Episode 79

# FireSide: Anatomy of a CRE correction—2024 Update

## CRE expert Andrew Korz joins Chief U.S. Economist Lara Rhame to update their outlook for the correction and discuss potential opportunities.

Lara Rhame (00:04):

Welcome back to Fireside, a podcast from FS Investments. I'm Lara Rhame Chief US Economist, and in today's episode we are talking commercial real estate. We have a new publication out the Anatomy of A CRE, correction. It's actually a take two. It's a sequel. And for anyone who wants to dig into this topic, please find this on our website because I am joined by the author, my partner in research, Andrew Korz, an executive director on our team. Andrew, welcome.

Andrew Korz (00:33):

Thanks Lara. I'm excited to talk real estate.

Lara Rhame (00:35):

Absolutely. I have a selfish reason for doing this podcast, or perhaps maybe it's more like a public service because I am often in advisor's offices. It's one of my favorite things to do, to talk to advisors, talk to their investors, and I wanted to call today's podcast CRE, myth busting edition. And Andrew kind of rolled his eyes at me. And this is really important because Andrew is an expert in this subject. He has written this piece, which as I said is a sequel. The original was one of our most successful, most widely circulated and most widely sent pieces that we've ever done in research. So when he redid it, it's important to recognize, and I told him this, he's in the weeds on this, and I am out there talking to investors who still have a lot of fear, a lot of uncertainty. We know there's a correction in progress and I understand that.

(01:45):

And I come home or back to home. We're in the office, but it feels like home, right? Come back to Philadelphia, our Philadelphia headquarters, and I say this to Andrew and he takes me through the nitty gritty of this sector and why it's so different, why it's changed, why this time is different, why this isn't a repeat of the 2009 crisis. So I wanted to bring all of this together today, the big questions I get asked and your expertise and hopefully dispel some of these big concerns and then we can kind of get into the nitty gritty.

Andrew Korz (02:21):

That sounds great, Lara. And just to be clear, I must've had something caught in my eye. I would never roll my eyes at you.

Lara Rhame (02:27):

He rolls his eyes at me all the time, but alright. Alright. Today, February 2nd, 2024. Let us just quickly set the stage right. How is the CRE market doing today? I want to set the stage before I hit you with my big scary questions. Yeah, let's

Andrew Korz (02:48):

Talk about just the lay of the land as we speak today. First of all, activity, acquisition, sales activity, whatever you want to call it, is still really challenged. 2023 was our lowest full year activity since 2012. I think people keep waiting for some savior in the form of much lower interest rates and it just has not come and we don't think it's going to come right.

Lara Rhame (03:09):

This week the fed pretty much took a march rate cut off the table. Markets expect five rate cuts now. But we also today just got this very strong jobs number and you and I maybe meme, I have a stronger feeling that we're probably going to get surgical rate cuts later in the year.

Andrew Korz (03:29):

And that's core to our view because absent some miraculous decline in rates, this sort of correction is going sort of extend for as long as our forecast period is. Yeah. Secondly, if you look at property prices, they're still under pressure. They've come down about 13% on a national basis from the peak in middle of 2022. Lots of dispersion in there. Declines have moderated the past couple quarters as rates have kind of stabilized, come down a bit over Q4 of 2023, except in the office sector that's sort of in its own private Idaho, if you will. Sure. But everything else price declines have, there's still pressure there, but they've kind of moderated distress has risen somewhat. But again, you might be noticing a trend here, more than 90% of the new distress in all of commercial real estate since the middle of 2021 is in the office sector.

Lara Rhame (04:19):

Okay. I know we're going to dig into office

Andrew Korz (04:20):

Later. We'll dig into that. On the fundamental side, if we consider offices like maybe 15% of the market, the other 85%, whether we're talking about in industrial, multifamily, retail, hotel, things like data centers, self storage, all of these, it's such a massive sector with so many different economic drivers. Much of the rest of the market fundamentals, just like the economy are really strong right now. So that continues to be the biggest support for the market. And to kind of wrap that all up of where we are today, we're just in a market that's kind of suspended in midair between a big tailwind fundamentals and a big headwind interest rates. And I think that's going to set the stage for the rest of our conversation.

