RBC Global Asset Management

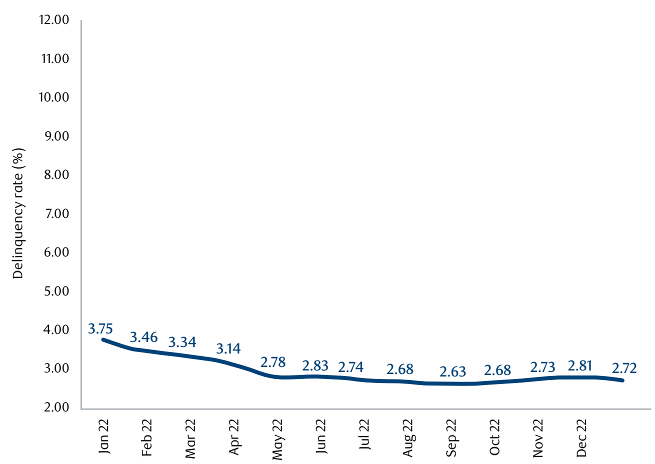
The state of the US CMBS market

February, 2023

The commercial real estate landscape has shifted sharply over the past year with rising interest rates, a slowing economy and a sudden decline in transaction activity. As we head into a new year, we take a look at the current environment, the outlook for property types and the upcoming debt maturity wall.

Headlines have been largely negative throughout the past year, but the current market has been resilient throughout 2022 and into 2023. We see this in the commercial mortgage backed-security (CMBS) delinquency figures which have fallen year over year by 103 basis points (bps). The overall US CMBS delinquency rate fell 9 bps in January to 2.7%.

Exhibit 1: CMBS Delinquency Rate



Sources: Trepp , January 2023.

Breaking down by property type, Industrial remains the lowest at 0.2%, followed by multi family residential and office at 1.6%, lodging at 4.4%, and retail at 5.9%. The all-time high was 10.34% registered in July 2012. The Covid-19 high was 10.32% in June 2020.

While delinquencies remain low, they are backward looking, and we expect to see an increase throughout 2023 and beyond with office being our main concern. Below we provide our view on the various key sectors of the CMBS market.

Office sector: Boston Properties CEO recently stated on their earning call that the office sector is currently in recession. We agree with that statement. We remain most concerned about the office sector, as companies have not yet fully determined their space needs in the new era of hybrid working. Higher cap rates along with slowing demand for space will challenge office valuations, especially for older Class B properties in need of upgrades. The office sector represents a large exposure within single asset single borrower (SASB) and conduit (multi asset, multi borrower) deals, although conservative underwriting should help to limit term defaults. We expect SASB office to weather the storm better than conduit office as SASB is generally secured by trophy Class A properties.

Retail sector: The Covid pandemic shutdowns and the continued growth of the e-commerce economy has been highly disruptive to the retail sector, causing many retailers to close, especially in enclosed malls. Moving past the pandemic, consumers have returned to brick-and-mortar stores and the retail sector has rebounded, especially open-air lifestyle and grocery-anchored centres. While we expect some retailers to continue to suffer and eventually go away, all retail is not created equal and expect properties located in growing markets with limited supply to continue to perform going forward.

Hotel sector: This property type was most directly affected by the pandemic as travel was severely constrained. As the country returned to normal travel patterns, hotels have bounced back significantly. Leisure travel has helped push hotel metrics back in line with pre-Covid norms, although business and international travel are still lagging, causing gateway cities to underperform. While a slowing economy may dent travel demand, we believe there is enough pent-up demand from consumers that hotels will likely continue their strong rebound.

