Commercial Real Estate: An Environment Ripe for Opportunistic Investing

June 2023

Introduction

Real estate is one of the largest alternative asset classes, with over $3 trillion in assets under management (AUM).[1] With historically low correlation to stock and bond markets, the asset class has long been regarded as a reliable hedge against inflation and carries the potential for attractive yield. Segmented by individual sectors, such as office, multifamily, retail, industrial, and hospitality, each subcategory has its own characteristics (both cyclical and defensive), allowing for further diversification by sectoral trends.

On the surface, however, the attributes of each sector and sub-sectors within the real estate asset class may be hard to discern. Amid rising interest rates and several high-profile defaults, U.S. commercial real estate (CRE), as measured by the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index, declined 3.5% in the fourth quarter of 2022 – the first negative return since the pandemic in 2020, and the largest decline since the Global Financial Crisis (GFC) in 2009.[2] Publicly traded real estate equities saw a much sharper decline of approximately 25% for the full year of 2022, painting an even grimmer picture.[3] Defaults are broadly expected to keep rising, as shown in Exhibit 1, especially with a $1.5 trillion looming wall of U.S. CRE debt needing to be refinanced at higher rates and tighter terms over the next two years.[4]

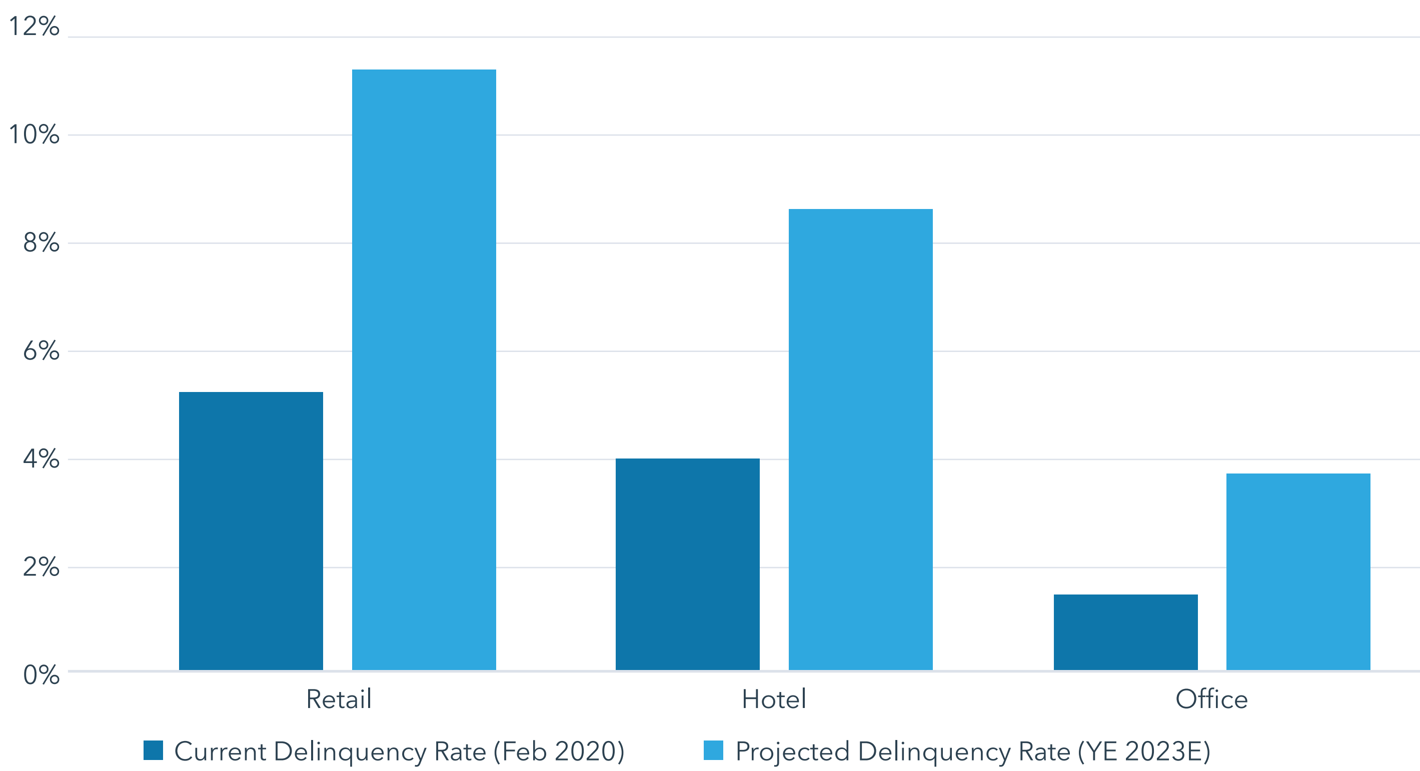
But after a closer look, we see a more nuanced story. Certain CRE sectors, such as multifamily and industrial, are experiencing a slowdown, but continue to exhibit relatively stable fundamentals. Other areas, such as office and business-related hospitality, are starting to show significant stress, driven by lifestyle trends that evolved from the pandemic. Oftentimes, the stress in the market, while jarring, provides a potentially attractive backdrop for investors with fresh capital to deploy.