Lara Rhame (04:59):

Okay. Alright. So another advertisement for this piece because when you did the first one in April of 2023 and the uptake from all of our investors was so strong, you said three things would happen and you were right. You said number one, we wouldn't see a repeat of the CR meltdown that happened. I guess I said 2009, but you mentioned 2012 was a multi-year.

Andrew Korz (05:25):

It took years crisis.

Lara Rhame (05:26):

Crisis crisis. So number one, you said that wouldn't be repeated. Number two, you also said fundamentals would stay strong, particularly in multifamily industrial, you threw in retail. That's also happened number three back in April of last year. You said it would be a slog that this correction would take time to occur and that activity would be weak because investors have to recalibrate in this new interest rate regime. I think that slog is still where we are. Correct me if I'm wrong.

Andrew Korz (06:00):

Absolutely. Yeah. We don't expect turn of the year to create some massive uptake in activity. It's going to take time. I think that's still where we are.

Lara Rhame (06:08):

Okay. Alright. So let me ask my first sort of question that I get regularly that is scaring people. Is there a wall of refinancing that is going to cause some banking system crisis level event?

Andrew Korz (06:30):

Yeah, a wall just that sounds so like

Lara Rhame (06:33):

We're going to crash into it.

Andrew Korz (06:34):

Yeah, yeah. It's not so finite. I prefer a wave that's kind of coming through. I like that better and we can work our way through it. So I think this is a really important question. It's something we think a lot about. I want to just give some numbers if that's okay with you. Yeah, do it to make my point. So if we look at the commercial real estate debt market, it's almost 6 trillion in the US. Trillion, 6 trillion, yes. Banks own about 60% of that currently. Of that 60%, about a little less than three quarters of it is owned by the non largest banks, regional banks, smaller community banks, et cetera. So we can say between 45 and 50% of commercial real estate debt is owned by these regional banks, smaller banks that I think people are concerned. I don't think anybody's really concerned about these. That was like, grant,

Lara Rhame (07:18):

I'm still scared you're 92.

Andrew Korz (07:21):

I think JP Morgan is going to be okay. But I think people are worried about still the outlook for regional banks,

Lara Rhame (07:25):

Especially regional banks.

Andrew Korz (07:26):

So if we look at the maturity wave not wall, we've got about, call it 600 billion of total commercial real estate debt maturing this year.

Lara Rhame (07:36):

So 10% of the total market, 10%,

Andrew Korz (07:39):

10% of all outstanding C debt, that's less scary give and take is maturing this year. It's more than the average year, but not crazy more than the average year going back. So we think about regional banks, they have been large commercial real estate lenders on average, call it a quarter of their assets are commercial real estate loans. If it follows that roughly 10% of all commercial real estate loans are maturing. And we make a pretty conservative assumption that a quarter of those loans are office loans, do the math. That's less than 1% of the average regional bank's assets that are maturing office loans less than 1%. So are there going to be banks that have problems, more office loans than that? Yeah. Are there going to be those that have fewer? Yes. So I think when we think about, first of all, the big banks are not in the line of fire here and we know that the 15 largest banks are two thirds of all assets in the banking system now. So people are worried about these smaller banks. On average, less than 1% of their assets are maturing office loans. That is very small. Yeah,

Lara Rhame (08:43):

No, and I think that helps and now is a time to also bring in where the other 40% of these commercial real estate loans are coming from. And to me that is the huge difference between today and 15 years ago. Because back then banks were the only game in town.

Andrew Korz (09:07):

Yeah.

