

As we look out into the year ahead, we suggest cautious optimism to rule over our view of the near-term future of the commercial real estate market, with the emphasis on *cautious*. What worries us are disconnects in the markets, beyond a possible recessionary climate despite a forecast that seems to be dissipating.

Going into 2022, optimism in the commercial real estate markets was relatively strong given a low interest rate environment and generally improving economic conditions. As we saw it, overhang from Covid-driven supply chain pressure kept the heat on inflationary pressures until they became the fly in the ointment, and later compounded with the outbreak of the Russian war with Ukraine that created dislocations of its own.

Still, positivity continued to reign throughout much of the year, with post Covid rents climbing and vacancies remaining benign despite new supply-side pressure in the markets. Many market pundits expressed optimism through much of the third quarter and into the fourth of 2022.

Several trends caught our attention making us think that 2023 won't follow the expected post-recovery trend similar to that after 2010-12, when investors began returning to real estate following the Great Recession.

So what's different now?

First, attitudes toward returning to the office have been evolving as engagement in work has declined and the desire increased for more flexible time and easier (if any) commutes.

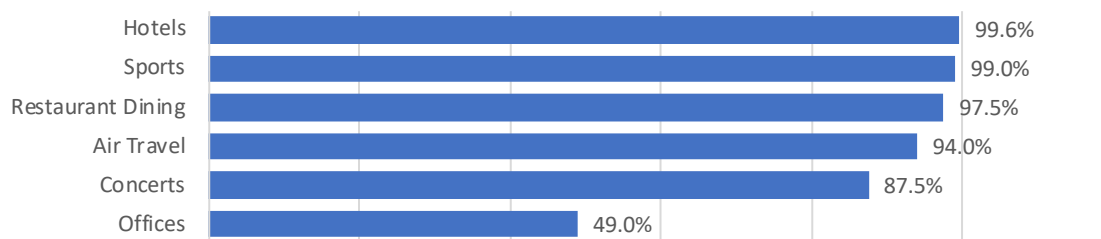
Second, interest-rate pressure has had a disproportionate effect on a lot of commercial real estate purchase activity. While rents continued to climb at inflationary levels, we were surprised by how much sponsors were getting squeezed by creditors, especially debt fund-based lenders. About midyear, we began to hear of lenders strong-arming rate caps on bridge loans and certainly a pullback of credit in various markets.

Third, the capacity of tenants to absorb further rent increases likely will be limited to our minds. While multifamily vacancies in many markets remain relatively low, office buildings in major metropolitan areas, aside from in the South, still haven't seen the emergence of the Great Return to the Office.

As we investigated cultural trends that may impact this year, one of the first things that surprised us was the discrepancy between where people felt comfortable – or potentially choosing – interacting with others.

The data revealed more people have been happier to attend sporting or concert venues than going to the office. Near the end of 2022, hotel occupancy had returned to pre-pandemic levels as did attendance at sporting events and restaurant dining. And yet office attendance demonstrated most workers continued

Current US Occupancy or Attendance as a Share of 2019 Levels



Sources: Vox.com in December 2022 from STR (hotels), PredictHQ (sports and concerts), OpenTable (restaurants), Transportation Security Administration (air travel), Kastle Systems (offices).

to favor the remote option. The absence of longer commutes on worker attitudes clearly played a role; however, the delta between the categories was astounding.

Yes, but is there upside?

Several factors to be watchful for: 1) The Infrastructure Investment and Jobs Act of 2021 hasn't yet begun fully showing up in improved public transit systems (\$39 billion allocated) or in upgrades to roads and bridges (\$110 billion). 2) The Fed seems more cognizant of the balance between overheating the economy and sending it into recession. 3) Funds still have a lot of sidelined cash.

Negatives still prevail

Aside from consumer behavior, other surprises were the escalation of housing costs the point where affordability indexes were reaching low points. At some point, renters will find fewer options in residential buildings, and we expect a resulting quality downshift.

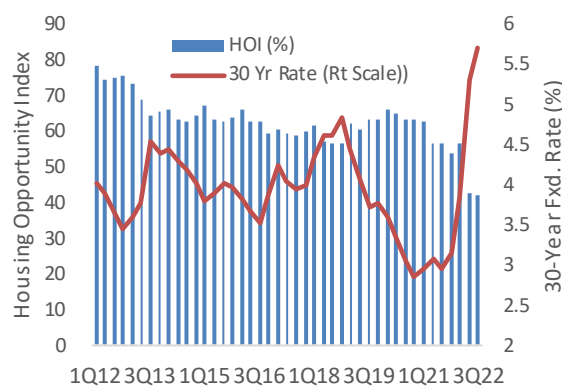
According to the NAHB/Wells Fargo Housing Opportunity Index (HOI), just 42.2% of new and existing homes sold in the third quarter of 2022 were considered affordable.

