SPECIAL REPORT

Marcus & Millichap

CRE Debt and Distress
Frequently Asked Questions:

MAY 2024

Q: Is commercial real estate facing distress?

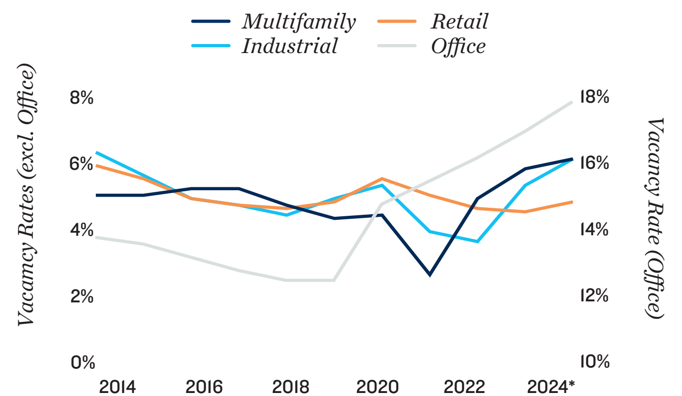
A: Although the rapid rise of interest rates since March 2022 has placed pressure on real estate investors, the commercial property sector as a whole is generally well-positioned as of early 2024. While some properties have and will experience distress, a widespread wave is unlikely.

- The multifamily sector is exiting a period of prodigious rent growth, with the average effective rent closing out the first quarter of this year more than 26 percent ahead of the pre-pandemic equivalent. While recent elevated development has pushed up vacancy, the rate remains comparable to the historical average on the national scale, and forward indicators suggest new supply pressure will lessen in coming years.
- Retail properties are benefiting from a prolonged period of subdued development, especially since the emergence of COVID-19, prompting prospective tenants to lease existing builds. This trend, paired with resilient consumer spending, is supporting low nationwide vacancy for multi-tenant retail space, which entered 2024 at a more-than decade low 5.2 percent.
- Much like with multifamily, the industrial sector is also in an elevated construction cycle after a white-hot stretch of low vacancy and historical rent growth. Still, marketed rates were 40 percent ahead of the pre-pandemic equivalent entering this year, with the amount of occupied space expected to reach an all-time high by the end of 2024. The reshoring and nearshoring of certain productive industries will also bolster space demand in the long-run, benefiting emerging high-tech manufacturing hubs and markets proximate to the U.S.-Mexico border.
- The office sector paints the most complex picture, with the rise of hybrid work schedules diminishing many employers' space needs. Utilization has been most impacted in older and larger downtown offices, whereas newer suburban offices have delivered stronger performance. Vacancy for suburban offices under 250,000 square feet built after 2010 was near 10 percent ending last year. Office may receive a boost from swaying working habits in the months ahead, as more employers are instituting in-office policies. While office properties account for the largest share of current distress in the market, price corrections are most apparent in downtown settings, which represent a relatively smaller share of the overall commercial real estate landscape.

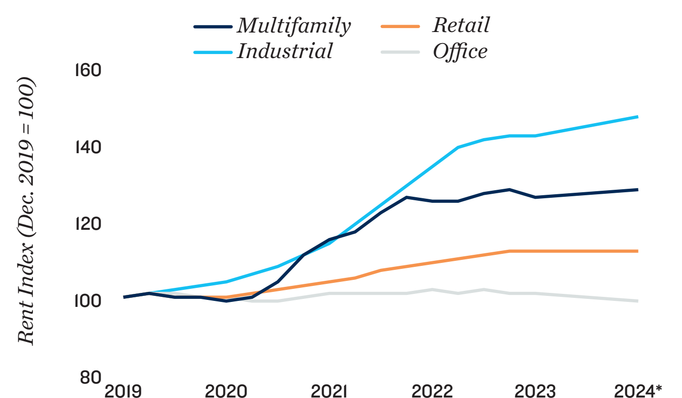
KEY POINTS

- The broad majority of commercial real estate assets report a positive outlook as of early 2024, indicating that widespread distress sales are unlikely.
- Less than 4 percent of total bank debt is held by challenged CRE sectors, limiting the risk of troubled properties to the banking system.
- Lending institutions have been flexible with delinquent loans from debtors that are otherwise in good standing, mitigating foreclosure risk.

