



Research

Fidelity Institutional Insights

# Commercial Real Estate: It is more than just office

Recent bank failures and rising interest rates have cast a shadow on the commercial real estate industry, which includes a heterogeneous set of property types.



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## KEY TAKEAWAYS

- Higher interest rates and slowing economic growth have created challenges for the commercial real estate (CRE) industry.
  - Broad CRE fundamentals are sound, but the office sector faces unique pressure as the COVID-19 pandemic dramatically accelerated trends toward flexible and hybrid work arrangements.
  - Office space utilization is unlikely to recover to pre-pandemic levels, and we expect occupancy to fall further as many tenants reduce office footprints upon lease renewal.
  - The banking crisis has fueled worries that banks will become more conservative in providing CRE loans as interest rates rise and the sector's fundamentals decelerate amid slowing growth.
  - We see minimal risk of widespread defaults and anticipate things playing out gradually as most borrowers will likely pay off their loans at or near maturity, while troubled loans will likely be granted extensions.
  - Commercial real estate does not pose a systemic risk to the U.S. banking sector and the broader financial markets, in our view.
  - Non-bank lenders have an opportunity to fill the void left by banks and take advantage of a unique opportunity to originate CRE loans with lender-friendly terms.
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## Introduction

The commercial real estate (CRE) market is broadly diversified and includes offices, multifamily complexes, hotels, industrial, healthcare, and retail, among other traditional property types. Additionally, newer, specialized property sectors have emerged in recent years including data centers, cell towers, timberland, and outdoor advertising. The U.S. CRE market is valued at an estimated \$20.7 trillion, according to data from the National Association of Real Estate Investment Trusts (Nareit),<sup>1</sup> representing a significant percentage of the total value of financial assets and a major economic engine. 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). These companies own more than 500,000 properties across more than a dozen different property sectors. Listed REITs and other owners of institutional-quality CRE have access to debt capital from a variety of sources that have expanded over time as the asset class has grown and matured. We will delve into the various sources of CRE debt capital in a later section.

<sup>1</sup> National Association of Real Estate Investment Trusts, as of the end of the second quarter of 2021. May 5, 2023.  
<https://www.reit.com/data-research/research/nareit-research/estimating-size-commercial-real-estate-market-us-2021>

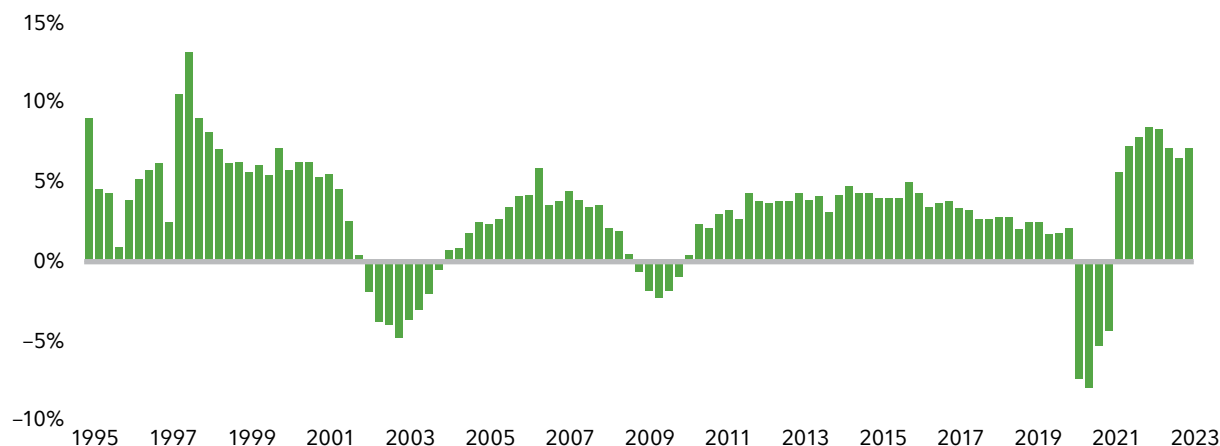
## Riding the waves of change: The sector's state of play

The CRE industry in the United States has faced headwinds amid rising interest rates, slowing economic growth and secular issues impacting the office sector. CRE is highly dependent on debt as most property owners use some amount of leverage to finance these assets. As the Federal Reserve has taken aggressive steps to try to tame inflation, investors have become more fearful about a slowdown in the capital-intensive CRE asset class. A series of rate hikes by the Fed since March 2022 has left the benchmark federal funds rate in a target range of 5.00%–5.25%, the highest level in 16 years.<sup>2</sup>

Despite the challenging backdrop, we believe on the ground CRE fundamentals remain sound as demand has been firm and rental rate growth positive across all property types, excluding office buildings. U.S. listed equity REITs posted strong gains on same-store net operating income (NOI)—a commonly referenced organic property growth metric—in Q1 2023, with average growth of 7.2%, led by industrial REITs at 11.6% and apartment REITs at 10.3% (Exhibit 1), according to data from Nareit.<sup>3</sup> While the first quarter result was a modest acceleration from the previous quarter, NOI growth has moderated since peaking above 10% in mid-2022. The recent level remained well above the long-term historical average of roughly 3%.

