

## Emerging opportunities in real estate debt

Commercial real estate fundamentals look healthy outside of the office sector while sentiment has been improving



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### KEY TAKEAWAYS:

- Investor sentiment towards commercial real estate (CRE) has improved markedly since reaching a multiyear low in 2022, overcoming several investor concerns and setting the stage for potential investment opportunities in 2024 and 2025.
- Industry fundamentals outside of the office sector may be stronger than many market participants appreciate, supported by historically high occupancy rates and still above-average cash flow growth in most segments.
- Commercial mortgage origination volume declined by roughly 50% in 2023 at a time of looming loan maturities.
- Banks represent roughly half of CRE debt outstanding and office loan exposure appears largely manageable for most of these institutions, which could help mitigate some of the contagion risk of spillover into other CRE sectors.

Market headwinds likely gave many real estate investors pause in recent years, although several of these headwinds, including poor investment sentiment, muted deal activity and the interest rate environment, may be changing to tailwinds.

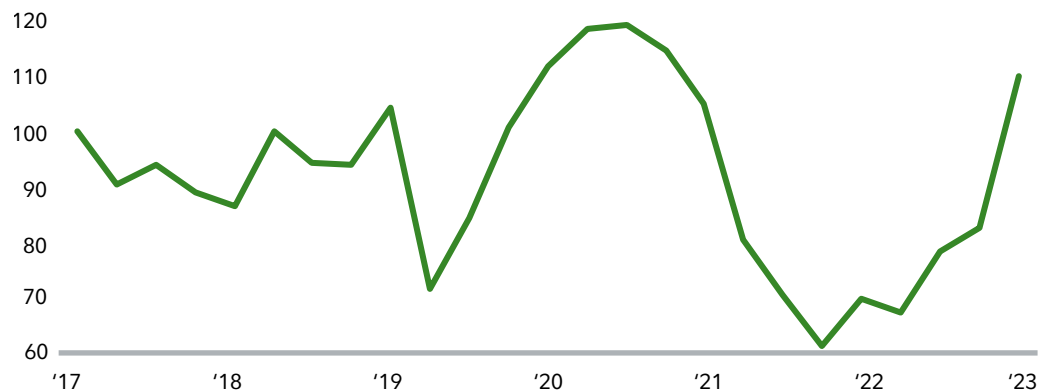
## Optimism for the sector

As of early 2024, investor sentiment towards CRE has been gradually improving after reaching a multiyear low in the third quarter of 2022.

The Commercial Real Estate Finance Council Board of Governors Sentiment Index, which tracks senior industry members' feelings about market conditions, rose 33% in the fourth quarter of 2023 (Exhibit 1). This marked the largest quarterly increase since the survey began in 2017. Sentiment improved for every survey question, reflecting the breadth of industry optimism. Investors became increasingly sanguine about the economic outlook, the impact of interest rates, and the health of the commercial real estate finance business.

### EXHIBIT 1: Industry participants have expressed optimism

Commercial Real Estate Sentiment-Index Value



Source: CRE Finance Council, data gathered on 1/18/24.

## The outlook is still somewhat mixed

This does not mean the CRE outlook is pristine going forward. Concerns persist, especially about the long-term health of the office sector and the overall CRE market's ability to endure a high interest rate environment. Office vacancies ended 2023 at a 30-year high and there's no sign of office demand coming back to its pre-pandemic level anytime soon. Demand could fall further in 2024 as in-place leases reach maturity, and most tenants renew only a fraction of their former square footage.

There are some broader concerns for commercial real estate as well, including the potential for higher-for-longer interest rates, tighter credit conditions, and the wide bid-ask spread between property buyers' and sellers' expectations in many segments. (We'll address these concerns shortly.)

