Verus

SEPTEMBER 2024

Office Market Update

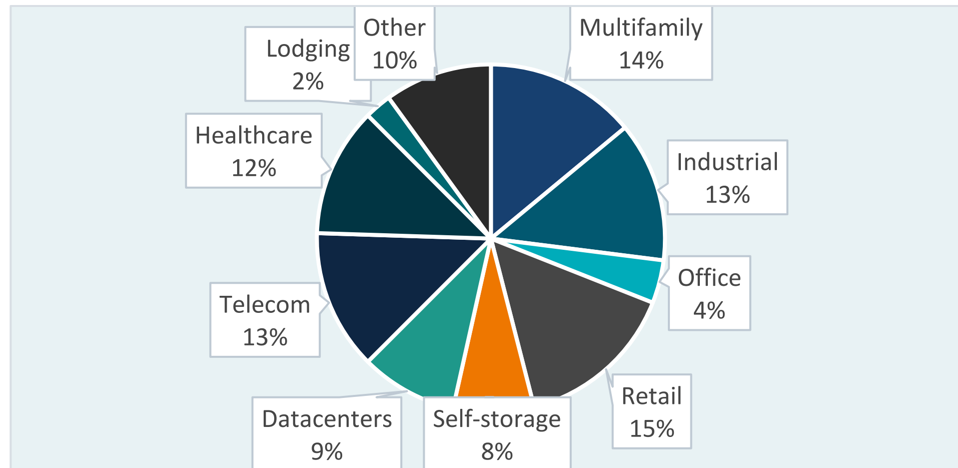
U.S. office market overview

— We believe that headlines warning of commercial real estate risks to the broader financial system overstates the size and scope of the challenges in real estate. The office market faces serious challenges, but we seek to show that those are manageable and less dire than media stories would indicate.

— Estimates vary around the size of the office market, but it is likely to comprise 15-20% of the total market capitalization of commercial real estate in the U.S. Within publicly traded real estate (REITs), office comprises 4% of the total equity REIT market. Office exposure within the NCREIF ODCE universe averages 17%. Private investors comprise the bulk of the office sectors ownership.

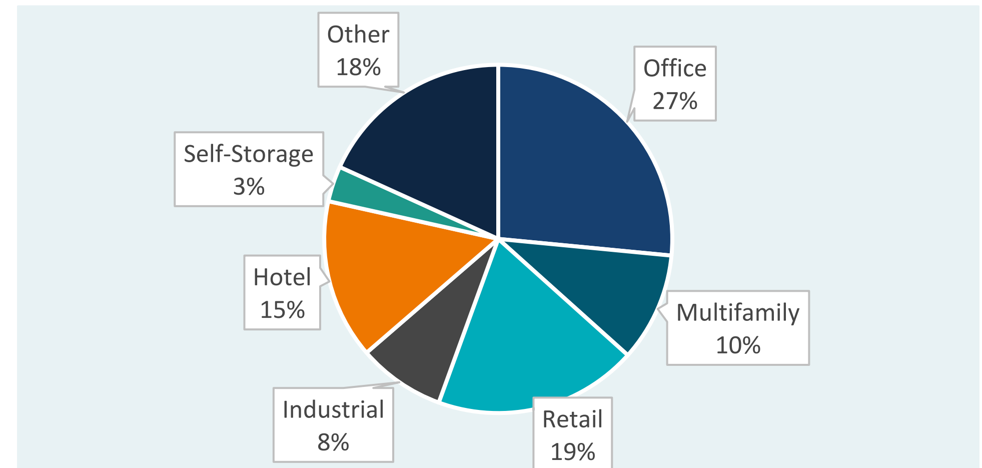
— Commercial mortgages backed by office assets are estimated at a similar percentage of 15% of total CRE debt outstanding. Office assets comprise around 4% of total bank loan exposure, nationally. Debt backed by office assets are held by a wide set of investors, including asset managers, banks, insurance and government agencies. The CMBS market has a relatively high percentage of office exposure at 27%.

REIT CRE MARKET CAP BY SECTOR



Source: NAREIT

CMBS MARKET COMPOSITION



Source: Trepp LLC

Office – challenges persist

— According to Kastle research, physical occupancy remains at 51% of pre-covid levels (nationally) and has not seen any significant improvement over the last 12 months. Structural shifts remain with most companies embracing a hybrid work environment.

