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Conversations with Commerce Trust podcast
Episode 6: Is Commercial Real Estate on Shaky Ground?
04/10/2023

David Hagee: Hello, and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today we're going to the real estate sector, and its impact on the financial markets. I'm joined by Eric Simpson, our Senior Fixed Income Credit Analyst here at Commerce Trust. Welcome to the podcast, Eric.

Eric Simpson: Thanks, David. I'm happy to be here.

David: Yes, so real estate is a large, broad subject, but today we're going to refine it a little. Certainly, most of our listeners are familiar with residential real estate, but as we're talking about real estate as an investment outside of the residential space, what does this sector look like? How is it broken out?

Eric: Yes, broadly speaking, when we're talking about the US commercial real estate market, we're talking about multi-family housing, which is, typically, apartments, but can also be smaller multi-family units, and then depending on the analysis, you can throw student loan housing (student living/housing) in there as well. You're talking about retail centers, so these would be your big national malls, anchor malls throughout various cities in the United States, but this could also be strip centers, anchored by something like a grocery store or a T.J. Maxx.

We're talking about industrial warehouses that are for capacity in our manufacturing side of our economy, and then traditional office space, so this would be class A, B, and C offices across the country that service our services sector. There's also some “nichey” segments of the market, which include data centers, infrastructure needs, self-storage, things of that nature. Then, you can also break this market down along geographic lines too, so coastal cities exhibit different trends than cities in the Sunbelt or the Midwest to some degree.

David: Looks like we have a lot of area to cover here. Maybe we'll just focus on a couple of different areas inside the real estate space. Certainly, office space is interesting post pandemic. Also, I think this last mile logistics, that warehousing space is very interesting, and you mentioned data centers earlier. As we look at those, what are the characteristics surrounding those areas of the real estate market?

Eric: Yes, it's really interesting. Office space is obviously prevalent in every major city. It can differ a little bit based on the larger cities like in New York, versus we're located here in St. Louis, so the values will tend to adjust based on the demographic trends, and just population of any given city. Data centers, you mentioned are obviously a long-term secular story within the real estate market. As our data needs and cloud storage needs continue to increase, as a lot of companies try to digitize a lot of what they're doing, through AI or otherwise, you're seeing a lot of data centers crop up across the country. Then, also you mentioned a lot of the reshoring efforts that are going on, especially, in the wake of a post-COVID world, where we're trying to reshore some supply lines, and then, there's some geopolitical consternation there.

You see in parts of the country like Arizona, where they're starting to reshore some manufacturing facilities to meet domestic needs, so it's really interesting. Office space has been a constant drum beat of the real estate market over the past 40 years or so. Office space has always been there, but then some of these warehousing needs have ebbed and flowed, as we've went through a period of globalization and offshoring, and now that seems to be reversing itself, so you're seeing a lot of issuance and narrative around that part of the market, which is atypical for investors recently.

David: As we think about the different sectors that we've discussed inside the real estate area; it'd be nice to walk through some of the larger investment themes that are having an impact on the real estate market. Certainly, we've had inflation be a dominant theme inside financial markets for the past year, and so we're faced with higher interest rates today.

We've also seen a pandemic that has reshaped how America works, and additionally, we've seen more recently with the failure of Signature Bank as well as Silicon Valley Bank, some stress being put on regional banks. How are all those different themes impacting the real estate sector?

Eric: It's been a pretty challenged sector for a few years now, but in the backdrop of the past 40 years, where interest rates have been perpetually declining, overall, the sector has had a pretty nice run. As interest rates decline, property values have obviously increased over that time, and given that real estate is a very highly levered portion of the economy, it's financed with a ton of debt. As interest rates decline, that makes borrowers able to take on more debt at lower cost, and finance some of these projects. A lot of the consternation, you can even think back to the earlier part of last decade with a lot of the decline in oil prices, and that hit portions of the economy that were tied to the energy side of things. Down in Texas, you had a lot of consternation with office space down there.

With the rise of online shopping, a lot of retail centers have been challenged over the past 5 to 10 years, as consumers now pivot towards online shopping, as opposed to going to their local mall. Then, recently, obviously office space is in the news again, as people want to work from home. In the wake of the pandemic, you've seen occupancy levels drop pretty precipitously across the country, but more so in your heavily urban areas that were disproportionately impacted by the pandemic. That's really stressing a lot of these office borrowers, as they're facing lower occupancy levels at a time when their borrowing costs are increasing. They're really getting squeezed from both sides there.

Now, you overlayed the recent banking issues on there, and I think it's important for people to understand that regional banks account for about 70% of overall bank lending on the commercial side of things. As they start to get a little bit nervous about their financial position, they'll start to pull back from that market. That'll start to manifest by shaking out some of the weak hands within the commercial real estate, which will further exacerbate some of these trends.

David: As we talk about the stresses that are placed on the real estate sector from all these larger investment themes that we've been confronting over the past couple of years, how do we think that shakes out? Does that have an impact on fixed-income portfolios? Does that have an impact on equity portfolios? What does that look like?

Eric: As we look forward over the next 12 to 18 months, it's hard to find a way that there won't be a little bit more stress, both on the equity side and on the fixed income side. Now, this won't be a broad-based downturn. Obviously, they're going to always be pockets of strength, but I think for your traditional, just commercial real estate borrower or lender, whoever's on the other side of that deal, it's not unlikely that we're going to see some losses accrue to someone.

Whether those be equity holders on publicly held real estate investment trust, or debt holders, if that takes the form of a regional bank. It's going to be on everyone's radar to do a little bit more due diligence when it comes to their underwriting, to make sure that they're getting into well-structured deals that are well-capitalized and have the ability to withstand some of the consternation over the next 12 to 18 months.

David: As we're faced with these headwinds, you've seen certainly PIMCO (Pacific Investment Management Company) with their Columbia (Columbia Property Trust, Inc.) acquisition have a larger default out there, and a lot of the commercial real estate debt is getting refinanced over the next couple of years. Is this going to be an opportunity for us to do some investing inside the commercial real estate space, or is this just an opportunity for us to avoid this space?

Eric: I think 2023 will continue to be a year where defense reigns supreme. I definitely don't think this is time to lean out over the plate and try to hit a home run when it comes to commercial real estate. I think there's still a lot of uncertainty out there over the path of interest rates, and how aggressive the Fed's (Federal Reserve) going to end up having to be. There will no doubt be opportunities.

Even probably within the office side of things, as these valuations come down a little bit, and return to levels that are more reasonable going forward, there's definitely going to be opportunities out there, but I think the rest of this year, especially, with everything that's unfolding, with all the uncertainty with regional banks, this is still a year for people to remain on defense, and be incredibly selective with how they want to gain exposure to this sector.

David: How are you guys playing on that inside of a bond portfolio with these pressures in the defensive theme that you have for the commercial real estate space?

Eric: When it comes to bond portfolios, we like REITs that are very high quality in terms of their credit ratings, that have a lot of financial flexibility with how they're going to handle a lot of their maturities going forward. Then on the CMBS side, so commercial mortgage-backed securities, this is an area where we're, honestly, trying to hammer home some themes that we've played on over the past few years. That's really largely avoiding very vulnerable office properties, and large metropolitan areas that don't have very favorable demographics, and weak borrowing profiles. Again, this is just another way to be selective within the fixed-income space.

David: That's an interesting discussion today, Eric. Thank you very much for joining us. For more information around this topic, you can download our piece at www.commercetrustcompany.com. Thanks for joining us on *Conversations with Commerce Trust*. I'm David Hagee. We'll talk again soon.

April 10, 2023
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