### EXHIBIT 1: Listed U.S. equity REITs posted historically strong same store net operating income (NOI) growth in Q1 2023.

U.S. Equity REITs Same Store NOI Growth (%)



**Past performance is no guarantee of future results.** Nareit's Total REIT Industry Tracker Series—the Nareit T-Tracker®—is the first quarterly performance measure of the “heartbeat” of the U.S. listed REIT industry. The series includes three key REIT industry measures: the Nareit FFO Tracker, which monitors equity REIT Funds from Operations (FFO); the Nareit NOI Tracker, which reports the equity REIT industry's Net Operating Income; and the Nareit Dividend Tracker, which monitors the dividends U.S. listed equity and mortgage REITs pay to their shareholders. Source: National Association of Real Estate Investment Trusts, as of March 31, 2023.

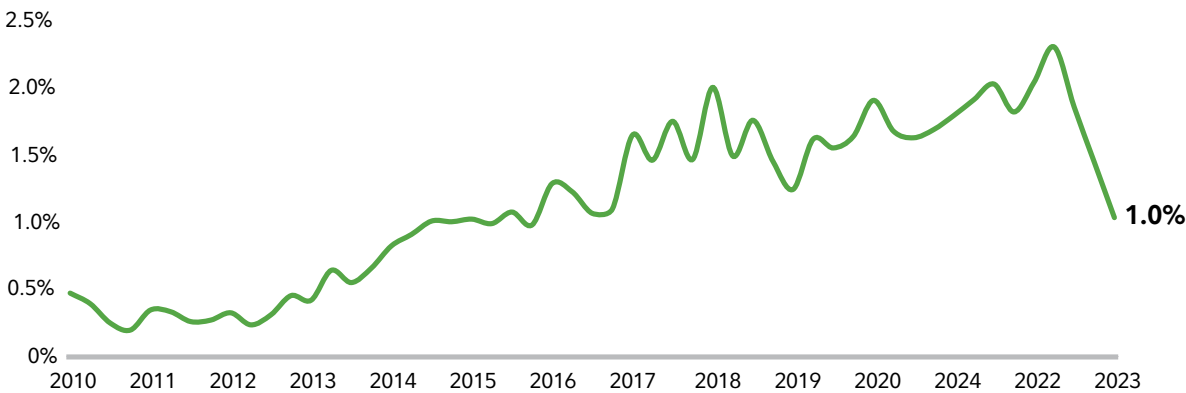
<sup>2</sup> Federal Reserve, May 4, 2023. <https://www.federalreserve.gov/monetarypolicy/openmarket.htm>

<sup>3</sup> National Association of Real Estate Investment Trusts, March 2023. <https://www.reit.com/data-research/reit-market-data/nareit-t-tracker-quarterly-operating-performance-series> and <https://www.reit.com/sites/default/files/2023-05/Ttracker2023Q1.pdf>

Furthermore, new CRE supply in U.S. metro areas is declining owing to higher capital costs and tighter credit conditions (Exhibit 2). The result is what we consider a sound fundamental backdrop with supply and demand reasonably balanced.