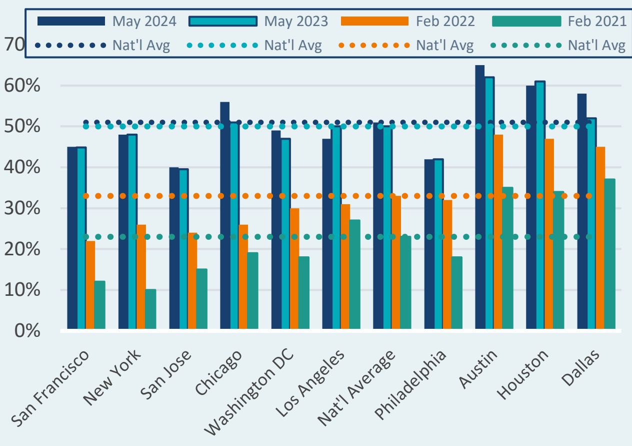
— Peak office usage on a given week is modestly higher as peak Tuesday office usage is averaging 60%, leaving room for employers to continue to shrink their office footprints.

— New leasing activity is trending slightly upward, however is still down 25% relative to pre-pandemic levels.

— We continue to see a bifurcation in demand with new leasing activity gravitating towards newer office buildings with more attractive amenities. Office buildings delivered since 2015 have experienced positive net absorption since Covid while all other buildings are facing net tenant outflows.

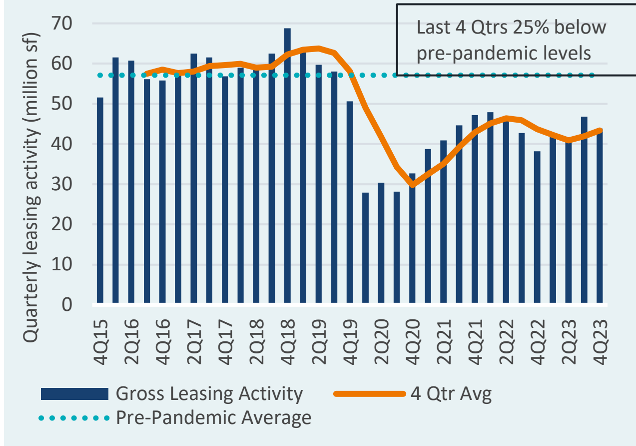
— The leasing cycle for office tends to average 5-7 years, so many leases are still at pre-pandemic levels. Values remain uncertain and will likely take several years to work through the system and fully reset. Capital is scarce for office assets, leading to few transactions and financing is a challenge as lenders are reducing exposures to the sector.

OFFICE PHYSICAL USAGE TRENDS



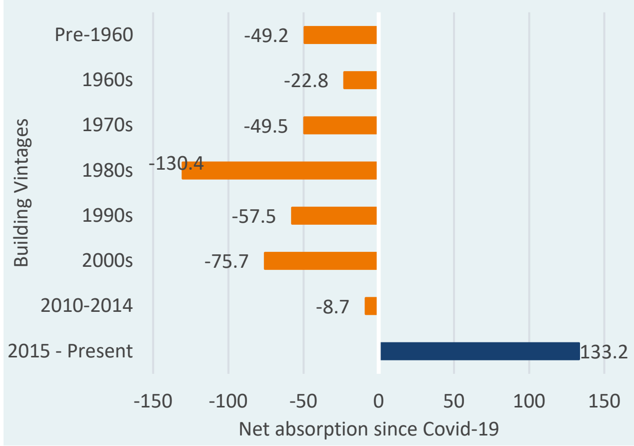
Source: Kastle, 5/13/24

OFFICE LEASING ACTIVITY (QUARTERLY)