A Changing Paradigm

Real estate is a capital-intensive business requiring a combination of consistent rental growth and attractive financing for success. The extended period of low interest rates following the GFC combined with economic growth was a boon to the CRE market; and many operators and

Exhibit 1: Current and projected CRE delinquency rates

By subsector



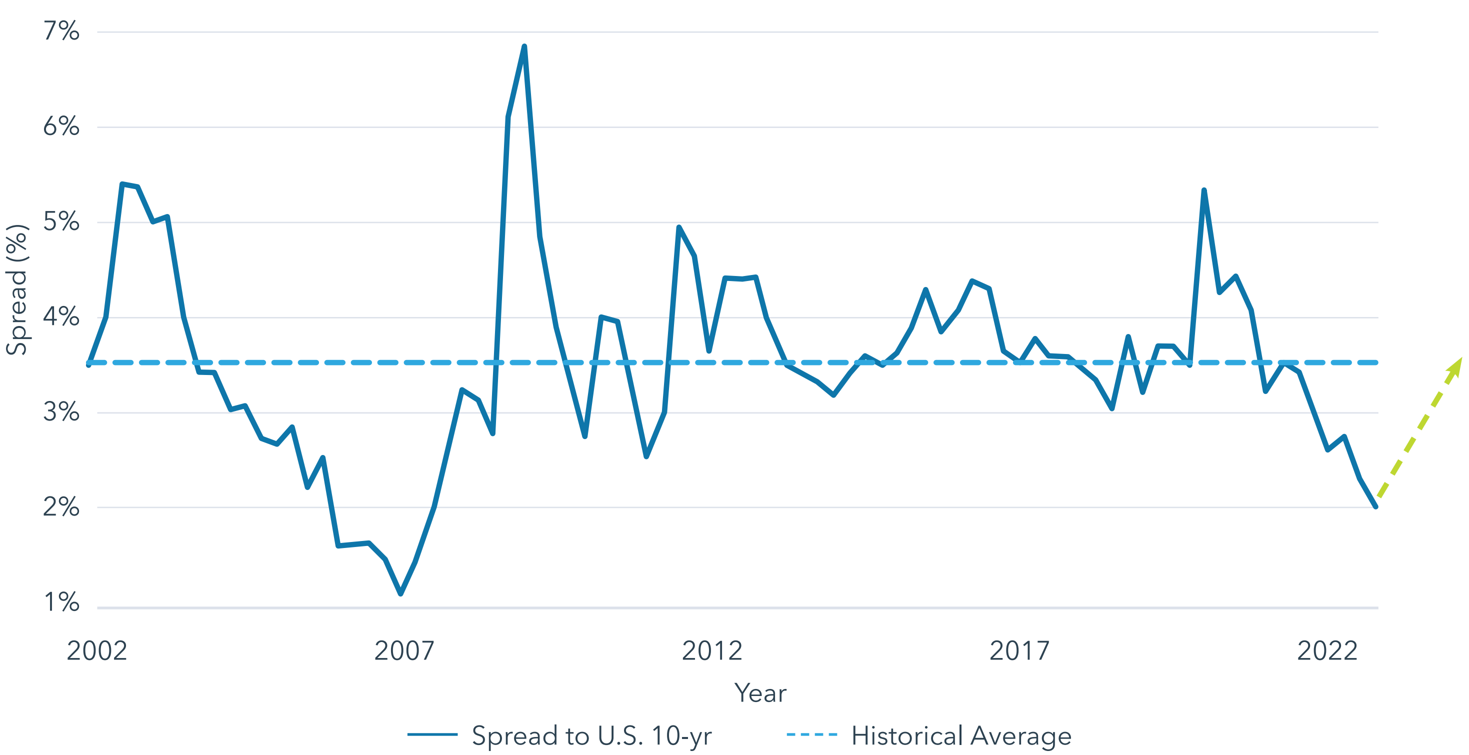
Source: Fitch Ratings, as of March 2023. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