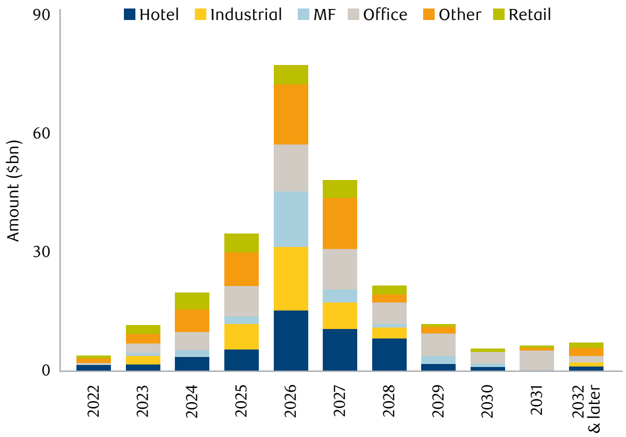
Multi family residential: The sector has done very well coming out of the pandemic but rent growth at these properties should slow this year as inflation eats into household budgets and limits affordability. Although there are some headwinds to the multi family residential sector, the overall lack of housing supply in the United States and higher costs to purchase single-family homes should offset any major disruption.

Industrial sector: We remain optimistic about the industrial sector, which has benefited the transformation of the US economy to e-commerce and an increase in manufacturing coming back to the United States due to international supply issues. Cash flow growth should continue, especially in locations with limited new supply.

With the current challenging capital markets environment, market participants have focused on the upcoming wall of maturities facing the market and the possibilities of elevated defaults and forced sales driving down valuations. Conduit maturities gradually increase over the next few years, but we expect the majority of these loans to be able to be successfully refinance. These loans are generally 10 year loans originated in 2013-2015 which have seen significant net operating income (NOI) growth and deleveraging via loan amortisation during their loan terms which should allow them to successfully refinance. Office, especially properties with near-term lease rollovers, could experience issues as lending has significantly tightened for this asset type.

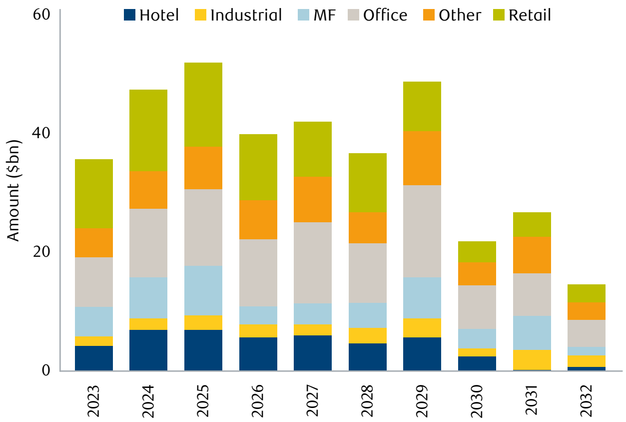
Within Single-Asset-Single-Borrower (SASB) transactions, maturities are more concentrated in 2026 as 2021 had significant issuance. While there is a large amount that is due in 2026, these loans were underwritten conservatively and to asset types (industrial, multi family residential, hotel) that continue to show robust NOI growth which will lessen the impact of higher interest and capitalisation rates. The office component of SASB has been generally secured by trophy assets with long-term leases in place.

Exhibit 2: CMBS SASB Maturity Schedule



Sources: Intex, BofA Global Rese, January 2023.

Exhibit 3: CMBS Conduit Maturity Schedule



Sources: Intex, BofA Global Research, January 2023.

In conclusion, the commercial real estate market is in transition with higher cap rates and lower valuations.

Although loan defaults and losses are likely to increase, we don't believe that all properties will have issues. While some property types such as office will suffer, other properties such as multifamily and industrial should continue to perform well. We also believe that borrowers will inject equity into properties that they believe are viable over the long term. In addition, lenders and special servicers, as they have in the global financial crisis and the depths of the pandemic could offer borrowers options to help them from default including modifications and extensions. We expect them to use the same playbook rather than liquidating loans.

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Brian is a portfolio manager on the Securitized Credit team at Bluebay. Before joining the firm in December 2021, he worked as a portfolio manager and member of the investment committee at KLS Diversified Asset Management for thirteen years, where he was head of the CRE/CMBS investing in both whole loans and CMBS. Prior to this, he worked on the sell side at Morgan Stanley and UBS on their CMBS securitization teams specialising in origination, distribution, and execution of CMBS transactions. Brian began his career in 1998 at Fitch Ratings in the CMBS group working with sell side origination/ securitization firms and analyzing both conduit and large loan translations. Brian holds a BA in economics from Columbia University.

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