Indeed, this level marks the second consecutive quarterly record low for housing affordability since the Great Recession.

The disparity among regions in the US has become even more pronounced, particularly in the Western states where affordability in major metro areas of California, for example, was dramatically lower than other regions of the country.

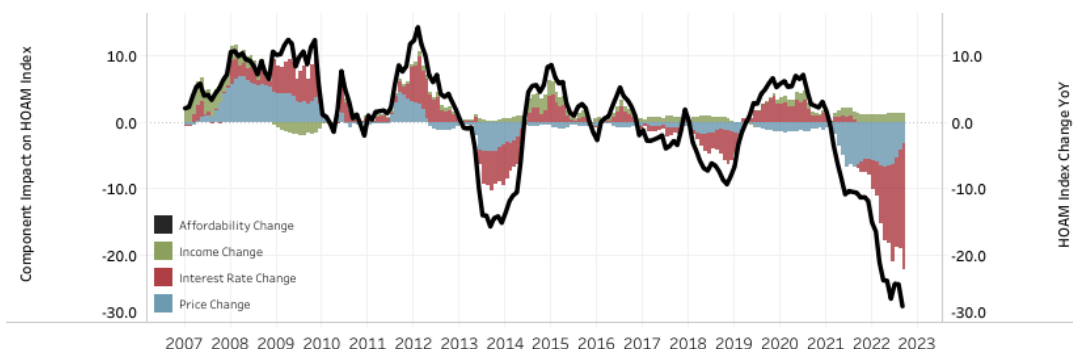
The recent dramatic rise in interest rates drove much of the rapid decline in affordability. According to the Atlanta Fed, rate rises and to a less extent house price inflation only modestly offset income increases. Should the Fed soon reverse its course on rates and the economy reach a soft landing, this trend may slow.

NAHB HOI and 30-Year Fixed Rates



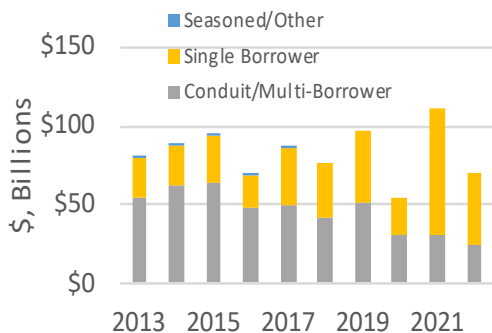
HOI. NAHB/Wells Fargo Housing Opportunity Index HOI for a given area is defined as the share of homes sold in that area that would have been affordable to a family earning the local median income, based on standard mortgage underwriting criteria. Source: NAHB/Wells Fargo.

Drivers of Affordability to Changes in the Home Ownership Affordability Monitor, 2007-3Q 2022



Source: Federal Reserve Bank of Atlanta Center for Real Estate Excellence.

Pvt. Label CMBS Originations, 2013-2022



Sources: Commercial Mortgage Alert, Green Street via WealthManagement.com.

Trends in affordability have major consequences for multifamily and residential housing, especially in the areas deemed least affordable such as California and Florida.

We found it interesting to study what is happening in CMBS to give proxies for broader implications in each of the major CRE sectors. While CRE holdings in securitized form are dwarfed by those of banks, it is often easier to see how individual sectors perform.

Over the last several years, CMBS originations have remained relatively strong, apart from 2020. Much of the recent growth has been driven by large, single-borrower securitizations of either single assets or portfolios from single borrowers.

Another movement has been the rise of CRE collateralized loan obligations (CLOs) that have taken market share from private label CMBS. In 2021, CRE CLOs accounted for \$45 billion sold versus \$111 billion in private label CMBS. While some CRE CLOs may focus on direct loan origination, others may allocate at least a portion to purchases of CMBS. Although the rise of CRE CLOs likely will distort some future comparisons of sector analysis, we believe that, for now, CMBS offers a reasonable assessment of underlying market directions.

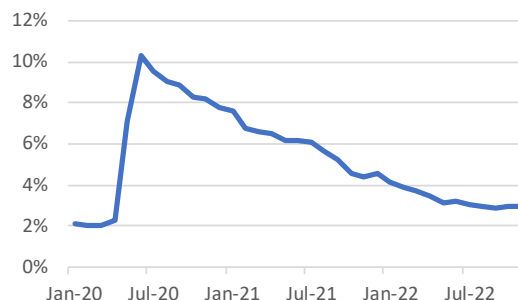
Delinquencies – better, but very uneven

After a significant leap in early 2020 when the world entered the pandemic, most CMBS class’ delinquencies have declined to nearly pre-pandemic levels.

