All the Credit® Episode 40

Transcript

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Female Voice: You're listening to *All the Credit*, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager. And now your hosts, Senior Portfolio Manager, Mike Collins, and Co-Head of Credit Research, Brian Barnhurst.

Brian Barnhurst, CFA, Co-Head of Credit Research: Hello, and welcome to *All the Credit*. I'm Brian Barnhurst.

Mike Collins, CFA, Host and Senior Portfolio Manager, Multi-sector Strategies: And I'm Mike Collins. We're just two of the many investment professionals at PGIM Fixed Income and your hosts of *All the Credit*.

Brian: Just a few months ago, the market was confident that post-global financial crisis financial sector reforms and regulatory scrutiny ensured that the U.S. banking system was rock solid and that the next cycle's culprit would emanate from elsewhere. And yet during the past few months, banking is once again front and center as investors weigh systematic risks from another perspective real estate crunch, this time in the commercial property sector. In today's discussion, we will outline the scale of the potential problem, including the cadence of decay and potential flashpoints in commercial real estate, and then discuss potential transmission through the banking system, extension of credit, and the real economy. Mike and I are fortunate to be joined by two of our colleagues from investment research. Jason Pan is an Analyst on PGIM Fixed Income's Securitized Products team, where his primary area of specialization is commercial mortgage-backed securities. Jason also serves as a Co-Chair of the Structured Finance Association's CMBS committee. Jason earned a BS in Bioengineering from the University of Pennsylvania and an MBA with distinction from New York University. He holds the Chartered Financial Analyst designation and is a fellow of the Society of Actuaries. This is Jason's first appearance on *All the Credit*. Welcome, Jason.

Jason Pan, CFA, FSA, Securitized Products Credit Research Analyst: Thanks, guys. Glad to be on the podcast.

Brian: David Jiang is a Credit Analyst for PGIM Fixed Income's U.S. Investment-Grade Credit Research team. David focuses on U.S. financials, banks, and the specialty finance sectors. David received a Bachelor's in International Relations from Boston University and an MBA from Darden Business School at the University of Virginia. David has previously joined the podcast to share his thoughts on the banking system. Welcome back, David.

David Jiang, U.S. Investment Grade Credit Research Analyst: Great to be here.

Brian: And now Mike and I bring you all the credit. So, to start, let's very quickly set the table. Jason, take us through your big picture, high-level base case views on commercial real estate. Where are we today and what's your thinking one and two years forward?

Jason: So, the challenges facing the roughly $20 trillion CRE sector have been well publicized at this point. The sector faces numerous headwinds, including softening or deteriorating fundamentals, tighter lending conditions, and stress brought about by the higher rates, both short-term and long-term. Given this challenging backdrop, we have been predicting a significant correction in CRE prices that will vary depending on the property sector. We expect lodging and industrial to perform the best with only a 10% decline from peak valuations to trough, retail and multifamily to fare slightly worse, approximately 15 to 20% on average, and office, as everyone is well aware, faces numerous challenges and we expect the client to be from 20% to 50%. The wide dispersion in peak to trough for office, well, there is certainly uncertainty in the outcome, but it's actually more to signify the dispersion that is very dependent on the quality of the office property and the geographic location. In regard to CRE debt, there is 5.5 trillion outstanding when you include owner-occupied and construction loans. Out of those mortgages outstanding, banks, the topic of discussion today, have 50% of the total market share. And that total lending market share for banks has increased with time. Right after the GFC back in 2012, banks were only responsible for 30% of the CRE loans originated that year. That percentage has steadily increased from there.

Mike: And so, Jason, I like how you break down the drawdown in valuations really based on two primary factors, right? The first one is interest rates, and interest rates globally have gone up a lot and they're still going up. Just in last month, the 10-year treasury yields up 40 or 50 basis points and other central banks are still hiking rates and including maybe the Fed. So, that hits all property values just by discounting the future cash flows. But then there's the fundamental drivers, as you mentioned, right? And that is where it really varies. So, how do you really separate those two, and how do you anticipate going forward which one will be a bigger factor? Obviously, as you mentioned, occupancy levels in certain areas are coming down, and even rent increases in places, hot areas like multifamily might roll over, right? And you may even see rent declines in certain areas in multifamily. So how do you weigh those two factors going forward?