**EXHIBIT 2: The supply of commercial real estate trended lower.**

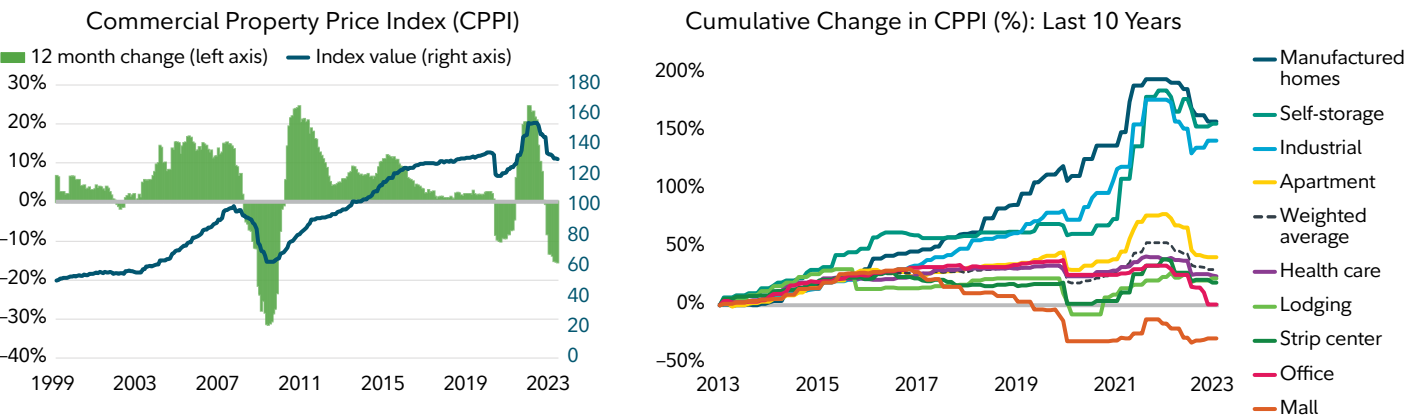
Commercial Real Estate Supply as % of Inventory (U.S. Metro Areas, Seasonally Adjusted)



Source: Moody's Analytics, as of March 31, 2023.

Offsetting these strong CRE fundamentals is significantly higher interest rates that have pressured property values lower. Green Street's Commercial Property Price Index®, which tracks the pricing of institutional-quality commercial real estate, declined 15% as of the end of April 2023 from a year ago<sup>4</sup> (Exhibit 3).

**EXHIBIT 3: Commercial property prices have declined more than 15% over the past 12 months.**



**Past performance is no guarantee of future results.** All Property CPPI® weights: retail (20%), office (17.5%), apartment (15%), health care (15%), industrial (12.5%), lodging (7.5%), net lease (5%), self-storage (5%), and manufactured home park (2.5%). Retail is mall (50%) and strip retail (50%). Core Sector CPPI weights: apartment (25%), industrial (25%), office (25%), and retail (25%). Source: Green Street Advisors, as of April 30, 2023. Dates correspond to the last day of the month (e.g., 2002-10-01 is actually 2002-10-31).

<sup>4</sup> Green Street, Commercial property price index, May 2023. <https://gs-s3-prd-usw2-website.s3.us-west-2.amazonaws.com/uploads/2023/04/04090259/GSCPPI20230504.pdf>

CRE owners with in-place floating rate mortgages have felt additional pain as loan coupons have reset higher pushing up the cost of debt. Borrowers with fixed-rate loans that were originated at lower rates are in a better spot for the time being. Still, as loans mature these borrowers find themselves seeking to refinance in a higher rate environment with a dearth of available capital—a difficult proposition.

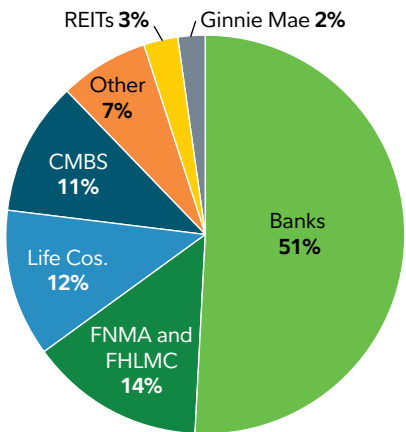
Recent bank failures have raised questions about the future of the CRE industry. The worry is that deposit outflows at small and regional banks could affect their ability and willingness to provide credit to CRE owners and add additional pressure to the market. There is a major difference, however, between what is happening now and the 2008–2009 global financial crisis. The current banking sector challenges appear unique to a small number of institutions and at this point do not appear to be a systemic problem, in our view. One positive aspect is that should banks turn off the loan faucet, the CRE industry has access to other sources of private and public funding that can help to fill the void. CRE owners can access capital from life insurance companies, bond investors, private debt funds, and government sponsored enterprises (GSE). A reduction in lending to CRE borrowers is most likely to have the greatest impact on smaller markets and smaller properties and less of an impact on larger, institutionally-owned assets that tend to be concentrated in primary markets across the country. Therefore, we believe recent bank failures are not likely to cause widespread CRE issues, although they are likely to lead to tighter credit conditions and higher borrowing costs over the short term, which could further pressure property values.

### The banking sector's exposure

Against this backdrop, concerns have emerged over the banking sector's exposure to CRE loans as borrowers face the highest interest rate environment in a generation while at the same time property-level cash flow growth is slowing—adversely impacting borrowers' ability to service existing debt and refinance maturing loans. Stress in the office sector is only compounding the problem.

