreams*, it may have stopped being, "If you build it, they will come," and may now be, "If you build it, you probably can't expect them to come more than two days a week." As demand for space drops, this pushes down the value of the buildings.

The second cause is the rising interest rate environment. Interest rates have increased substantially and vary depending on location, condition, sector, and timeframe. But there is no question that the rate hike is highly problematic for investors and property owners, some of whom may have never seen rates this high and rely on interest-only mortgages with the ability to refinance when the loans come due. And what happens if they can't refinance? What happens if the new or developing valuation for the property no longer supports the previous levels of debt? The collateral has become worth considerably less, and the cash flows from the rents have become less predictable or certain. This isn't a small or isolated problem for this sector. It has been predicted that up to 83% of outstanding securitized office loans won't be able to refinance if interest rates stay at current levels.

Even if a property owner can refinance, the bank might not be willing to, pushing the owner into foreclosure or some other remedy. Banks are selling their commercial real estate loans. Let's



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make sure we don't miss this point: Banks are selling, perhaps at a discount, loans that are performing and not in default. That is very rare, the *Financial Times* reports:

"Typically, banks are reluctant to accept losses on big blocks of loans that will retain their full value as long as borrowers make repayments on time. But some are being convinced to take the plunge amid fears of an increase in delinquencies — especially on debt secured against office properties that have experienced falling demand because of the enduring popularity of working from home."

San Francisco presents an immediate and cautionary example. The owner of the largest hotel in the city, the Hilton Union Square, just handed the keys to the property back to the lender and walked away, thus creating a massive problem for the new lender after First Republic Bank failed. We expect to see the new lender attempt to sell the property as it is a bank and not a hotelier. But we should also expect to see the value of hotel real estate plummet in San Francisco as the market as a whole tries to absorb its largest hotel.

Even if banks want to execute loans, new reserve requirements for banks may make lending tighter. This remains to be seen, but this tightening could pose an impediment to new investors who want to take advantage of the repricing in this asset class. The risk of a total asset class repricing appears very possible.

If you are in the commercial real estate space or think this is a good time to begin looking at commercial real estate, our team of experienced attorneys can help guide you through what will be a difficult time.