Jason: The tough thing for CRE here is that no matter the scenario, CRE seems to be in a difficult spot. Either you have a soft landing where property fundamentals and cash flow growth can stay where they are or revert back to a pre-pandemic normalized growth rate for most sectors outside of office, but you have higher rates which will impact valuations. Or you have a hard landing, where maybe rates come down, but your cash flows for your various property types are going to be impacted. So CRE really does feel like it's in a lose-lose situation. But to answer your question, Mike, about which will be a bigger factor, rates or cash flows, it would be rates in my mind. If I had to choose, I would choose a hard landing over a soft one for CRE. I'd rather NOI that I can forecast a recovery for than structurally higher rates.

Brian: I liked how you broke down the commercial real estate market into distinct subsectors. I think quite often, it gets spoken about just as a holistic market, but it really is a collection of diverse property types. And if we drill down to some of the more idiosyncratic components, you hit on office. It gets the most attention. Clearly, that's very warranted. But also, some of that might be asset or geographic-specific. The real question for office is, is it big enough to be systemic to the U.S. economy or the banking system?

Jason: My view is that it's not systemic on its own. And I think it's important to remember that out of the total CRE market, office is around 15 to 20% of the outstanding, both on total CRE assets, but also on the CRE debt. So, it's just one piece of the pie, even though it is the sector getting the majority of headlines here, which is warranted. However, while I believe office is not big enough to generate losses that are systemic, the question is whether that office exposure can create another crisis of confidence for depositors. There are certainly select banks that are overexposed to CRE and office in particular that could trigger additional headlines.

Mike: Yeah, and then talk about idiosyncratic risks away from just broader office. Are there other pockets of vulnerabilities or pressure points that you're looking for across the broader commercial real estate sector?

Jason: Mike, as you alluded to, multifamily. Certain subtypes of multifamily we are concerned about. First and foremost, rent-controlled. The issue there is you're seeing expenses increase, such as taxes, insurance, in this inflationary environment. But because the properties are rent controlled, the annual increases in rent can only increase so much. So you're really seeing that operating income squeeze for that property subtype. In addition, we're concerned about the supply that's coming online within the class A multifamily space. You have higher margins for developers, so that's where all the development has been. Class A, particularly in select submarkets, that supply is going to bring pressure to occupancy rates as well as cash flow growth for existing properties. In certain markets, such as Miami, Austin, Nashville, sure, you're seeing a great migration trend to those markets, but you're seeing construction as a share of inventory exceed 15% eye-popping numbers. Lastly, I wanted to highlight hotels. In a hard landing, hotels are going to struggle. Currently, cash flow growth has been great. I'm sure everyone booking a hotel these days, those rates are tough to stomach. But in a hard landing, given the overnight lease nature, those things can flip overnight. Not a property type, but another area of potential credit concern is transitional and construction loans. These loans are collateralized by assets that are not stabilized by definition. For many of these projects, aggressive cash flow and business projections are much less likely to be met in the current environment.

Brian: You know we've spent a lot of time internally across the teams thinking through how this may play out and what the implications may be over the next couple of years. One thing that always stands out to me, seems to get less attention is the amount of commercial real estate that was debt financed in the past couple of years with short-tenor floating rate structures. I can't help myself. It begs the question, is there a subprime reset moment coming for the U.S. commercial real estate market?

Jason: It's not necessarily a single moment, but certainly, floating-rate commercial real estate loans are seeing their cash flow coverage getting squeezed. Borrowers who took out floating rate loans three years ago, when short-term rates were close to 0%, are now seeing their total debt service triple. So, a lot of these borrowers are going to find themselves having to pay out of pocket, where their property is just not generating enough cash flow to cover the debt service. And you're seeing this already play out within the CMBS market. Single asset, single borrower, at least recent issuance over the last couple of years, has primarily been floating rate. And if you look at single asset, single borrower, special servicing, delinquency rates, they have been steadily increasing over the last couple of months, and we expect the trend to continue. We're about to get into the bank discussion, but that is another area where we are concerned. Most bank CRE exposure is generally floating rate in nature. It makes sense, as they're trying to manage their duration. From what we can tell, there's been little focus on the fact that most of bank's CRE exposure is floating in nature. While bank CRE loans may have been underwritten at more conservative metrics, it will be interesting to see if some of the stress we are witnessing in floating rate CMBS will be echoed on bank balance sheets.

Mike: So that's a great segue. Thank you, Jason, for that. And David Jiang, our lead banking analyst. So, you've been a really popular guy this year. Just a few months ago, the regional banks were blowing up, and it was really an interest rate-driven effect. The valuation of their assets were down just on a mark-to-market basis, not even based on fundamental asset quality considerations. And then we had the big historic run on some of those big regional banks. I know you've done all the screening, screened out the top hundreds or thousands big banks across the country to find ones that have now any budding concerns about commercial real estate exposure. And as Jason mentioned, the banking sector, largely, I guess, the regional banks have really been the big financers of a lot of the local commercial real estate development and those markets. So what are you finding in terms of your analysis with regard to the banking sector?

