PGIM FIXED INCOME

All the Credit®, Ep. 50

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.

Tom Porcelli, Chief U.S. Economist: Hi, everyone. This is Tom Porcelli, Chief U.S. Economist at PGIM Fixed Income. And in this new episode of *All the Credit*®, we're going to talk about a topic that is getting a ton of attention, so much attention that we did one of these like maybe eight or nine months ago. But we thought it deserved a refresher, and that's the commercial real estate sector. There's obviously points of stress within that sector and I think, in fairness, there's a lot of worry. And so, thankfully, I have two fantastic guests to talk to us about this, about the degree to which we should be worried, if at all. First, I have Dave Jiang. Dave is our Bank Analyst here at PGIM Fixed Income. And then Jason Pan, who's a member of the research group and he is, fair to say, I think our CRE expert. I don't know if you want to be called that, but we're going to call you that.

Jason Pan, CFA, FSA, Securitized Products Credit Research Analyst: Okay.

Tom: Okay, good. So, let's just get right into it and maybe we should start with like a level setting. So, a ton has occurred, as I said at the onset here. Jason, set us up for where we are in the CRE space right now.

Jason: Yeah. So, a lot has happened in the last nine months since the previous podcasts. I think we've seen a significant repricing across all commercial real estate, primarily from cap rate expansion. As interest rates have increased, new buyers and investors require higher cap rates, and that's translated to lower prices. Across all property types, depending on which transaction price index you're looking at, values have fallen around 12 to 15%. At the same time that cap rates have increased, we've seen normalizing rent growth across all property types outside of office. Office is still experiencing its secular shift, given the work from home environment. So we've seen normalizing rent growth akin to what we're seeing in CPI but, at the same time, rising expenses, particularly insurance has been in the headlines. This backdrop along with maturities that have come due has contributed to rising defaults, delinquencies, workouts, a lot of the headlines that everyone continues to see. Now, this all sounds very negative, but I will point out some positives. And, first and foremost, I believe that CRE prices today are closer to the trough than the recent peaks. The prices are much more reflective of the higher interest rate environment, particularly a 4% 10-year.

Tom: So, if we're closer to the trough, which I'm sure that comes as a huge source of comfort for folks, but we're close to the trough, how close could we actually be? I mean, are we talking sort of within months? Quarters? What would your best guess on that be?

Jason: So outside of the office sector—and I'm probably going to say that a lot throughout this podcast—for the other sectors, I think by end of the year we could be at the trough. For the office sector, it's going to take longer. The secular shift that I described, you have long 5- to 10-year leases that were in place that have to roll off. And companies continue to kind of right size their office footwork.

Tom: So, I'm a macro person, right? I mean, I think about the world in macro terms. And so that means I'm usually at 60,000 feet. But I think when it comes to this, in particular, the commercial real estate piece, most people, whether you're macro or otherwise, I think most people really think of CRE as this one big category. But it's really not, right? I mean, there's like all these different sectors. And there are going to be some sectors that are under stress and some sectors that are actually performing better, and I think it's probably worth just exploring that idea—the different buckets of CRE.

Jason: Yeah, yeah. Sure. I think that's exactly right. So first, with the bucketing, office before coming into the cycle consisted approximately of 20% of the overall CRE market; multi a little higher, call it 25%; retail, industrial maybe around 15%; hotel around 10%; and then the more esoteric stuff that consists of the rest. And, like you said, very non homogenous. Pre-GFC from 2000 through the GFC price action across the sectors was very similar. But what we have seen since the GFC is a divergence in performance across property types. For example, in the 10 years leading up to the recent peak in valuations caught mid-2022, multifamily increased by nearly 200% in value. Meanwhile, retail only went up 60%.

Tom: Had we ever seen an increase like that? 200% just strikes me as sort of an outrageously big increase.

Jason: It's definitely an outlier. I think we've certainly seen it, but it's been a tremendous bull run for commercial real estate. I think part of that is rent growth, but part of that is this secular cycle of interest rates falling.

Tom: Got it. Okay.

Jason: And that's helped cap rates compress over time.

David Jiang, U.S. Investment Grade Credit Research Analyst: And the impact from the great financial crisis, right, in terms of building a lot of this supply, is that a big phenomenon, too, in terms of the increase?

Jason: I think more so is that there's not enough supply. When you look at single family and multifamily relative to household formation, over time, we've actually created this deficit in terms of total housing supply relative to demand. So, yes. That has contributed to growth in rent growth and valuations as a result.

Tom: So, when we think about these different silos within CRE, it sounds like the biggest point of stress is really in the office space; is that fair? Like full stop fair?

Jason: Full stop fair. I mean, there's valuation declines across the board, given that CRE is a lever to interest rates. But office is the biggest risk.