Vacancy in Most Sectors Near Historical Mean



Rent Gains Bolster Revenues

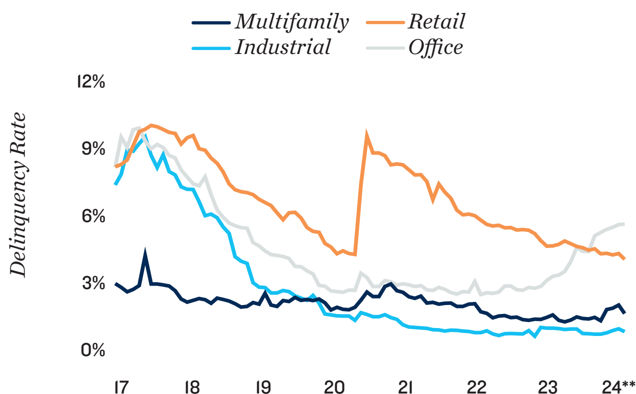


** Forecast*
Sources: CoStar Group, Inc.; RealPage, Inc.

Q: How do current levels of delinquency compare to those observed during previous cycles?

A: Owing to solid fundamentals across most sectors, the vast majority of commercial real estate owners have been able to continue making payments. Delinquency rates for CMBS loans, while up from recent years, trail historical norms across most major property types, with the industrial sector observing a metric as low as 0.4 percent entering 2024. Some asset classes are more challenged than others, however. Posting a delinquency rate of 5.5 percent, the office sector noted the highest such metric in February of this year. This is still well below the peak seen in the aftermath of the Global Financial Crisis, when the segment's delinquency rate rose above 10 percent.

Delinquencies Below Prior Peaks



*** As of February*
Source: Moody's Analytics

Q: Are foreclosures elevated over historical norms?

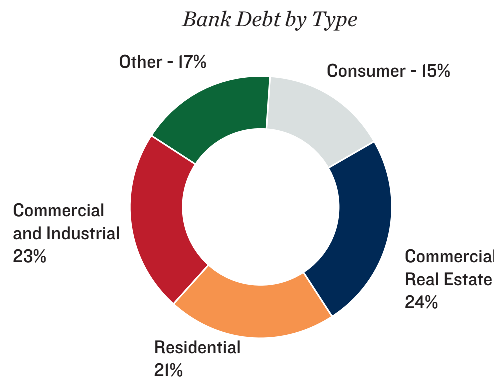
A: Foreclosures have somewhat risen in recent months, but have remained below the historical average. Headlines began to spark concern earlier this year when roughly 635 foreclosures on commercial real estate properties were observed in January. While a notable jump from the prior year, this number is not much higher than the average monthly foreclosures noted from 2014 through 2019, when an average of roughly 500 properties were foreclosed on per month. Some of the recent foreclosure activity likely stems from the health crisis. Between 2020 and 2023, lenders foreclosed on an average of just 255 properties each month, indicating that some troubled properties were able to obtain deferrals for a period. Some of these delays may now be coming to resolution, lifting foreclosures today, but reflecting problems from a previous period. With peak health concerns now in the rearview, solid fundamentals across most CRE sectors as of early 2024 indicate that a wave of foreclosures akin to what was observed in the wake of the financial crisis remains unlikely.

Q: What is the banking sector's exposure to CRE?

A: Brought to the forefront of media attention last spring when multiple high-profile banks closed, the commercial real estate sector's risk potential to banking as a whole has been overstated. As of late 2023, commercial real estate constituted about 24.2 percent of debt holdings across the banking sector nationwide. Although exposure can vary greatly between institutions, the majority of property types are unlikely to see a wave of defaults. The office sector, which notes the highest potential for default among asset classes, comprises just 15.8 percent of CRE-related debt, translating to only 3.8 percent of total bank holdings nationwide.

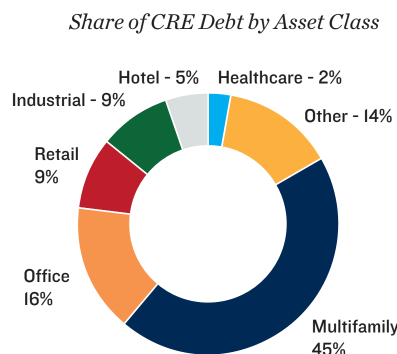
CRE Represents a Quarter of Bank Debt

Bank Debt by Type



Challenged Sectors a Small Part of Debt Picture

Share of CRE Debt by Asset Class



Source: Mortgage Bankers Association

Q: What is the debt maturity landscape for CRE?

A: By estimation of the Mortgage Bankers Association, a record $929 billion of commercial real estate debt is scheduled to mature this year, equating to roughly 20.4 percent of all outstanding loans. An additional $2 trillion of debt is slated to mature before the end of 2029, with all remaining loans coming to maturity in 2030 or in subsequent years.