## But look at the fundamentals

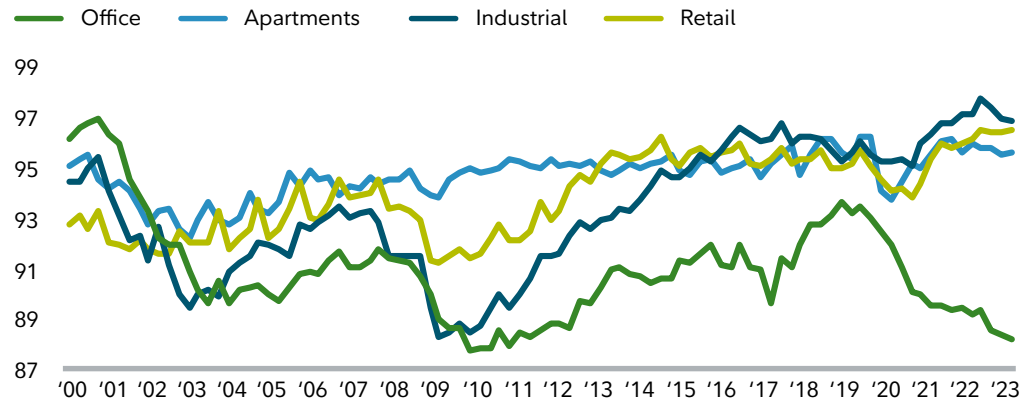
Yet in the big picture, investors may be surprised at the fundamental strength of the overall real estate market ex-office. Earnings growth appears to be slowing to a far lesser degree, valuations have improved and importantly, market fundamentals appear solid—driven by resilient demand—supporting above-average rental rate growth across nearly all property types.

## Several segments have thrived

Healthy fundamentals also are reflected in historically high occupancy rates ex-office (Exhibit 2). Industrial remains a favored property type among many investors due to its multiple secular growth drivers. The availability of warehouse space recently reached an all-time low in the U.S., driven partly by new and expanding direct-to-consumer businesses. Real estate niches including data centers have continued to experience outsized demand driven by artificial intelligence (AI) projects.

### EXHIBIT 2: Buildings are nearly full in most segments

Occupancy Rates (%)



Source: S&P Capital IQ, Nareit T-Tracker, data gathered on 12/31/23.

Elsewhere, the retail sector has experienced a renaissance of sorts, particularly open-air and neighborhood shopping centers. A healthy U.S. consumer and virtually no supply of new retail centers have combined to fuel the highest occupancy rate in over 20 years.

Lastly, residential for-rent properties, such as apartments and single-family home rentals, have benefited from the nationwide housing shortage and relative affordability versus home ownership.

## The lending environment

Over time, real estate investors in private markets may see an increasing number of opportunities. As of early 2024, banks originated roughly half of all commercial real estate lending by dollar volume. Yet banks have been reducing the amount they have been lending and have sought to keep their capital levels high amid expectations of stricter federal banking regulations.

Meanwhile, capital market volumes for commercial real estate have trended lower in recent years across traditional lending sources such as banks, commercial mortgage-backed securities, and the unsecured corporate bond market.

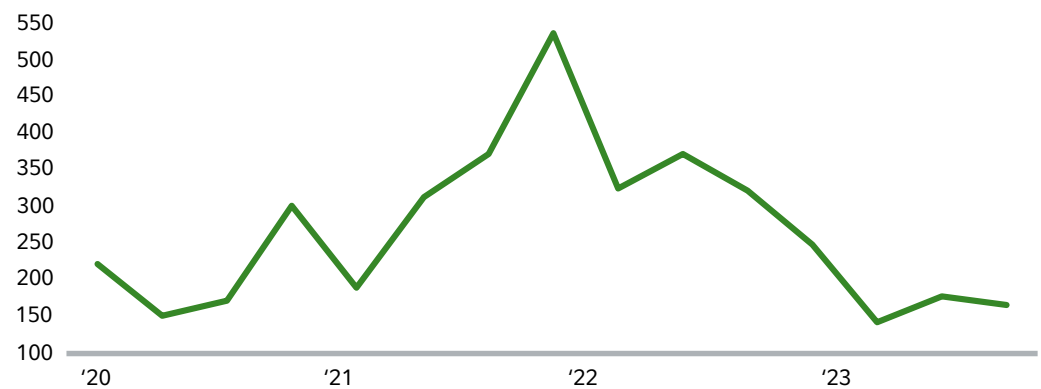
This trend could present a multiyear tailwind for private capital to step up and fill the void. Private lenders have taken share from traditional lenders in recent years, and this may be poised to continue. Many private pools of capital, such as debt funds, have significant “dry powder,” or capital available to make additional investments, and they can carefully select among borrowers and properties to invest at lender-friendly terms with high yields, low leverage, and strong covenants

