The Commercial Real Estate Bust

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Certain property types and regions of the US commercial real estate sector are currently experiencing a bust of historic proportions. This is largely due to two separate but mutually-reinforcing phenomena. The first is the inevitable repricing that had to occur after the manic bubble that was inflated by the Federal Reserve with its policy of ultra-low interest rates. Inexperienced buyers bid prices up to unprecedented levels in many locations, but those properties can no longer cover their costs now that the interest rates on the debt of these highly-leveraged investments has increased to more typical levels.

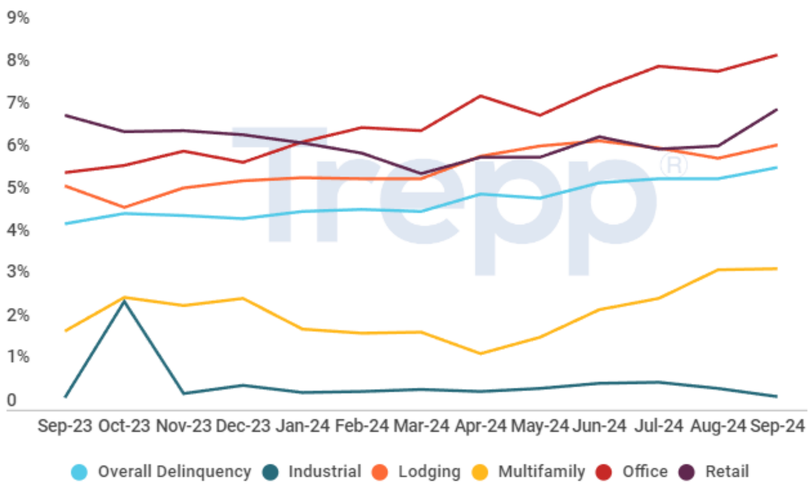
The second is the impact of remote working policies. These policies have caused firms to release or sub-lease large amounts of office space, causing gluts in many cities. It has also impacted related property types, like the retail spaces that used to cater to those workers, and the garages where they used to park their cars. (It is also causing some stress to municipal cash flows, but that is a different story).

We have seen this reflected in some of the broad commercial real estate property indices, which show prices down about 13% from the recent peak. However, in more distressed markets, it is not uncommon to see buildings sell for less than half the value they traded at a few years ago, and in some cases the are actually worthless since the structures are no longer viable and need to be removed before a new development can proceed. This has been particularly acute in formerly high-flying locations such as San Francisco and New York City. Charlotte has not escaped this trend, as it sports an office vacancy rate of over 25%, one of the worst in the country.

Outside of offices, commercial real estate loan delinquency rates have deteriorated but are not at crisis levels. Demand for industrial properties remains strong in general. Retail properties have deteriorated in recent months. The chart below from CRE data firm Trepp shows recent trends in problem loans. Keep in mind that lenders are not eager to foreclose, and often roll over loans that they know are no longer viable to avoid recognizing losses (a practice known as extend-and-pretend).

There are very large losses hidden under the relatively calm surface in this space, as is also the case in other sectors such as private equity, venture capital and private credit. Therefore, it seems likely that large amounts of inflation are likely to be needed to cover these losses and prevent further damage to the owners and lenders, which include large and regional banks and public and private pension plans. Investors should position themselves now to avoid seeing their savings destroyed when this occurs.

CMBS Delinquency Rates by Major Property Type



Delinquency Trends

10.34%
Peak Delinquency Rate (July 2012)

5.70%
Overall Delinquency Rate (September 2024)

4.39%
Overall Delinquency Rate (September 2023)

8.36%
Office Delinquency Rate (September 2024)