Source: JLL, March 2024

FLIGHT TO QUALITY – NET LEASING ACTIVITY



Source: JLL, March 2024

Impact of the office challenges

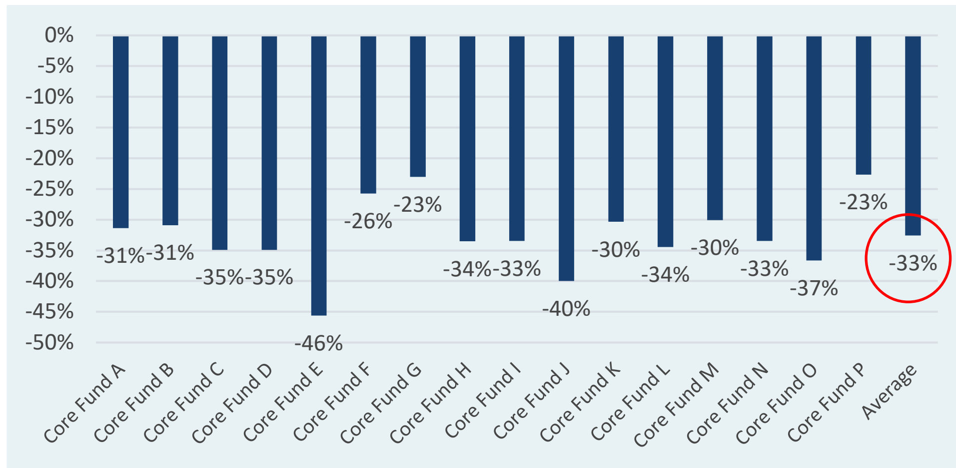
— Class B/B+ quality (and lower) office assets in gateway markets will continue to struggle and likely fall further in value. Debt holders that have not already restructured are expected to as leases expire and property income declines. Importantly, this is a subset of the office market that will need restructuring, and debt is held by a wide set of market participants.

— Banks, and other debt holders are likely to take further incremental write-downs which will be offset somewhat by higher lending rates on new loans. We expect headlines around office defaults to continue, though any broader systemic risk to the market is a low probability.

— Class A, trophy assets have seen price stabilization and will likely recover in value over the next several quarters as investors look for attractive relative values.

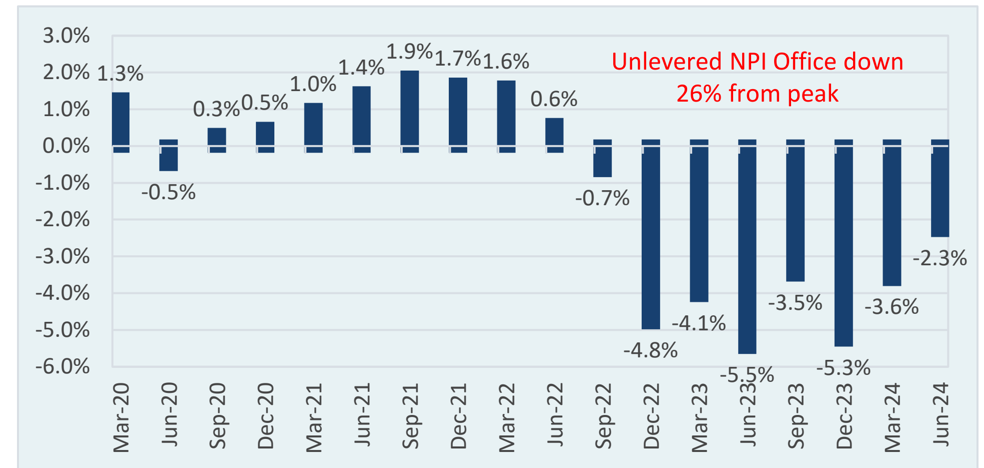
— Our observation is that most asset managers have substantially marked down their office assets and further markdowns, while possible, should have less of an impact on future returns as they comprise a smaller portion of investor portfolios.

PEAK-TO-TROUGH OFFICE VALUATIONS (ODCE FUNDS 4Q'21-4Q'23)



Source: Verus

NPI OFFICE RETURNS (UNLEVERED)