Lara Rhame (09:09):

Did I steal your next point? That's

Andrew Korz (09:11):

Exactly where I wanted to go next because I think people are worried about systemic history of the banking system. We do not see that at all.

Lara Rhame (09:18):

And I think this is the point we cannot guarantee there won't be little, I think there will be, we know that there are a few problem loans out there. I'm not even going to attempt to quantify that because I don't know, nobody knows, but, and we will talk about office, but outside of that, the real issue is a systemic concern. And that's what I hear when I hear the questions about this deep overarching wall. And I think it's important to, what I've heard is wave of a much more dispersed source of lending and that really the problem areas are much smaller and going to be sporadic. One alarm fires not the systemic fire.

Andrew Korz (10:02):

Yeah. Look, I think the concern of everybody is that there will be a vacuum of capital availability to address this wave of maturing loans. And that's exactly the issue of the global financial crisis. When people look back, there were no lenders that were willing to step in when banks stepped back when the CMBS market was closed, there were no other lenders. That is not the case today. We have another cohort of lenders who by the way is comprised more than 40% of the growth of CRE debt over the past five years. That's a massive amount. So

Lara Rhame (10:36):

Couple trillion dollars, right? Yeah.

Andrew Korz (10:37):

Well the growth in debt, so it's a little bit different. But you think about who are those lenders? They're insurance companies who mostly do fixed rate loans. It's debt funds, it's mortgage REITs who mostly do floating rate funds. So there's not only a massive cohort of lenders there that are able to take up the mantle, but they're offering various different types of lending products that may appeal to different parts of the market. So look, the market outlook, the debt market specifically is completely different than it was during the GFC. And by the way, again, fundamentals are still really good outside office. That's important

Lara Rhame (11:12):

And that's important too. Let me just say this because as chief economist, I get to make the GDP forecast and I think the beginning of last year when there was pervasive concern of recession, the outlook very different. The economy remains strong and I think looking forward, while we expect growth in 2024 to be slower than 2023 when growth was over 3%, the outlook for growth of one and a half, 2%, it's not pessimistic, it's a little slower. It's more sustainable I would

Andrew Korz (11:43):

Say. And to be clear, for these sort of banks that are more geared towards office loans, are they going to kind of step back and be more focused on triaging their balance sheets than they are making new loans? Yes. There's an opportunity here for these lenders to step in and fill the gap with these banks. Opportunity. Opportunity, absolutely. Yes. You can go word

Lara Rhame (12:05):

Here is the other big question because I think we recognize that office makes for troubling headlines, bad headlines sell. That's kind of most of the news that we hear about. Let's talk about office because we know the bad news sell and a lot of the bad news has been in office. We've seen a couple of Marques defaults. There's concern that now it's all starting to crumble. This is just the beginning of the cracks forming. Take me through, and you've talked to me about this before, that offices only 16% of the entire CRE market that even within office, there's a huge dispersion between central business district, old office buildings in central business district are going to be troubled, whereas suburban office space in the Sunbelt states it's doing fine. Take me through office and why, how bad it's going to get and how concerned should I be? Yeah,

Andrew Korz (13:08):

So I think with the office sector it's sort of degrees of how everybody agrees that it's challenged. It's just a question of how challenged do you think it is and what's your sort of forward outlook on office utilization and what are companies going to do with the real estate footprint, et cetera. I think one thing you're going to see and we are starting to see is that foreign investors have historically have had really big footprints, especially in the Manhattan office

Lara Rhame (13:35):

Market in San Francisco.