## Can deal volumes improve?

It’s true that the number and value of real estate deals stood at dismal levels in 2023. Commercial mortgage originations declined more than 50% from the end of 2021 peak through the first quarter of 2023 and remained muted through the rest of the year (Exhibit 3). The precipitous volume decline is associated with higher interest rates, a lack of clarity on property values, and debate around fundamentals for some property types—particularly office. Each of these factors has caused CRE transaction volume to decline, which in turn has reduced the demand for debt/mortgage capital.

### EXHIBIT 3: Commercial mortgages activity remains low

Mortgage Originations Volume Index Value



Source: Mortgage Bankers Association, data gathered on 1/31/24.

Still, optimism is rising for modest deal-volume growth in 2024 into 2025 as real estate values reset in certain sectors and the market gradually unclogs. More properties could come to market as owners begin to accept current pricing and lending terms and lenders hold the line on loan extensions and force borrowers' hands. While this could add further pressure to property values in certain segments, it could create attractive potential upside for real estate debt investors with the opportunity to lend against reset property values and earn high yields with low leverage. As deal volume slowly normalizes, the demand for debt capital is expected to increase, which will expand the real estate debt opportunity set for active managers like Fidelity.

### Lower inflation would help

The future direction of origination volume likely will be influenced by the trajectory of interest rates, which may depend partly on the economy and, more specifically, the rate of inflation.

Absent a geopolitical shock, investors generally expect lower inflation in 2024. Lower prices for Treasury Inflation Protected Securities (TIPS) reflect generally waning inflation expectations as the effects of record economic stimulus recede. Energy prices have cooled and many supply chains have returned to normal. Even chief executives generally expect lower rates, as noted by the November 2023 reading from Survey of Firms' Inflation Expectations (SoFIE), gathered by the Federal Reserve Bank of Cleveland.

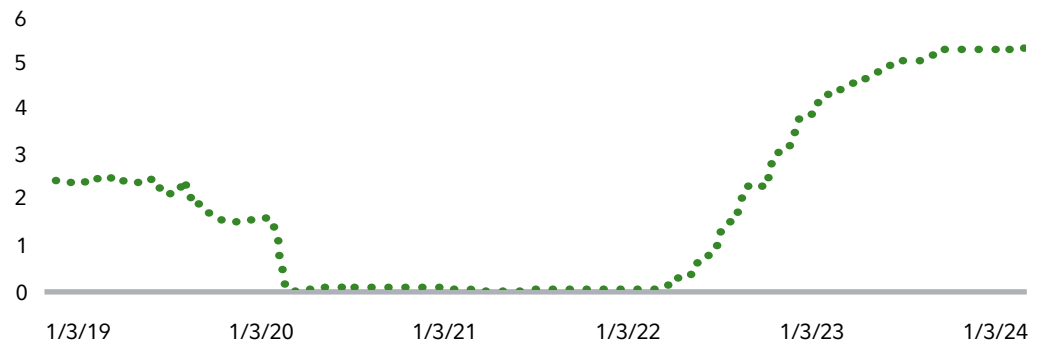
Partly driven by lower inflation expectations, the Mortgage Bankers Association is calling for a rebound in commercial lending activity into 2025, even though the industry group does not foresee a return to 2017 levels.<sup>1</sup>

## To-date, rates remain high

But will lower rates happen? As of early 2024, they have yet to come down substantially (Exhibit 4). The Secured Overnight Financing Rate (SOFR)—the overnight borrowing rate that serves as the benchmark for most floating rate CRE loan coupons—remains at more than 5% as of mid-February.