David: Great. Glad to be back here. So, to start with, we want to size up the exposure to the U.S. banking system. And I know Jason has given you some numbers on the $5.5 trillion CRE, commercial real estate debt market. When you peel back the layers, the distribution of risk is pretty spread out, and it's more concentrated at the smaller banks than the larger banks. To start with, there are $5.5 trillion of total CRE debt, of which $2.8 trillion is with the banking system. However, $600 billion of that is known as owner-occupied. So the characteristics of those loans are more related to the cash flow characteristics of the small business or the middle market company that owns the property. So, if you exclude those type of loans out, you're looking at about $2.2 trillion of exposure for the banking system. Call it 18 to 20% of total loans in the banking system. Within that, the top 25 banks, which includes the large GSIBs and goes all the way down to the $160 billion mark, they have about 12% of the exposure. The next set of banks, which are about 135, we call mid-sized regionals, have about 14% of the exposure. These are banks between 10 and 160 billion of total assets. And then below that, we get very granular. We have about 800 banks that have between one and 10 billion of assets that have 10% of the exposure, and another 3,700 banks, which is the bulk of the banking system in terms of the number of banks, that have less than a billion dollars in assets out of only 3.2% of exposure. So that's the 40% of the total commercial real estate pie that's residing at banks. And within that, again, the large banks have 10% of the exposure and the smaller banks have 30% of the exposure. So, we do really think that the large banks that are systemic to the banking system have much more granular exposure and lower exposure than the smaller banks. And within the smaller banks, what we have to really peel back is the type of exposure. As Jason pointed out, the bulk of it is multifamily, roughly 37% of total. Around 22% is office, which is under the most stress. You have a combined 18% between retail and hotel, and then 8% industrial and 15% other. When you translate that to the 20% of loans, we're looking at 7 to 8% of total loans that are exposed to multifamily, 4 to 5% for office, 2 to 3% for retail, 1 to 2% for hotel, and 3 to 4% for other. So, in terms of the actual exposure by sub-asset classes, it's very manageable for the banking system. The office exposure, which is the one we're monitoring the most closely, is something that we see somewhat bifurcated. So the large banks will have predominantly the office exposure that are in the large cities, like large metropolitan areas, but they also have the smaller percentage of exposure to the office sector, and that's vice versa for the smaller banks. So, at the end of the day, I think office is the one area to look into and then watch how that leads into potentially other large subsectors such as multifamily.

Brian: David, when we think about the bank exposure to commercial real estate, I think it's instructive to think about where they started from. Help us to mention in super rough terms what bank underwriting has looked like. We know that banks typically underwrite to 50, 60% LTVs on average, but also that commercial property values have gone up for the past decade alongside the bull market and interest rates. After the large rate move we saw during the past 12, 14 months, does that mean that, on average, banks are now holding assets with 70, 80 plus percent LTVs before even considering the notion that underlying valuations have only partly retraced the appreciation of the past decade? And how do you think about that as you think through the U.S. banking sector and financial system?

David: That's a really good point. The LTVs are relatively low at origination for the commercial real estate loans on the balance sheet. As you noted, they started out at 50 to 60%. The lending standards were tightened post the great financial crisis 15 years ago. In the aftermath of the financial crisis, the leverage was lower on origination of commercial real estate property. And over the last decade or so, property values have gone up dramatically to increase evaluation and equity cushion on these loans. Given some of the more severe valuation impacts from the higher rates on the office sector predominantly, we're seeing refreshed LTVs closer to 75 to 80%. Again, there are other criteria around debt service ratios as well as guarantees and other covenants that go into these loans. We do believe that most of these loans will be amended and extended through the process of engaging with the borrower and potentially finding other sources of equity or potentially extending out the term or restructuring a loan in terms of rate or tenor. But we do believe that for these banks, the incentive is to work out these loans and to work with the borrowers and not foreclose on the property.

Mike: Yeah. We've seen a handful of high-profile defaults, right, on big commercial real estate properties, mostly office at this point. But to your point, David, that's not going to be wholesale. There will be other techniques or other steps that the banks take, right? It's really not in their best interest to take over the buildings and operate them, right? So, they really want to try other routes before the bankruptcy process.

David: Absolutely.