developers took on significant debt to support their businesses. However, with inflation running high and the cost of debt rising precipitously since the beginning of 2022, this extensive use of debt financing is now having the inverse impact. Higher financing costs will certainly lessen the attractiveness of new projects, but the greater concern is the refinancing of existing CRE debt, especially for less attractive properties. Approximately $1.5 trillion of U.S. senior CRE loans are set to mature by the end of 2024.[5] The recent turmoil in the regional bank sector further adds downward pressure on CRE - regional banks account for 70% of total CRE loan exposure in the U.S., and CRE loans represent 43% of regional banks' total loans outstanding (versus only 13% for large banks).[6] Moreover, of the estimated $2 trillion of CRE exposure carried on the balance sheets of regional banks, over half is within the troubled office segment, which could pose challenges as these banks may be unwilling to extend and amend existing loans coming due as they look to cut their loan exposure and implement tighter loan standards.[7]

While the combination of higher interest rates, cooling real estate valuations, and tightened lending standards is challenging, its impact on the CRE market will vary depending on strategy and property types. With cap rates increasing off low absolute levels and very tight spreads to U.S. Treasuries, upward moves of 50 to 100 basis points (bps) can equate to significant downward pressure on valuations, given all else is equal. For example, Asset Consulting Group (ACG) estimates that with a starting cap rate of 4%, an increase of 50 to 100bps results in valuation declines of 12.5% to 25%, respectively.[8] According to Morgan Stanley, real estate asset prices could decline as much as 30 to 40% peak-to-trough depending on the property type.[9] Even more modest valuation declines will put significant pressure on debt servicing and loan covenants. As debt maturities approach, borrowers seeking refinancing will not only face tighter lending standards and higher borrowing costs, but also a significant drop in valuations. For example, consider an office building that was acquired for $100 million in 2020 at 70% loan-to-value (LTV). Assume the same asset has declined in value by 20% with the original $70 million loan maturing at the end of 2023. At a constant LTV, the property owner can now only expect to borrow $56 million against the building, creating a funding gap of

Exhibit 2: Spread of CRE cap rates over U.S. 10-yr. Treasury

By percent



Source: Bloomberg, NAREIT, iCapital Investment Strategy, data as of December 31, 2022. The REIT-implied cap rate is the average cap rate implied from publicly traded REITs. It is not reflective of the overall CRE universe. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

$14 million ($70 million less $56 million). However, in a more challenging credit environment, LTVs, if anything, are likely to be lower, potentially creating an even wider gap, as shown in Exhibit 3.

The Time to be Opportunistic

Given this context, many properties that were once considered stabilized may display significant challenges. While unnerving for some, market turbulence can provide compelling conditions for opportunistic real estate strategies. Aimed at generating outsized returns through capital appreciation rather than income, opportunistic strategies are structured to take advantage of market dislocations across sectors and regions. These strategies generally involve closed-end funds with defined 8- to 10-year terms that help insulate managers from liquidity mismatches of core open-end funds, and provide managers with the flexibility to acquire, rehabilitate, and exit assets in the fund.