Even with declines in lodging (which peaked over 24% in June 2020) clearly adding a significant punch, multifamily – one of the larger component CMBS asset classes – played a large role. Multifamily delinquencies fell from a peak of 4.5% to less than half that by December 2022; however, multifamily delinquencies have begun to rise since bottoming over the summer.

While office delinquencies have dropped below pre-pandemic levels, retail delinquencies remain stubbornly high, and we expect past due loans in both classes are not likely to abate in the near term.

Overall CMBS 30+ Days Past Due



Source: Trepp.com.

CMBS 30+ Days Delinquent by Asset Type, Dec 2019-Dec 2022

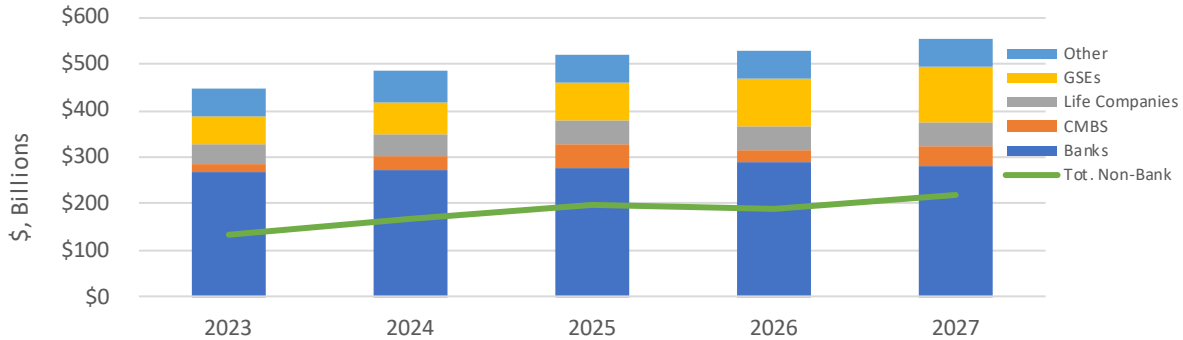
	Dec 22	Nov 22	Jul 22	Dec 21	Dec 20	Dec 19	Covid Peak
Overall	3.0%	3.0%	3.1%	4.6%	7.8%	2.3%	10.3%
Industrial	0.4%	0.4%	0.4%	0.5%	1.1%	1.5%	1.8%
Lodging	4.4%	4.6%	5.6%	8.8%	19.8%	1.5%	24.3%
Multifamily	2.2%	1.8%	0.9%	1.8%	2.8%	2.0%	4.5%
Office	1.6%	1.7%	1.6%	2.5%	2.2%	2.0%	2.7%
Retail	7.0%	6.6%	6.6%	8.3%	12.9%	4.4%	18.1%

Source: Trepp.com.

Refi volume – it’s coming...

With a somewhat cloudy outlook for interest rates, another area of concern for us is the loans coming due in the near term. While we have anecdotal evidence of banks’ willingness to work with stressed borrowers, we are also aware of debt-funded lenders squeezing troubled CRE deals. Limited capacity of bank lenders to take on sponsors fleeing these funds remains to be seen, and at the same time, higher rates are likely squeezing borrowers further with diminished capacity to pass on rate increases to tenants.

Projected CRE Loan Maturities by Holder, 2023-2027



Source: Trepp, Inc.

Recent Moody’s research suggested that the volume of performing non-defeased conduit loans scheduled to mature in the second half of 2022 or in 2023 totaled \$29 billion, adding to the scramble for friendlier lenders. Still, the amount represented a fraction of the \$386 billion CMBS conduit market standing in 2022. According to Moody’s analysis and assuming a 6% refinancing interest rate, borrowers would struggle to maintain a debt service coverage ratio (DSCR) of 1.4 times on an interest-only mortgage for 14% of loans with 2022 maturities and 15% of 2023 maturities. Bumping the refinancing interest rate to 8%, the risk of troubled borrowers would rise to more than double those levels.

With considerable uncertainty around the next leg of interest rate changes and the resultant effect on the economy, we are perhaps less optimistic than other market pundits. While we do see cash sitting sidelined in a number of funds waiting for distressed opportunities, a rush to “catch the falling knife” will likely end the same way. Strict attention to fundamentals will help judge the best situations and the market likely will be presenting a number of them, good and far less good. Our advice? Stay close and dig deep.

-Ron Thompson, Managing Director

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