Andrew Korz (13:36):

Yeah. You're seeing some of these big foreign banks that have seen losses on some of their office portfolios. So of course that's going to hit Bloomberg and it's going to sort of exacerbate these headlines. And I think to your point, when you think about the office sector, it's about 15% of the commercial real estate market. About 60% of that's suburban, about 40% central business district. And again, not all CBD offices bad, it's mostly these bigger primary metros and it's mostly buildings that haven't been renovated since the eighties of the nineties. So we're talking about what's still probably a trillion or $2 of the market that's potentially challenged, but we're not talking about the entire sector. I think that's important to sort of start off on. The other thing is there's still a huge question as to where is work from home and the hybrid world and all that going to land. We track a ton of data from a great source called work from home research and they analyze the micro data from I don't know where, and basically get a gauge on how many days. We

Lara Rhame (14:34):

Probably all have trackers implanted on us right now and

Andrew Korz (14:37):

They can tell the

Lara Rhame (14:38):

We're here in our home office in Philadelphia,

Andrew Korz (14:40):

They already know all my info anyway, so that's fine. But I think we've yet to settle on a new normal in terms of remote work. Right.

Lara Rhame (14:48):

That's important to understand.

Andrew Korz (14:49):

Yeah, it is. It is. And it gives credence to this. We track data from a lot of these different metro areas where they look at utilization of public transportation, subways, trains, buses, et cetera, during weekdays. So most of the people who are utilizing these during weekdays are going to work, are coming from work. If you look at this, again, we have not seen a plateau. If you look at the Long Island Railroad in New York, it's up to 80 or 85% of what it was pre covid, right? If you look in Chicago, not quite as good, more like 60%, but it continues to go up. Even in San Francisco, believe it or not, the BART train, it's slowly but surely rising. So I think there are some reasons to believe that we have not hit a new normal on this yet. We're only less than three years into the recovery from Covid probably.

(15:38):

So I think there's still some shakeout there. But look, office is challenged again, especially these weaker assets and I think the challenging thing is a lot of investors are just going to step away from the space, cold Turkey, just like even good assets. I'm wiping my hands of it, I don't want anything to do with it. So that's a challenge. The good thing is that these leases in office buildings tend to be 10 plus years, so there's some time for us to go through these issues. Thankfully lenders are much more willing to work with borrowers who still want to support the assets. So there's a lot more to come here. It's going to take a long time I think for it to play itself out, but I think there's a lot more nuance even to the office sector than a lot of the headlines that we're seeing come across.

Lara Rhame (16:20):

Yeah, yeah. Okay. Alright. So hopefully so far we've managed to talk people out of either panic attacks or this pervasive concern that the sector commercial real estate's going to experience. A repeat is on the same track of a repeat. Hopefully we stop the doom thinking of commercial real estate and for those of us who are still now willing to take the next step for those listeners who are still with us, I think I want to turn now to the investing side of all of this because that's where, and again your chart book I think really gives now the meat of accessing commercial real estate, investing in it and how to harvest the gains that come from the fact that banks are stepping back, that private lenders are able to charge a higher rate in a high yield environment already. And the fact that if there are good investments out there, and here's something that we talk about a lot times of dislocation are the best opportunities to come in and to invest. The problem is, and this takes us right back to where we started in times of dislocation, people are scared and are scared to dive in. So given that this is a time of dislocation, how do we invest in this space?

Andrew Korz (17:56):

That's such a good framing of the issue. I think the returns wouldn't be there if it wasn't a little scary for some people, right? Yes.

Lara Rhame (18:02):

You can harvest higher return when it's a little scarier. If

Andrew Korz (18:07):

You look back, the end of the credit cycle where everybody's feeling great about everything is not necessarily usually the best vintage. It's when the market is really dislocated that you tend to get the best investment periods. So I think that's a great point and I want to kind of dig into that a bit. Usually during times of dislocation, especially in real estate, it's kind of one of two things, right? Either there's no capital available or fundamentals are bad. Those are normally kind of the two reasons that you get these dislocations. And I think the opportunity in those types of situations is pretty clear. If there's no capital out there and you're one of the few people that has capital, you can go out there, name your price, buy distressed assets and write it back up to pretty incredible returns. If fundamentals are bad, everybody accepts fundamentals are bad, we're in a recession. You can go buy a property, improve the property's cashflow, wait for the economy to recover again, get incredible returns. That's not this cycle. This cycle is not about a lack of capital availability and it's not about terrible fundamentals. What it's about is it's very unique. It's unique and we don't really have a good historical context for it. It's about the cost of capital and it's an issue of cost of financing, not availability.