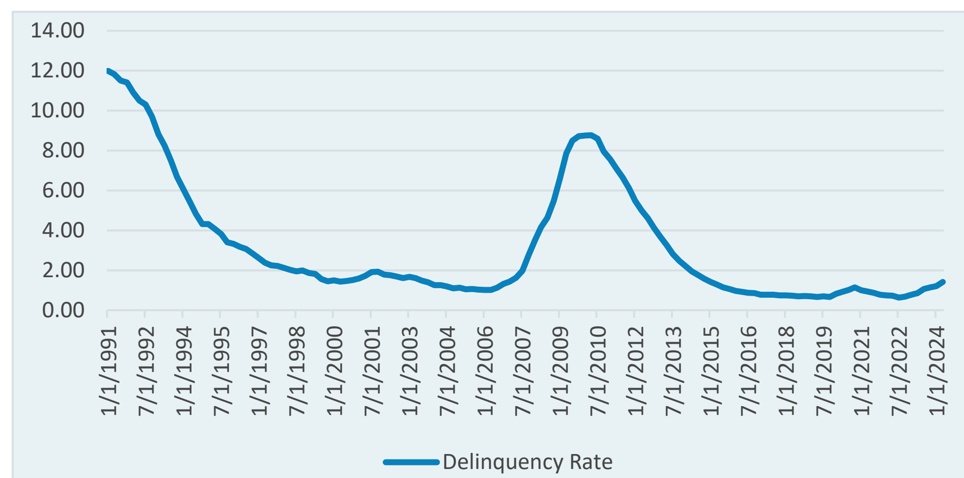


Source: NCREIF

Bank balance sheet concerns

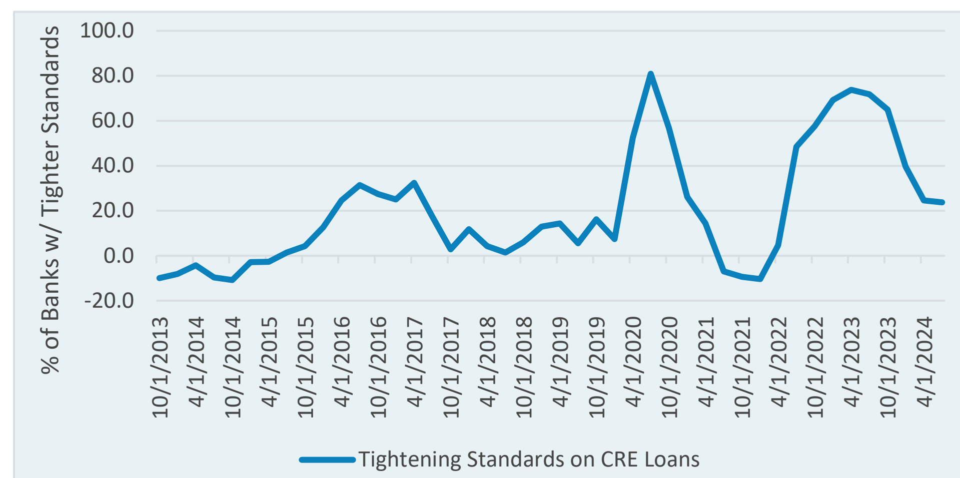
- Following the 2023 Banking Crisis, attention has been paid to the health of bank balance sheets, in particular their exposure to bad commercial real estate loans in the office sector and fear it could trigger another banking crisis. We think the probability of a second banking crisis triggered by bad commercial real estate loans is low given the improving health of bank balance sheets and, thus far, low default rates on CRE loans.
- Delinquency rates on commercial real estate loans has ticked up slightly from prior years but sit below 2%, as of Q1 2024. For context, delinquency rates at the peak of the GFC was close to 9%. Delinquency rates on all loans held by banks is at a similarly low level, below 2%.
- In one sign that banks feel comfortable with their CRE loan portfolios, the percentage of banks that have tightened their lending standards on commercial real estate construction and land development loans has fallen back to around 20% from a peak of 80% in 2023. Borrowers in the real estate market tell us that banks have reentered the loan market after being on the sidelines for a period.

DELINQUENCY RATE ON COMMERCIAL REAL ESTATE LOANS (ALL BANKS)



Source: FRED St. Louis

NET PERCENTAGE OF TIGHTENING STANDARDS FOR CRE CONSTRUCTION LOANS (ALL BANKS)