Banks are the biggest real estate lenders with an estimated 51% of the \$5.6 trillion of CRE mortgages outstanding as of the end of March 2023 (Exhibit 4) compared to about \$23 trillion of assets at commercial banks in the United States, according to Federal Reserve data.<sup>5</sup>

**EXHIBIT 4: Banks hold the largest share of total commercial real estate debt outstanding.**  
% by sector



Source: CRE Finance Council (CREFC), as March 31, 2023.

- Commercial Mortgage-Backed Security (CMBS): Securities collateralized by a pool of mortgages on commercial real estate in which all principal and interest from the mortgages flow to certificate holders in a defined sequence or manner.
- The Federal National Mortgage Association (FNMA), or Fannie Mae.
- The Federal Home Loan Mortgage Corporation (FHLMC), commonly known as Freddie Mac.

<sup>5</sup> Federal Reserve, April 12, 2023. <https://www.federalreserve.gov/releases/h8/current/>



Banks increased their share of CRE financing in 2022—representing 48% of loan originations—versus an average of 40% over the prior five years (Exhibit 5).

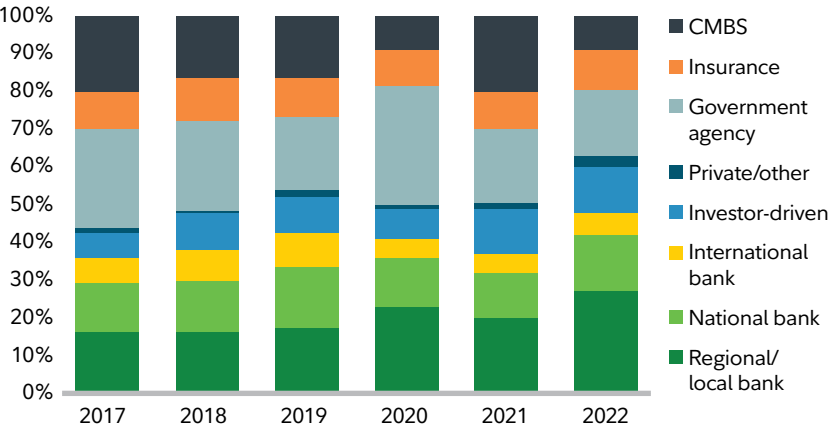
The growth in banks’ share of CRE financing over the past few years was driven primarily by regional and local banks. Small-to mid-sized bank lenders, including regional banks, were the biggest source of credit to the industry in 2022 and held a much higher share of CRE debt outstanding compared with larger banks. On the other hand, money center banks pulled back on CRE lending after the 2008 global financial crisis and represent a smaller aggregate share of outstanding CRE debt compared to their small and mid-sized peers. It is important to note that bank lenders are a diverse group with thousands of institutions involved in CRE financing—we consider this an important risk mitigant for the overall financial system.

Just like the overall CRE market, banks’ loan exposure is diverse across numerous property types and is much more than just loans on office buildings. The largest debt exposure is to multifamily properties (44%) followed by office (17%) and retail (9%) (Exhibit 6).

That said, there is refinancing risk for owners of properties across all types due to the Fed continuing to tighten monetary policy. In addition, weakening economic conditions could hamper rental income growth and occupancy rates in some sectors, especially for office buildings given secular issues unique to that property type. Higher interest rates have made it

**EXHIBIT 5: Banks have been one of the largest providers of loans to the commercial real estate industry.**

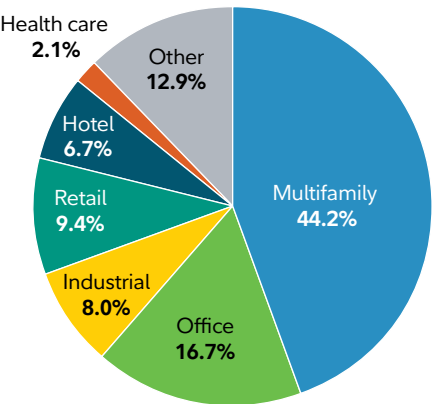
CRE Lender Distribution—All Property Types



Source: © 2023 Real Capital Analytics, Inc. All rights reserved, as of December 31, 2022.