Mike: So, Jason, it's a good time to pivot back to you. How does this play out, right? I mean, the question I get a lot from our clients is, all right, so we all know rates have gone up. We all know fundamentals are deteriorating. We all know prices, valuations of real estate have come down and probably have a little bit more to go. We know there's going to be some stress. But is there going to be this kind of Minsky moment, this knock-on effect, this secondary or tertiary effect where it really causes a big collapse in confidence and activity? Or is it just going to be kind of a slow-moving train wreck? How does this actually play out in real time over the next year or two? And how does the commercial mortgage-backed securities market adjust accordingly?

Jason: I think generally, it's going to be that slow-moving train wreck that you described. And part of that is due to the underlying leases. For office, retail, and industrial, you have multi-year leases. Focusing on office in particular, those leases are generally structured with five to 10-year terms. And so even if you see availability rates increase because tenants are putting a ton of space out for sublease, those tenants still have to pay their rent absent bankruptcy. Borrowers on those office buildings won't necessarily default right away as a result. The revaluation will also take a while to show up in the data. We're not seeing transactions because there's still a bid-ask between buyers and sellers. Now, what can make this train wreck happen faster is if we see more distressed sales from the banking sector, if there is a regulatory push or maybe potential deposit flight where banks need to raise capital by selling assets, that could drive an acceleration of this process. Otherwise, I do agree with David that it feels like this is once again, amend and extend or an extend and pretend, whatever you want to call it, that will help delay the problem.

Brian: Even to me, if sound financial analysis tells you that the regional banking system can handle most of the potential commercial real estate outcomes from an earnings, liquidity, or capital standpoint, I really wonder how much that ultimately matters given the risks and implications of a crisis of confidence. And it's possible that even though property valuation declines will play out over a number of years, that the commercial real estate market is ultimately a tinderbox sitting under the confidence in the banking system. And you wonder how much it takes to ignite the recent SVB failure is quite instructive there. Market perceptions and momentum can develop in a very short timeframe and prove hugely impactful to the banking system. So that may be ultimately the biggest flashpoint from commercial real estate, at least from a systemic standpoint. Obviously, there will be flare-ups and idiosyncratic issues, but from a systematic standpoint, I wonder if that's a crisis of confidence risk that we should be most cognizant of.

David: Yes, I agree. I think what's hard to dimension is at what point it becomes a crisis of confidence for the banking system. As everyone's noted, this is more of a slow burn that will eat through the two layers of capital in the banking system. There's loan loss reserves that come through provisioning on the income statement. That happens every quarter depending on what type of risk the bank management team sees over the horizon, as well as their equity capital, the regulatory capital that's been beefed up since the great financial crisis. I think this is certainly losses that are expected losses against your reserves. And only until it becomes a hit to capital, generally when you have to impair these loans, when you have to basically revalue these loans against a distressed valuation, and at that point, it's more than just the reserves you put up against it. It's actually capital that you have to impair. The scenarios that I see that can potentially trigger that tinderbox, I guess, is if we see a wave of commercial real estate defaults that overwhelm the banking system. And that's not something that's in our base case. It's more in our tail risk. When you have some of these smaller banks that ultimately decide to fire sale their assets, that's when you will plunge the valuations of that asset class and force everyone else to take much higher haircuts against their exposures. The second potential trigger is if all of a sudden, these borrowers decide that they rather not hold on to their property and just mail in the keys to the bank, what's known as the short sale. We saw that happen in the great financial crisis around mortgages and home loans. When borrowers were more than 25% on the water on their mortgages, they walked away. So, there's a point where if we see something like that happening across the sector and that causes contagion into other parts of the commercial real estate sector, such as multifamily, hospitality, retail, that's when we will get a lot more concerned about the systemic risk to the banking system.

Jason: To add to what David was saying, one reason why you might see greater amount of defaults occur is that floating rate exposure I was talking about. So at current short-term rates, perhaps these loans were underwritten conservatively enough that debt yields imply that the debt service can be paid. But, you know, the rate environment continues to be uncertain. If short-term rates were pushed higher because the Fed had to continue to be aggressive, I think that calls into question whether we will see more defaults occurring for bank CRE loans. And the second point in terms of owners handing back the keys, we're seeing that happen with single asset, single borrower office properties. Those are getting picked up in the headlines. I'd also point out the construction loan exposure at banks, potentially developers not seeing their business plans being played out or not having confidence in their business plans handing over the keys, stopping any development that they were doing.

Brian: I think it's an excellent point that we can't really assess the ultimate damage from commercial real estate until we know where rates are going to settle out. It's a really good point. Mike, let me turn to you. We've heard from Jason and David about the transmission of commercial real estate through the banking system. How does what you've heard translate into economic implications from asset deterioration, maybe tighter lending conditions, capital conservation? What's your perspective on how we're thinking about the U.S. economy?

