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Our Thoughts on Real Estate Today, and As We Enter 2025

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The environment for real estate investing continues to be uncertain, despite optimistic assessments from some quarters that the market has bottomed. Below are some headlines that convey our views on the US real estate market, including a few topics we have been discussing with clients (alongside some illustrative examples). If of interest, we would welcome the opportunity to discuss any of these topics in more detail.

While the structural issue is fundamental, the current problems in real estate were not catalyzed by fundamentals. As it happens, while fundamentals and certain other secular changes are a core part of the asset value reset in the market (e.g., the decreased utilization of office space), the actual trigger of the current market predicament was the recognition of the asset/liability mismatch within banks. In the case of banks, post-GFC, these institutions loaded up on commercial real estate debt, particularly the smaller, regional banks, who hold 80% of all CRE loans made by US banks.(1) For banks with less than $10 billion in assets, this sector represents 38% of their loan portfolios.(2)

At the same time, there was an assumption that demand deposits (i.e., one's checking or savings account) had a longer duration than term deposits (e.g., bank CDs), only reinforced by both extended zero-interest rate policy and decades of calmness (with, aside from early in the GFC, the last meaningful deposit run that happened pre-2021 was in 1984 at Continental Illinois).(3) And various studies supported this notion of demand deposits inelasticity from a variety of angles – for example, the elasticity of such deposits against short-term interest changes (i.e., do customers shift into term deposits to lock-in rates), against short-term versus long-term interest rate differentials (i.e., do people move money into longer-term investments), and with general reference to such deposits having a duration of 8 years or longer.(4) The demise of Silicon Valley Bank and First Republic revealed the new reality that this model had been technologically disrupted in today's digital world where all it takes is the click of a button on a smartphone to move money from one institution to another, and as social media has facilitated rapid awareness and potentially emotional among the general public.

Banks have an estimated $3.6 trillion in CRE debt today (and similar issues exist among CRE credit funds that were less discerning on credit decisions before rates rose significantly). As such, there needs to be a massive transition of the ownership of real estate loans and REO to more stable, asset-liability matched pools of capital such as institutional investors and insurance companies.

(1) Source: Goldman Sachs: https://www.goldmansachs.com/insights/articles/stress-among-small-banks-is-likely-to-slow-the-us-economy
(2) Source: CNN: https://www.cnn.com/2024/02/29/business/regional-banks-cre-exposure-explainer/index.html
(3) Source: https://www.stlouisfed.org/on-the-economy/2023/may/understanding-the-speed-and-size-of-bank-runs-in-historical-comparison
(4) As examples see: (1) Tanner, Zanzalari, Manion, and Haavind-Berman. Demand Elasticity for Deposit Services at U.S. Retail Banks in High and Low Rate Environments, Federal Reserve Bank of Boston, June 2021, and (2) Hoffman, Frontczak and Pierobon. Modelling the Duration of Retail Bank Deposits, European Central Bank, 2023.

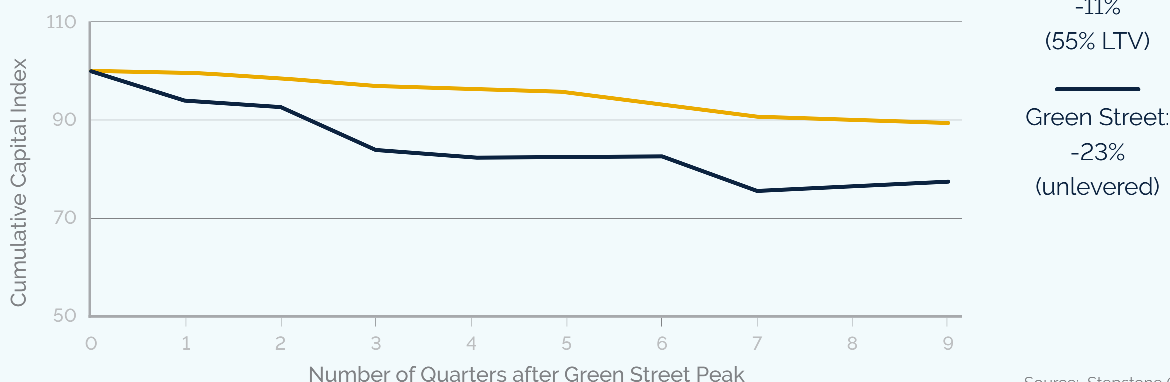
Debt investing during the peak bubble years likely leaves those investments massively impaired. Into 2021, CRE debt was being offered at 75%-80% advance rates assuming 4-6% cap rates for valuations at coupons of 5-7%. Those same loans today are measured against valuations that assume 5.5%-8.5% cap rates earning coupons of 8-12%. A quick comparison of pre- and post- is given below, where a generic loan valuation is about 21.5% lower at today' levels:

	Pre-2022	Post-2022	$/% change
Property NOI	$1,000,000	$1,000,000	N/A
Cap Rate	5.0%	6.0%	+1.0%
Real Estate Value	$20,000,000	$16,700,000	-$3,300,000/-16.5%
LTV	75%	75%	N/A
Loan valuation LTV	$15,000,000	$12,525,000	-$2,480,000/-16.5%
Coupon	5.5%	7.0%	+1.5%
Loan Valuation at YTM	$15,000,000	$11,785,710	-$3,210,000/-21.4%

Equity positions are likely even more impaired. Even in high quality "core" properties, equity owners under this massive amount of debt are severely impaired (if not wiped out) – as it is the economics of your position in the capital stack that determines your value, not the quality of the property. A quick comparison of pre- and post- is given below, where the implied equity value is 66% lower at today' levels:

	Pre-2022	Post-2022	$/% change
Property NOI	$1,000,000	$1,000,000	N/A
Cap Rate	5.0%	6.0%	+1.0%
Real Estate Value	$20,000,000	$16,700,000	-$3,300,000/-16.5%
LTV	75%	90%	+15%
Loan Size	$15,000,000	$15,000,000	N/A
Equity Value	$5,000,000	$1,700,000	$3,300,000/-66.0%

At the same time, GP valuations do not necessarily reflect reality, even when affirmed by third-party valuation agents. As you might expect, given the wide amount of freedom in marking private investments, many GPs and real estate investors are not reflecting any of this reality in current valuations but are instead hoping that interest rates will drop precipitously and operating conditions will improve (which we think is unlikely). As an illustration of this, Stepstone Group (using data from Green Street) recently showed that unlevered property values are down 23% peak-to-trough, while non-core funds, with much higher leverage, are down only 11%.



Our view is that regardless of "what inning we are in," **there are compelling investment opportunities across the CRE capital stack** as the market will continue to undergo a massive disruption due to the resetting of valuations and higher going-forward costs of capital following a nearly decade-long investment environment where the participants were working with "free money". Regardless of future rate cuts, the fundamental fact is that real estate values have been under pressure, and likely will continue to be – especially for those assets bought (and financed) at levels reflective of the near-zero interest rate environment during the late 2010s through the COVID period.

While significant in size, bank holdings of real estate equate to about 20% of their deposits, and regulators are telling banks to "take it easy on borrowers"[5] — so they are not facing a near-term crisis. **As such, the aforementioned transition will take some time** because it is in the interest of bank managements to smooth these losses out over time, building up reserves to buffer the losses. We estimate this will play out over the next 4-5 years. **In the interim, "distressed" opportunities are not yet happening in significant scale** — while we have invested in a few US distressed-oriented investments recently (and there have been some larger asset sales such as First Republic's portfolio), the vast majority of what we are seeing are only the "lightly scuffed" assets. That said, we are seeing opportunities. For example, earlier this year, we purchased a maturity-defaulted first mortgage for a multi-family property in Manhattan for less than 50% of its as-is value. Additionally, we have two $50mm debt pools offered from debt funds at significant discounts that we are currently underwriting. As mentioned, we expect many more of these types of opportunities ahead.