**EXHIBIT 4: The trend for rates**

SOFR Rate %



Data smoothed using a 14-day moving average. Source: FactSet, data gathered as of 1/6/24.

One worry is that rates might stay higher for longer. A recent paper written by Fidelity's Asset Allocation Research team ("The rising cost of capital and its investment implications") warned that higher real rates could engender a different economic and investment landscape that favors "incumbents," or companies with established brands that generate high free cash flow. This could have implications among CRE investors, favoring property owners with relatively stronger balance sheets at the expense of other investors that may be forced to exit the market.

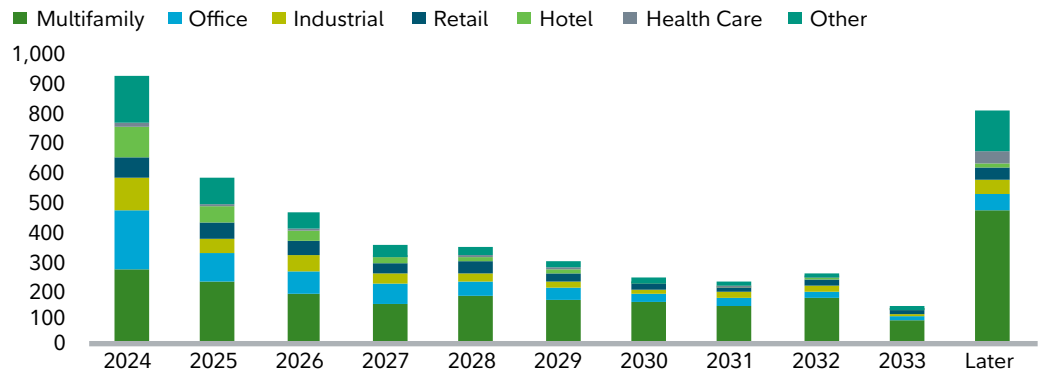
## The impact of rates

Continued-high rates would impact CRE investors in other ways as well. Borrowers with in-place floating rate loans already have felt the pain of loan coupons resetting higher with SOFR, which has materially increased their cost of debt. This type of pain could persist if rates stay high.

More than \$1 trillion of U.S. CRE debt comes due by the end of 2025, with office and multifamily making up the largest share (Exhibit 5). Higher rates could pose an obvious refinancing challenge while softening economic conditions could hamper rental income growth and occupancy.

### EXHIBIT 5: Lots of debt is coming due

Debt Maturities by Property Type (In \$Billions)



Source: Mortgage Bankers Association, data gathered on 2/14/24.

A potential offset to the issues that higher interest rates pose to borrowers with in-place loans is that banks' net interest margins tend to widen during these environments thus boosting banks' willingness to lend. This is another important fundamental impact that our team monitors regularly.