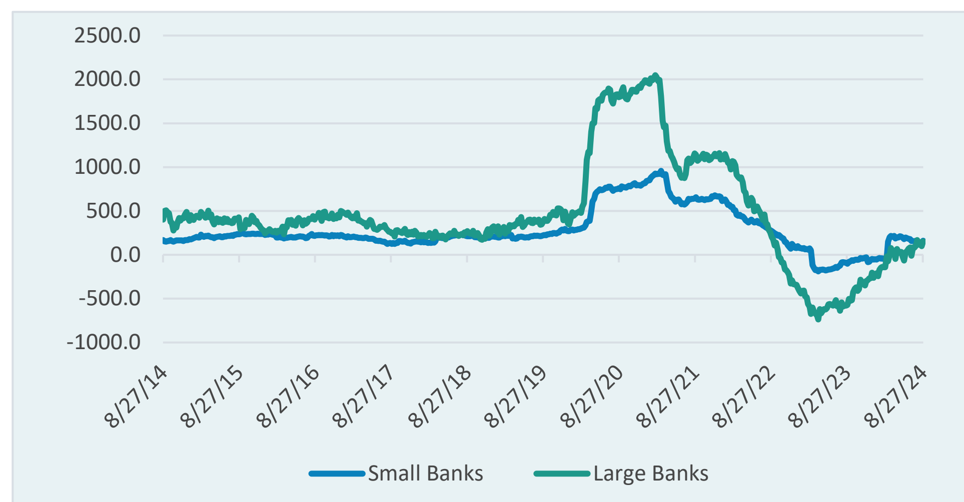


Source: FRED St. Louis

Bank balance sheet concerns

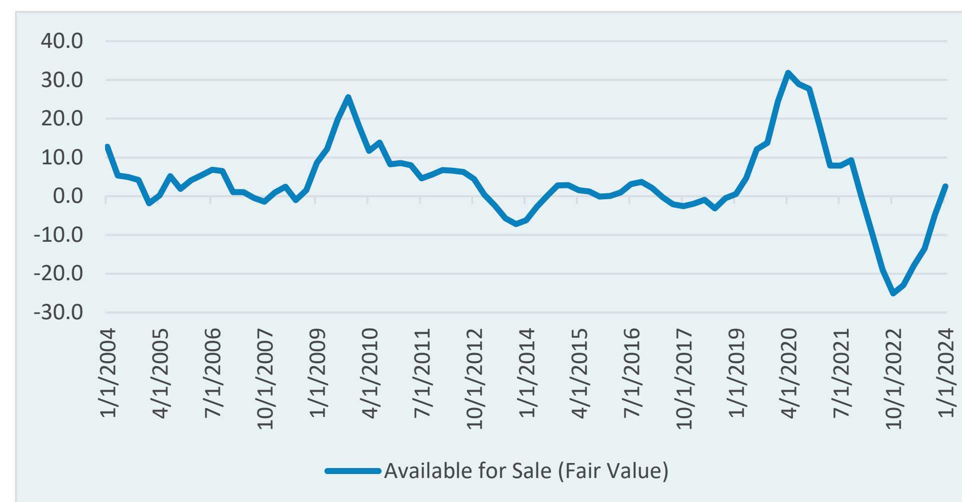
- Both large and small banks have seen a recovery in deposit levels from 2023 withdrawals, indicating consumer and business fears of additional bank failures has dissipated over time. Deposit levels were also impacted by investors moving savings into higher yielding instruments, like money market funds and CDs.
- The fair value of bank available-for-sale portfolios saw a sharp decline beginning in 2021 as interest rates moved higher, hitting a low in the third quarter of 2023. Fair values have begun moving higher and are expected to continue as interest rates decline, all else equal.
- We should acknowledge that slowing economic growth could push delinquency rates higher across loan portfolios, both real estate and non-real estate.

CHANGE IN BANK DEPOSITS YOY ($B)



Source: FRED St. Louis

YOY % CHANGE IN BANKS AVAILABLE FOR SALE SECURITIES (FAIR VALUE)



Source: FRED St. Louis

Where do we go from here

- Transaction activity is likely to remain muted across the office sector and we expect most asset managers will continue to deemphasize exposure to the sector.
- We would avoid the temptation to be a contrarian and buy lower quality office assets in gateway markets, particularly on the west coast. Buying a long-dated call option on an office asset that requires regular cash infusions may end up being valuable but there are easier ways to make money in commercial real estate.
- In contrast, there likely will be some attractive buying opportunities for high quality office assets in growing markets. We expect this to be a short window opportunity as we expect few forced sellers of high-quality assets.
- ***We remain bullish on commercial real estate opportunities and have taken advantage of investor apathy to the asset class over the last 12 months. Unfortunately, prices are stabilizing in non-office sectors and the window for buying discounted assets will not stay open indefinitely.***

Appendix

Office debt exposure

- Office comprises around 15% of all commercial mortgage debt outstanding
- Banks comprise the largest segment of the commercial real estate debt market
- Within Bank CRE mortgage portfolios, office assets comprise around 15% of the portfolio. Office comprises around 4% of total loan portfolios for banks, nationally
- CMBS market has a relatively high percentage of office exposure (27%). The largest investors in the CMBS market are insurance companies, which typically own the highest rated tranches, while hedge funds and asset managers own most of the lowest quality tranches.

CRE DEBT EXPOSURE BY LENDER TYPE AND SECTOR