Q: Why is so much debt set to mature in 2024?

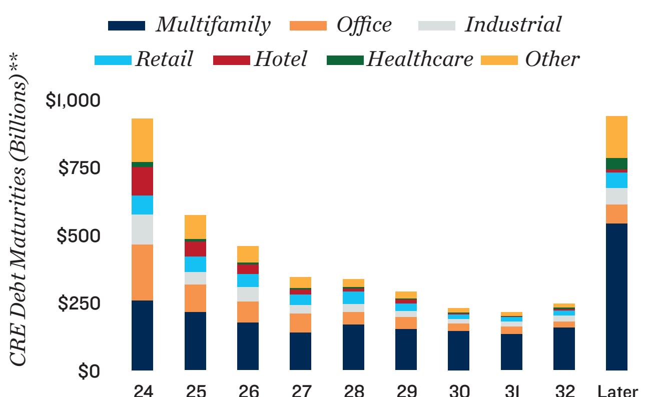
A: Last year, the FDIC offered updated guidance for lending institutions urging leniency toward borrowers who were delinquent on payments, but otherwise on good standing with their creditors. This helped facilitate roughly $270 billion in loans originally slated to mature in 2023 being deferred to this year.

- In addition to the payments deferred to this year, more than $100 billion in debt that was originally scheduled to mature in 2023 is estimated to have been extended to 2025 and later. Furthermore, roughly 42 percent of currently held debt volume will not mature until 2029 or later, when the interest rate environment will have changed dramatically.

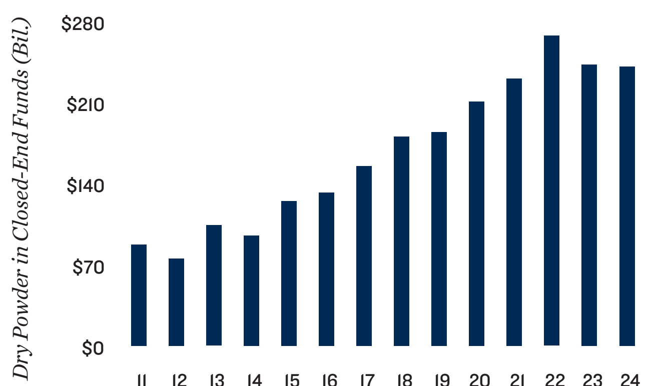
Q: What does this mean for the investment market?

A: Institutions have assembled substantial capital via various funds aimed at acquiring commercial properties, including troubled assets at potentially opportunistic pricing. As of this January, there was more than $240 billion of dry powder in closed-end funds ready for deployment. The last time pent-up capital was higher was immediately following the pandemic, which preceded a span of record trading activity. While widespread distress is unlikely to materialize in the near-term, a substantial amount of capital awaiting placement could provide the investment market an additional shot in the arm when the Federal Reserve begins to cut rates later in 2024, providing an additional accelerant to thaw investment markets.

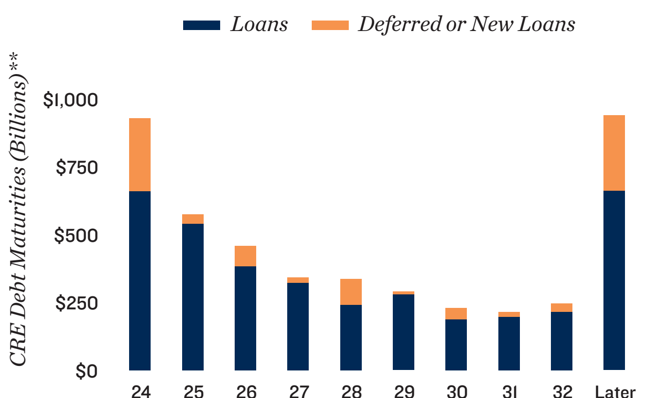
Debt Maturities by Property Type



Pent-Up Capital Near All-Time Highs



Deferrals Shift Payments Forward



***For Loans Outstanding as of 2023*

Sources: Marcus & Millichap Research Services; Mortgage Bankers Association

Q: Are outstanding loans at risk of default?

A: The majority of lending institutions will be heavily incentivized to work with debtors struggling to make payments, as the negative press of foreclosing on delinquent loans could spark bank runs comparable to the collapse of First Republic Bank in 2023. Combined with debt obligations that were deferred from last year, this indicates that lenders are willing to work with struggling clients, and delinquent payments may continue to be deferred for the foreseeable future.

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