Further, opportunistic strategies have more levers to drive returns than their core counterparts: greater pricing inefficiencies among non-core assets; value-add through renovations, repositioning, and development; hands-on asset management; and the ability to extract a portfolio premium by building a pool of diversified assets. As such, we believe the current environment offers experienced opportunistic managers one of the richest opportunity sets for CRE since the GFC era. A few key themes stand out:

1. **Distressed Office:** Significant pandemic-driven changes in residency, especially with remote and hybrid work environments, continue to be sticky. While the number of fully remote jobs may be waning, the "new normal" of hybrid/flexible work should continue to have a material effect on commercial real estate as companies are taking less space. Office vacancy levels remain elevated, with usage rates still 50% below pre-pandemic levels in many major cities and a growing discrepancy between Class A and Class B & C buildings, as reported by Trepp.[10] There will likely be compelling opportunities to reposition well-located yet underperforming Class B & C properties through renovations and adding amenities to attract Class A tenants.

Exhibit 3: Office property financing example

In millions

Capital Structure		
	2020	2023
Value	$100	$80
Equity	$30	$10
Debt	$70	$70

Refinancing Scenarios		
	@ 70% LTV	@ 65% LTV
Available Financing	$56 ($80 x 70%)	$52 ($80 x 65%)
Existing Debt	$70	$70
Funding Gap	$14 ($70-$56)	$18 ($70-$52)

Source: iCapital, as of May 31, 2023. For illustrative purposes only.

2. **Business-heavy Hotels:** Business travel has been slow to return, leading to strains in hospitality assets that are dependent on business travelers and conference attendees. Hospitality assets tend to be cyclical in nature and with three years having passed since the pandemic, many properties remain under pressure. From an investment standpoint, hospitality assets are relatively straightforward to reposition through renovations, marketing, upgraded amenities, and anchoring with destination restaurants.

3. **Life Sciences:** While supply in the biotech sector continues to increase, the demand has cooled in the post pandemic era. Dow Jones reports that many biotech firms have had to moderate and even slash growth plans in the face of difficult capital market conditions.[11] According to CBRE, vacancy rates have moved meaningful higher across the three biotech hubs of San Francisco, San Diego, and Boston, while supply is expected to grow over 20% by 2025.[12] However, unlike traditional office jobs, most life sciences workers do not work primarily from home. As such, this temporary period of dislocation could be an attractive entry-point in an otherwise resilient sector.

It is important to note that opportunistic real estate strategies carry risks, usually targeting assets with limited, if any, visibility into cash flows, often in dislocated markets. As a result, the return dispersion among non-core real estate managers tends to be significantly greater than core managers. Investors should focus on experienced managers that have exhibited pricing discipline across the business cycle and an ability to generate value not just through financial engineering, but also in operational expertise.

The CRE market is entering a more challenging environment after years of growth supported by low interest rates. All major CRE sectors are likely to feel some pricing pressures, but certain segments, such as office and hotel, that were already experiencing structural changes in demand, are particularly vulnerable. At the same time, asset price dislocations coupled with strong, identifiable secular trends provide an excellent backdrop for experienced investment managers to deploy new capital. We believe the current environment offers one of the most attractive entry points into the CRE market since the GFC. Now as much as ever, manager selection is paramount. Investors will need to narrow in on managers with experience, sector and geography focus, and use of leverage, especially in a volatile macro environment.

ENDNOTES

1. McKinsey & Company, "A Turning Point for Real Estate Investment Management," November 2019.
2. NCREIF Property Index (NPI), as of June 8, 2023.
3. NCREIF Property Index (NPI), MSCI Global REIT Index, as of June 8, 2023..
4. Morgan Stanley Credit Strategy, "Scaling Maturity Walls," April 2023.
5. Ibid.
6. JPMorgan, Bloomberg, iCapital Investment Strategy, March 13, 2023.
7. Ibid.
8. Asset Consulting Group, "Real Estate in a Rising Interest Rate Environment," July 2022.
9. Morgan Stanley Credit Strategy, "Scaling Maturity Walls," April 2023.
10. Trepp, "CECL Allowance Ration Remains Low, but Concerns in Office Sector are High," March 2023.
11. Dow Jones, "Life-Sciences Market Is Cooling Off," May 3, 2023.
12. CBRE, U.S. Life Sciences Real Estate Market Normalized in Q4 After Robust Growth of Previous Two Years, Jan. 27, 2023.

iCapital®

60 East 42nd Street, 26th Floor
New York, NY 10165
212.994.7400

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