**EXHIBIT 6: Banks exposure to multifamily properties has outpaced the office and retail sectors.**

CRE Debt Market—Exposure by Property Type

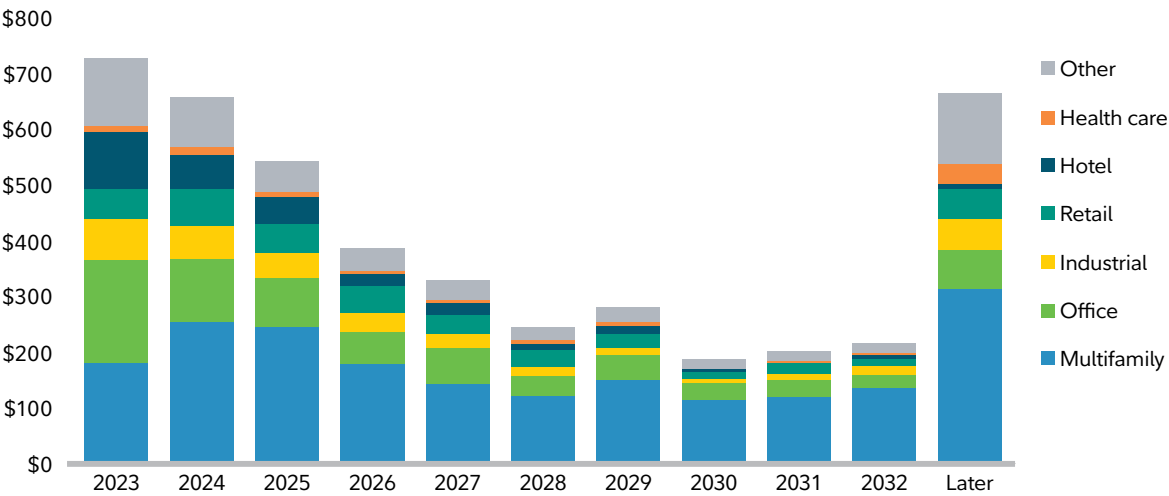


Source: Mortgage Bankers Association, as of March 10, 2023 .

more expensive for CRE borrowers to take on new debt or roll over existing debt obligations, and therefore more expensive to make potential portfolio acquisitions. About \$730 billion of U.S. CRE debt comes due for repayment before the end of 2023, with offices and multifamily making up the largest share (Exhibit 7).

**EXHIBIT 7: Office buildings and multifamily have the largest share of debt maturing in 2023 and 2024.**

Debt Maturities by Property Type (\$B)



Source: Mortgage Bankers Association, as of March 10, 2023.

That dynamic could have a knock-on impact on lenders. There is risk of potential credit losses particularly in situations where property-level income no longer covers the debt service or a property's value has dropped below the loan balance. It's worth noting that history has shown that lenders are likely to avoid costly and time-consuming workouts, at least initially, and grant loan extensions to more troubled borrowers.

Offsetting this risk is the fact that CRE loan underwriting standards remained disciplined in the post-global financial crisis era. Leverage, on average, has been modest, amortizing loans have benefited from natural de-leveraging over time, and there has been meaningful property price appreciation over much of the past cycle. Each of these facts improves the likelihood of successful loan payoffs and mitigates risks to the system. The delinquency rate on CMBS loans, a reasonable proxy for overall CRE loan performance, stood at what appears to be a cyclical trough of 3.09% in March, according to a report from CRE Finance Council.<sup>6</sup> Among individual property types, delinquency among retail and lodging properties have steadily improved in the recent past, although these were offset by worsening payments trends for office buildings. We expect office loan delinquency to slowly rise over time given our negative outlook on the sector. Still, we see a reduced risk of widespread contagion.

<sup>6</sup> CRE Finance Council, March 20, 2023. [https://www.crefc.org/cre/content/News/Items/Research\\_and\\_Data/CMBS\\_Performance\\_and\\_Maturity\\_Update.aspx](https://www.crefc.org/cre/content/News/Items/Research_and_Data/CMBS_Performance_and_Maturity_Update.aspx)

## Conclusion

Higher interest rates and slowing economic growth pose challenges for CRE though the industry overall, apart from the office sector, is exhibiting strong fundamentals. We think the interest rate shock is manageable as industry-wide leverage is not excessive, and existing CRE debt is held across a diverse set of lender-types and institutions. In addition, many of these lenders stand ready to provide capital to CRE owners—albeit at a higher cost. While a subset of troubled CRE loans could put additional stresses on the U.S. banking sector, we do not anticipate widespread bank failures. As banks pull back on CRE loan origination, it is our view that alternative providers of capital will fill the void. For these lenders, this could be the beginning of a unique, multiyear opportunity to originate loans with lender-friendly terms unlike anything seen over the past decade.





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Andy Rubin is an institutional portfolio manager for high income and alternative strategies at Fidelity Investments. In this role, Mr. Rubin serves as a member of the investment management team, maintaining a deep knowledge of portfolio philosophy, process, and construction.

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*Fidelity Thought Leadership Vice President Shanthi Nambiar provided editorial direction for this article.*

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