Lara Rhame (19:19):

Most aggressive rate, fed rate hike cycle since the 1980s has really been the root cause of this.

Andrew Korz (19:25):

And I think when you think about it, you think about investing into a dislocation, what does that mean? Again, if there's no capital available and you have capital, you're putting yourself in the path of that dislocation. What does putting yourself in the path of the dislocation mean today? It means taking advantage of that rising cost of debt. Take advantage of that cost of financing. Love it. Dislocation, right? And what does that mean? It means lending into the market, right? You can lend into today's market at very low leverage levels, fully collateralized by a performing property asset, by

Lara Rhame (20:00):

A building, by a building, by a bricks and mortar, by a building.

Andrew Korz (20:04):

Absolutely. That has probably significant land value and you can do it again with base rates that are really high and spreads that are wider than we've seen outside of recessions in a pretty long time. So it's a pretty unique situation and I think in two years we may look back and say, I wish I'd done more of that. Well

Lara Rhame (20:24):

That's always what we all look back on in times of dislocation. I really wish I'd bought a beach house in 2011. I did not for our listeners. Alright, thank you, thank you, thank you. This publication I know will be as successful as the last one. Hopefully this podcast will get a few people who wouldn't normally dig into the capital markets backdrop of the CRE market. We'll get them to come to our website, fs investments.com, the insights page to get them to download this because I think it's a must read if you're terrified of the CRE market, read this if you're comfortable with it, but just interested in getting an update on the capital markets backdrop. Also read this. So here's my last question to wrap it up. What is your core prediction for 2024?

Andrew Korz (21:15):

Yeah, so we've been in a correction since, call it the middle of 2022. I think we're still in a correction in the market. I fully expect to be writing the third version of this chart book and call it late summer, early fall. We'll see. And it'll probably still be called anatomy of a correction, but I think the difference is we're entering a new phase of the correction, right? Like I said, 2023 was about what we call triage and digestion. Trying to get a grasp on what are the possible outcomes in the macro world and the rates world. Where are my exposures? Where is my risk in my current portfolio? Not necessarily looking to go out and buy new properties. I think 2024 will be different. I think it's a bit more of acceptance that we are in this higher interest rate world and acceptance of what that means going forward. And I think we see a slow improvement in activity as 2024 progresses. You have, as we mentioned, refinancings, that is activity that will sort of need fresh equity capital, it'll need debt capital. It's

Lara Rhame (22:09):

Price discovery, right? Price

Andrew Korz (22:10):

Discovery. You have 350 billion of equity dry powder sitting on the sidelines. It's burning a hole in people's pockets, right? It needs to be deployed into the market. To your point, that means acquisition activity. That means lending activity and ultimately that means price discovery and it's sort of a flywheel, right? Once you start getting place price discovery, people start feeling more comfortable about where value is in the market and it helps to, what we hope by the end of the year and going into next year activity starts to sort of look a bit more normal.

Lara Rhame (22:38):

Alright, thank you very much. I think this has been a phenomenal discussion. I always appreciate hearing your thoughts on this sector. Your expertise is something that brings nuance and I hope that I thank you for tolerating the myth busting idea behind this because I think your nuance is really helpful, but pulling people out of that scared place in getting them at least interested in learning more about this opportunity is I think was really my goal today. So I think we did it.

Andrew Korz (23:10):

I enjoyed it and I do love that show. So thanks Lara.

Lara Rhame (23:16):

Thank you.

Lara Rhame (Credits) (23:19):

This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy art. It was produced by the investment research team. It was edited and engineered by Aaron Sherman. Special thanks to show coordinator Ellie Zang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.