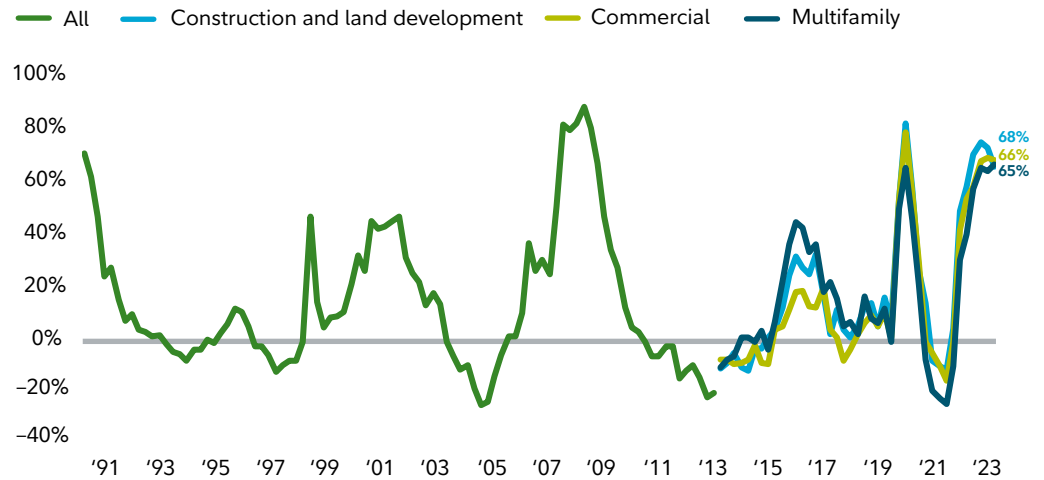
## Will lending standards loosen

Demand for CRE loans declined in the fourth quarter of 2023, which weighed on loan origination volume. Meanwhile, the percentage of U.S. banks that are tightening commercial real estate lending standards has reached levels akin to the environment at the onset of the COVID-19 pandemic and during the Global Financial Crisis of 2007–2009.

One positive aspect of the tight lending standards, however, is that it creates opportunities for lenders with strong balance sheets to take market share from troubled lenders. Lenders with “dry powder,” or capital for additional investments, can exploit their ability to originate loans with enhanced yields over prevailing rates. This dynamic is driving increased interest in private real estate debt investments.

### EXHIBIT 6: Bank lending standards have tightened

Percentage of banks tightening similar to Covid and Great Financial Crisis



Source: U.S. Federal Reserve, data gathered as of 12/31/23.



### The basics of real estate investing

- The commercial real estate (CRE) market is broad and diversified. It includes offices, multifamily complexes, hotels, industrial, healthcare, and retail, among other traditional property types.
- Newer, specialized property sectors have emerged in recent years including data centers, cell towers, timberland, and outdoor advertising.
- The majority of CRE assets by value is held by a highly fragmented collection of private owners, while roughly 10% of the overall U.S. CRE market by estimated value is owned by listed or publicly traded real estate investment trusts (REITs).
- Listed REITs and other owners of institutional-quality CRE have access to debt capital from a variety of sources, including banks, insurance companies, the commercial mortgage-backed securities (CMBS) market and debt funds, among others.

### Are dangers lurking?

Finally, we're always on the lookout for hidden dangers. One of the issues we continue to follow is the health of regional banks in the U.S., as they have been a historically important lending source. In fact, CRE loans account for more than a third of assets for some regional banks. Fed Chair Jerome Powell has called financial stress among regional banks a "manageable problem," even though some continue to face challenges in early 2024.

Some small U.S. banks could face continued difficulties with losses related to office loans. Yet, as of February 2024, we believe most smaller banks in question appear to be prudently setting aside loan loss reserves. For most banks, office loan exposure looks largely manageable. We think this could help mitigate some of the risk of significant value deterioration in the office segment that could spread to other property sectors.

We believe that non-bank lenders will step in and fill at least part of the void left by banks that are forced to work through issues within their existing loan books and in turn pull back on new loan origination.

### Conclusion

CRE could be at an inflection point. The typically forward-looking listed REIT equity market, as measured by the MSCI U.S. IMI Real Estate 25/50 Linked Index, gained 18.18% in the fourth quarter of 2023. This suggests that investors may be looking through the current on the ground choppiness and could be a harbinger for future performance from private CRE assets.

Going forward, real estate debt investors could see attractive opportunities emerge amid an environment of historically high rates, expectations for eventual monetary easing, a continued late-cycle economic expansion, and a normalization of commercial real estate transaction volume.



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He is team lead for high income and alternative strategies on the Institutional Portfolio Management Team. He assists portfolio managers and their Chief Investment Officers in ensuring portfolios are managed in accordance with client expectations. Also, he is a principal liaison for portfolio management to a broad range of current and prospective clients and internal partners.

<sup>1</sup> DuPlessis, J. Jan. 26, 2024. "Commercial Lending Rebound to Continue Into 2025, MBA Reports," Credit Union Times.

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