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Morgan Stanley analysts think commercial real estate is heading for something 'worse than in the Great Financial Crisis'—here's what Goldman Sachs and UBS have to say

BY ALENA BOTROS

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The commercial real estate space faces some pretty big headwinds.
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Following the failures of both Silicon Valley Bank and Signature Bank, all eyes have been on commercial real estate (CRE), with some sounding the alarm, claiming it's the next shoe to drop. As *Fortune* has previously reported, commercial real estate lending standards were already tightening up over the past year as the Federal Reserve flipped into inflation-fighting mode. The ongoing bank troubles, however, will only exacerbate that tightening.

Even before the banks went under, experts within the sector knew it would be a challenging time for commercial real estate, particularly for office properties with rising vacancy rates and falling property values, amid the shift to remote work. Not to mention, the entire sector faces a

wave of loan maturities—meaning they'll need to refinance to higher interest rates.

Those commercial real estate headwinds—which are particularly strong in the office space sector—will increase the risk of defaults, distress, and delinquencies, as the industry is largely built on debt.

Last week, Allianz's chief economic advisor, Mohamed El-Erian, told Insider that "the moment of truth will play out" for the commercial real estate market once those loans mature and the sector is forced to adjust to the current economic climate. "This is part of a larger set of activities that, while they made sense when interest rates were rock-bottom and liquidity was abundant, make a lot less sense today," he told Insider.

Billionaire investor Howard Marks, cofounder of Oaktree Capital Management, also expressed concern over the sector's health, writing in a memo that "notable defaults on office building mortgages and other CRE loans are highly likely to occur." As for banking giants, they've presented their outlooks for the sector, ranging from almost apocalyptic to manageable losses.

But what do big banks think about all this?

To better understand, let's take a look at the commercial real estate landscape from Morgan Stanley, UBS, and Goldman Sachs from this month—all of which touch on various, but sometimes similar, aspects of what's to be expected.

Morgan Stanley gets bearish on CRE

Morgan Stanley's wealth management chief investment officer, Lisa Shalett, wrote in a recent report, "More than 50% of the $2.9 trillion in commercial mortgages will need to be renegotiated in the next 24 months when new lending rates are likely to be up by 350 to 450 basis points."

Even before the bank failures, office properties were already facing "secular headwinds," and are expected to face more challenging times ahead, Shalett wrote, with vacancy rates close to 20-year highs.

Therefore, Morgan Stanley's "analysts forecast a peak-to-trough CRE price decline of as much as 40%, worse than in the Great Financial Crisis." The distress, following the number of loans set to mature, and the likelihood of defaults and delinquencies as a result, will trickle down and affect more than banks and landlords—and no sector would be "immune" to the effect of that, Shalett wrote.

Commercial real estate can absorb the looming shocks, says UBS

UBS, the Zurich-based multinational investment bank that recently acquired Credit Suisse, employed a less dire tone, arguing that commercial real estate "headlines are worse than reality."

Despite the fact that "rising interest rates, a slowing economy, and increasing vacancy rates in office buildings have weighed on the sector in the last couple of years," UBS said, a "repeat of the 2008 liquidity crisis" is unlikely— even if credit tightens further.

UBS expects around $1.2 trillion of the outstanding $5.4 trillion in commercial real estate debt, aside from multifamily, will "mature" and be up for refinancing. That will likely happen amid higher interest rates, which, UBS said, will "only add to existing challenges around servicing debt—especially in areas like office and certain segments of retail where cash flows have become challenged due to post-pandemic behavior." Like others, UBS suggested defaults will occur as a result.

However, those defaults don't necessarily mean the sector as a whole is at risk, particularly as beleaguered sectors, like office properties, account for only 15% of commercial real estate. And the circumstances, the bank said, are much different than those of the Great Financial Crisis, which is why it argued that a repeat is unlikely.

"The health of the overall banking system and market liquidity conditions are substantially better than they were during the GFC," UBS said. But that's not to say things can't necessarily get worse from here. If the economy entered into a recession, commercial real estate losses that UBS

expressed as manageable over the long term could result in "meaningful deterioration in CRE to pressure banks' shares due to both earnings/profitability risk."

Goldman Sachs: Pain awaits office space owners

Goldman Sachs says the real risk is in the office sector, writing that it has been the "subject of high investor focus in recent months, and rightly so, in our view." But most of its fundamental troubles "preceded last year's back-up in policy rates." Nonetheless, Goldman Sachs pointed to three particular risks awaiting commercial real estate.

First, commercial real estate borrowers are exposed to higher interest rates, Goldman Sachs said, which translates into higher funding costs and increased exposure to floating (or variable) rate liabilities. That risk leads to the second, in that refinancing will be painful for some commercial real estate borrowers. Goldman Sachs estimates that $1.07 trillion worth of mortgage loans will mature before year-end 2024. And borrowers' ability and willingness to do so amid higher rates will be limited. As for the third risk, Goldman Sachs points to tighter lending standards ahead, and the effect of that on both banks and those within commercial real estate.

"The potential for disruptions to U.S. commercial real estate activity from a pullback in small bank credit availability is substantial, unaided by the fact that the segments most dependent on bank financing—offices and retail properties—are also facing the strongest risk of functional obsolescence."

The three risks outlined above, Goldman Sachs says, could put more pressure on net operating income and increasing vacancy, along with an increase in delinquencies—particularly for office properties.