Tom: And so when I think about these worries, I'm trying to gauge the degree to which we're supposed to be worried. And we just want to sort of level set in terms of if this is a sector that could really sort of do some damage.

Jason: Office is the biggest pain point. The second is multi. And that's coming to headlines now for several reasons.

Tom: So, if I look at something like CRE loans and what they've done, just from a growth rate perspective, it's sort of interesting to me that, I mean, if you just look at a chart, you would say, “Hey, they collapsed,” right? They were running at around 15%, and now they're running at 2%. But maybe even more interesting is they're still north of break-even. That haven't really gone into negative territory. To me, that's an interesting story because you could think or make an argument that this thing could actually sort of slip below break-even.

Jason: Yeah. It's been a little perplexing to us, given the commentary around tightening lending conditions, a senior loan officer opinion survey. But what we chalk it up to is two things. One, a lot of the existing loans are not paying off. So, they're having trouble refinancing, resulting in extensions and that existing book, staying outstanding for longer. At the same time, if you are underwriting to the right valuation, the right cap rate, it's a great time to continue to be a lender on the yields that you can get when you originate a new loan are quite attractive. So, I think those two dynamics plus the fact that construction financing requires future funding. So, if business plans are hitting your objectives, banks have to provide that future funding. Those aspects help contribute to that growth, but yes, I agree that is a little surprising.

Tom: You know, Dave, that's probably a good point for us to sort of pick up on the specific bank side because, you know, again, the thing that I hear from a macro perspective is there's this big worry about this becoming a systemic event, that this could sort of take down multiple additional banks from here. So, tell me what you're thinking.

David: So just diving into the CRE problem at the banks, if you want to break it down, that's the best way to see where are the concentration risks to the system. Overall, the entire CRE mortgage market, it's about $5.5 trillion. This is data from various sources, including the Mortgage Bankers Association. Banks own or hold 50% of that exposure. That's roughly $2.8 trillion. Now, the interesting thing here is that that is very bifurcated across large, medium, and small banks. Just over the years the large banks actually hold a very small share of total CRE exposure.

Tom: Like what? Give me a percent.

David: The large banks, let's call it $250 billion of assets and above. Round numbers hold about 10% of the CRE exposure.

Tom: And we've defined that as small, right? And it's been sort of steady around that?

David: I mean, it's grown a bit. But it's small relative to the rest of the universe. So, like the midsize banks maybe hold somewhere around 20% of the total exposure. And then the smallest banks, call it under 10 billion in total assets, hold about 70%.

Tom: That's amazing. Does that give us a sense for the size of the loans that are taking place? Does a small bank loan have a very different size than a large bank making a loan in that sector?

David: I would say yes, proportionately to how large they are. And that's the amount of credit risk exposure.

Tom: So, most of the risk, then, is in relatively smaller loans.

David: And granular risk. There is definitely a concentration of higher commercial real estate risk amongst the smaller banks.

Tom: Right.

David: There is definitely a concentration of higher commercial real estate risk amongst the smaller banks. Their loan sizes are generally smaller. There's 4000-plus banks in the United States, and they're spread out across the geography. If office is the epicenter of the commercial real estate risk, a lot of declines that we've seen in valuations are in large metropolitan cities that have seen higher vacancy rates.

Tom: Is there a specific city that stands out as being very concentrated in terms of these risks?

Jason: Broad-base office is struggling here. Where the valuation declines are probably most pronounced are the markets with extremely low cap rates going into the cycle. So those gateway cities like New York, San Francisco, Seattle, they started with a really low cap rate and have a greater impact in terms of valuation from rising interest rates. There are a couple markets that were more levered to the tech sector. They've since started coming back a little. But San Francisco and Seattle, they've struggled. And then finally Washington D.C., which has significant employment to the federal sector, they haven't come back to the office yet. So, D.C. is struggling.

Tom: That makes sense to me.

David: We've noticed that, in the data that we collect from the banking universe, as well, the office loans are disclosed by the large banks are predominantly where most of the stresses are in these large metropolitan urban areas, San Francisco, New York, D.C. In fact, the loan loss reserves that are held against these office portfolios have risen dramatically over the last several quarters to a point where it's close to around 10% of loans that are held in reserves against loan losses. As a point of reference, the entire loan book, these banks may have somewhere around 1.5-2% loan loss reserves. 10% is a very high number in terms of percentage of reserves held against them.

Tom: So that gives you some degree of comfort as it relates to banks and their exposures.

David: It does, especially the large, concentrated ones. Ultimately, it's a question of going through the loans one by one and seeing where the losses are. But, if you look at the Fed stress test, the Dodd-Frank Act Stress Test (DFAST) federal stress test that occurs annually for the largest 30-plus banks, banks over $100 billion in assets, they do a CRE stress test on the loan books. They're coming up with cumulative loss rate of around mid to high single digits for the entire CRE book. And, for office in particular, they're looking at 20% loss rates. So, there is quite a bit of data and collections done around how well reserve these banks are.