We are often asked, **'if all of that is the case, is the 'coming $2.2 trillion wall of maturities' real?'** Our answer is, 'yes,' as even where banks are aggressively "extending and pretending," that activity is suppressing the provision of new credit. And because an accelerated amount of this activity started occurring some time ago (i.e., post-pandemic), the volume of loans set to mature in the near-term has increased materially.[6]

At the same time, new-issue lending is very attractive. Banks have retreated from making new loans leaving alternative lenders to fill the gap. As mentioned before, one can advance 75% assuming a 6%-8% cap valuation for 18-24 months and charge 11-13% unlevered, secured by income producing or near-income producing transitional properties. As one example, we recently made an 18-month loan at 48% loan-to-cost (50% loan-to-stabilized value) secured by an Orlando Hotel in the heart of the entertainment district in close proximity to other key locations, where the owner had gut renovated and re-flagged the property into a resort-style hotel to cater to tourists and group travel. We believe this new-issue opportunity will persist, as the next wave of buyers needing financing will be those looking to play offense as the distressed transition plays out.

We further believe the most compelling opportunities are in (generically) the sub-$40 million size range (where there is a dearth of institutional-quality alternative lenders with sufficient scale). While opportunities exist in many primary markets, secondary markets provide very compelling opportunities for similar reasons. Further, those that have the experience and expertise to lend to more niche/specialty property types (e.g., senior living, medical office, self-storage, single family rental, student housing, etc.) have an even larger opportunity set from which to choose.

How would you look at office today? In many instances the economics of office building investing comes down to the lower of land value minus cost of demolition and the present value of existing in-place rents minus now-escalating operating expenses. If you apply that lens, the reality is that office has not capitulated to those levels, but we expect they will, over time, and it is being more widely recognized that the ultimate losses to existing investors across this space will be severe. As one datapoint, an analysis by Bloomberg[7] recently showed that almost every single CMBS transaction tied to office property is impaired all the way up to buyers of the AAA tranches of the debt.

(5) Source: https://www.bisnow.com/national/news/commercial-real-estate/regulators-say-lenders-should-pitch-in-and-help-stressed-cre-firms-119638

(6) *Crosignani, Matteo, and Saketh Prazad. Extend-and-Pretend in the U.S. CRE Market, Federal Reserve Bank of New York Staff Reports No. 1130, October 2024*

(7) Arroyo, Carmen, et al. "AAA Bonds Go Bust and Reveal Depths of US Office-Market Crash." *Bloomberg Law*, 28 October 2024.

We would also add that we are generally very averse to the "convert an office to multi-family" thesis as building layouts are not typically suited to this being a straightforward process (e.g., the number and location of bathrooms), and in our experience, we have observed that the economics of these types of projects frequently struggle to compete with simply demolishing and rebuilding.

Will losses be limited to banks? Whether or not you are asset-liability matched (or mismatched), the economics remain the same, and the bill will eventually come due. As such, we see these issues spanning across pre-2023 real estate investment portfolios, unless extreme prudence was applied in the bubble years. Even further, for those firms that lack sufficient workout and operational capabilities (i.e., the infrastructure and staffing to step-in, take over and monetize) the ability to protect value is even further at-risk.

Any other things to be worried about as a real estate LP?

As investors in real estate with extensive workout and operational capabilities, we are working with certain of our clients (through our affiliated entity Quaestor Consulting Group) in advising them on how to maximize value in investments that might be either already impaired and/or where they are at-risk of "creditor-on-creditor violence" (i.e., having conflicting incentives across the investors in the capital stack of the asset that may further impair their recoveries).

We would also mention another emerging dynamic in what we call the coming wave of "GP on LP violence". Stepping back for a moment, since the GFC, the only area of private markets to have gone through a meaningful cycle has been energy private equity. If you look at that area as a case study, values were meaningfully impaired in 2016. Based on the creativity GPs can (and do) apply in valuations, the value impairment did not show up in the original LP marks until 2019. Only in the last 2 years have we now been seeing GPs, who are significantly below their incentive promote levels and do not have the prospect of raising future funds, cherry-picking assets out of their funds where LPs are fatigued and are willing to be "out at any price". They are doing this through continuation vehicles that are created at a significant discount to actual value, leaving large upside to the GP (at the LPs' expense). We expect to see this across other private market types, but particularly in real estate in the years to come, given several factors (capital structure opacity might hinder LP interest sales, GP incentives, etc.). LPs need to be able to identify if/when this is occurring and game-plan on how to manage that future risk (e.g., educating stakeholders today). This is a topic on which we have spent time with several of our clients, and would be happy to discuss it with you.

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