Mike: Yeah. Well, like most things happening in this cycle, it's really difficult to forecast what the next year will look like in any one area. We've already knocked about half a percent of GDP off our forecast, really as a result of the much tighter lending standards, tightening financial conditions, mostly among the regional banks, right? They are big lenders in the regional economies and not just commercial real estate. So that adds up to about half a percent of GDP. So our forecast is very mild, kind of zero to 1% GDP growth probably in the U.S. this year partly as a result of that. And you would think hearing this conversation that nobody in their right mind would start construction today on any new commercial real estate project, whether it's an office or maybe even take a break on multifamily, but that's actually not what's happening. We're actually seeing a transition. Just as we have a two-speed economy, right, certain areas of the manufacturing and interest rate-sensitive sectors are weakening, but, wow, the service and hospitality and leisure and transportation sectors are booming. So you are actually seeing a lot of construction activity in the transportation sector. Think of airports, right? And we all see every airport we go to. It seems like they're getting revamped. But other areas, technologically driven areas like EVs and battery production and semiconductor fabrication plants, right, they're building these as fast as they can. There's this whole kind of on-shoring of supply chains that's happening in the U.S. economy that could very well offset kind of a lull in traditional commercial real estate construction. So, it's not actually a terrible macroeconomic perspective overall.

Brian: With the growth and sophistication of private credit, a lot of capital focused on disintermediating traditional banks from the lending role, I also wonder if the negative credit impulse from the banking system retrenchment might be less negative than otherwise assumed. Super interesting to watch. So, let's bring it all together and talk positioning. Mike, how do our views across structured products and U.S. financials translate into portfolio positioning across our multi-sector strategies?

Mike: Well, that's the good news story, right? And thank you to folks like David Jiang and Jason Pan and our whole Credit Research team and Security Selection team and Structured Products team. We've actually been really well positioned for this type of drawdown. We tend to have a slightly more conservative underwriting style, underwrite through the cycle. Within the financial sector, we have an overweight. We're generally overweight banks and financials, but it's almost solely in the big money center banks that, as David said, have very, very modest exposures. They've done a really good job underwriting through the cycle, partly due to tighter regulatory standards, but their asset quality actually, even looking at commercial real estate and office exposure looks really good, right? It is not a systemic problem for the big banks. We're actually just starting to look at some of the big super-regional banks, which have cheapened up a lot. Their bonds have underperformed. We really haven't been involved in them, but, wow, they're starting to get attractive in some areas, and these are the ones that will probably be the winners in that through David's screens show that they don't have a lot of exposure either. So that's good news there. And on the real estate side, within the commercial mortgage-backed securities markets, where we are big investors, we are overweight CMBS in general, across all of our portfolios that can do it, and especially in our multi-sector funds that I co-manage, but it's almost solely in the AAA tranches of these big diversified, what we call conduit CMBS structures that have a lot of different types of commercial mortgage loans under them. Jason and his team have actually done a good job over the years, steering away from some of the more at-risk sectors like office and even lodging and certainly weaker retail players. And also, these bonds are trading at discounts to par now because of the higher rates and they are fixed-rate bonds by and large. So, in a default scenario, you actually have upside in price, which is really interesting. We do have some, Jason mentioned single asset, single borrower transactions where we own small percentages in certain portfolios. Some of them are not at the top of the capital structure. Some of them are more subordinated or mezzanine. And yeah, as those loan-to-values have gone from 50% when we first underwrote them to 60 or 70 or 80, yeah, it certainly demands a lot of scrutiny. But by and large, we still – thanks to the solid underwriting at the onset of the transaction – feel pretty good. And they are trading cheap. That's an area of the market if you do your homework. The average spread on some of those parts of our portfolios are 800 basis points and above, right? So, these things have already repriced significantly lower. So, who knows there may be even opportunities to add some of that. So, I feel really good about the way we're positioned, even in a worst-case scenario.

Brian: Sounds like we're well positioned today and poised to be opportunistic as opportunities develop over the ensuing months and possibly years, which is great to hear. That does it for today's podcast. A big, big thank you to our guests, Jason and David, for a great discussion. If you'd like additional content on these topics, please have a look at our award-winning Bond Blog accessed via the PGIM Fixed Income website, where Jason and his colleagues at Structured Credit have published a deeper look, a really good look at the commercial real estate space. Mike, as we conclude your 40th podcast, an impressive number, I turn it over to you for final remarks.

Mike: Yeah, well, thank you again, Jason and David and Brian Barnhurst, for spearheading the podcast, and to all of our listeners, thank you again for your loyalty. Until next time.

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