Tom: I think about it in the context of Powell, right. Fed Chair Powell, he gave his congressional testimony recently. And he said something to the effect of CRE issues are not a first-order risk. So, it sounds like you would agree with that.

David: Not a first-order risk, not a systemic risk to the economy or the bank system. What we saw last year, which was more about liquidity, that was a much larger risk. Now we're dealing with asset quality. And I think the asset quality cycle is going to take a while to manifest itself. It's going to take time to realize these losses. It's not a cliff event where all of a sudden you have to take a certain amount of losses on your book day 1. The one thing I want to spend a moment on is how banks account for loan losses. Loans are held on a balance sheet, and they accrue loan losses every quarter based on a risk rating system, that they evaluate each loan one by one at the end of the quarter. And, as they migrate down the risk rating into what's called criticized loans, they are starting to hold more reserves against those loans. Those loans have some type of defect, whether it's LTV, debt-service-coverage ratios, other types of geography issues. So, these banks have a very tightly controlled process of looking at loan loss reserves and setting aside from their earnings for loan loss reserves every quarter. So that the process that's going to take time to not only realize losses but to build up reserves against those losses.

Tom: Right. So, is it fair to say it's slow enough where the banks can actually get in front of it?

David: Right. Given enough time, a bank can earn its way out of a problem, as long as they can dimension the problem, right? The one thing about these commercial real estate loans, that it's a relationship loan. It's a relationship lending product. So, they have deposits, they have cash management, they have other services tied into the client. So, there's a point of negotiation that goes into restructuring the loan, getting more equity, getting guarantee.

Tom: So, I hear a lot of people trying to compare what's happening in the CRE space to what happened during the GFC. I mean, I think we all know that sitting at this table. But, you know, these are wildly different events.

David: Absolutely. The GFC has to do with over leverage in the financial system as it relates to, dominantly, residential real estate loans, subprime mortgage loans. That is a much bigger share of the bank balance sheet than commercial real estate, generally. And we just don't have the same excesses of leverage that we had in the system leading up to the GFC.

Tom: Right. There's no CDO squared happening here.

David: Right. The structure of these loans are different. They are generally underwritten at a much lower LTVs. We had residential mortgage loans that were north of 80%, north of 100% in some cases, during the GFC.

Jason: It does feel like the focus has been on larger banks. David, do you feel like there will be some smaller banks that struggle?

David: So, again, you know, what we're paying attention to are those that are kind of in that mid-size bracket, call it 50 to 100 billion or even 10 to 100 billion. There's only a handful of banks in that bucket. But because of the size of their balance sheet, that's where you can get into potential contagion risk.

Tom: Right. Does that mean consolidation? And to what degree do you see consolidation and over what period of time?

David: I think this asset quality cycle, we're in it for another couple years. Maybe we trough at the end of this year. I don't think we'll see consolidation until you see the tail end of the cycle.

Tom: And so that's another couple of years. Would you agree with that?

David: I think the consolidation will depend on a lot of factors. Outside of asset quality, it's going to depend on where the rates are, you know, the rate environment. How long are we in this peak rate cycle, and at some point, are we going to get to a more normal Fed rate cycle where it's less inverted, potentially positive sloping?

Tom: So we're at around what, 4000 banks right now? Where do you think that number is 10 years from now?

David: I saw some stat that it took 22 years to get to where we are in terms of having our banks.

Tom: We're a 10, right?

David: Around 10. And now we're somewhere around five or 4000. So, if that occurs, then maybe we'll see in 10 years maybe 25% less banks. One thing I want to say, the driver of this is scale. So, I get asked this a lot of times. Why are we not seeing more bank M&A? And a lot of it is the regulatory climate, the political climate, the administration's view on mergers and acquisitions. But I would say there's three kind of gating concerns around bank consolidation. One is the peak rates that we're currently in right now. Many of these banks that just went through the high interest rate cycle have a lot of what's called unrealized marks on their capital base. That's going to take time to realize and come back to their capital ratios as rates come down. So, once we get to a point where we don't have these unrealized marks that are taking the capital ratios down, we're going to see banks willing to do M&A because, once you do M&A, you are realizing those marks on day 1, which is a big hit to your capital. Second thing is the fact that book values, tangible book values have to go up. And, if a bank feels like they have higher currency to do M&A, they will go ahead and do so. And the regulators and the politicians have to be amenable to the fact that there needs to be more scale.

Tom: This was great. You two were fantastic. I feel lucky that I have you here to be able to ask all these questions. I think probably going to be a topic that continues to pop up. And so, as it does, we'll do more of these as necessary on this specific topic. So, until then, thanks everyone, as always. And we'll talk to you soon.

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