Problems in commercial real estate have not been a well-kept secret.

Park Hotels & Resorts — a public real estate investment trust (REIT) — recently made the decision to cease payments on a $725 million loan for two hotels in San Francisco. One of those hotels includes the Hilton Union Square — San Francisco’s largest hotel — which occupies an entire city block and is one of the country's largest hotels outside of Las Vegas.

Essentially, Park Hotels & Resorts is surrendering the property back to the bank. A press release issued on the company’s website stated:

“The Company intends to work in good faith with the loan’s servicers to determine the most effective path forward, which is expected to result in ultimate removal of these hotels from its portfolio.”

In layman’s terms, the plan is to make the properties somebody else’s problem.

A legal process will unfold, but this situation in San Francisco is a microcosm of what’s unfolding in commercial real estate.

**What Is Commercial Real Estate?**

Commercial real estate is a large category that includes office buildings, multifamily housing, hotels, restaurants, retail stores, and warehouses, among other categories.

It’s important to point out: Many areas of commercial real estate are performing well — warehouses that support e-commerce, multifamily housing, and self-storage facilities, just to name a few.

Even hotels — despite the recent story in San Francisco — are thriving from record travel demand. Real estate is famous for the “Three Ls” mantra: location, location, location. And it’s true — current demand trends for hotels in Las Vegas share nothing in common with the problems at Hilton Union Square.

The problems in commercial real estate are concentrated in a few areas: primarily office space and the adjacent retail that benefits from the foot traffic.
The Problems in Commercial Real Estate
Real estate has observed an unfortunate collision between two forces:

1. New realities of how and where people work.
2. One of the most rapid increases in interest rates ever over a one-year period.

The pandemic had a major impact on lifestyle and migration trends. Employees are still working from home and, in many cases, have migrated from urban to rural living spaces.

According to the U.S. Census Bureau, New York City saw one of its largest population decreases ever in 2021, while Boise, Idaho, saw one of its largest population increases ever.

This clearly impacts office buildings, as people are showing up less. U.S. office vacancy rates are at their highest levels since the savings and loan crisis in the 1980s and early 1990s.

Exhibit 1

Share of Vacant U.S. Office Space (50 Largest Metro Areas)


The 10 most vacant office markets have seen major upticks in vacancies relative to pre-pandemic. San Francisco’s office vacancy rate has gone from 5% in 2019 to 25% today.
Exhibit 2

Top Ten U.S. Markets With Largest Change in Office Vacancy Rates

Source: Cushman & Wakefield

Fewer people working in San Francisco’s offices means fewer people are traveling there for work—one obvious reason why hotel landlords are intentionally defaulting on loans.

And the market is indicating a larger default cycle could be looming. Spreads on commercial mortgage-backed securities (CMBS) are at their widest levels in over a decade, signaling the market is expecting more defaults.

Exhibit 3

Source: Intercontinental Exchange, Bank of America
Impact on Banks?
Investors began drawing attention to the vulnerabilities of regional banks—specifically their exposure to commercial real estate—in the wake of the bank collapses observed in March and April.

These concerns have merit. According to the Federal Reserve, small banks hold roughly 70% of commercial real estate loans, or CMBS. A wave of defaults will have a negative impact on their businesses.

There are two obvious worries for banks:

1. Defaults could rise.
2. Real estate prices fall harder than anticipated.

The Federal Reserve recently called this out. In its annual Financial Stability Report, the Fed highlighted risks to the market, calling out commercial real estate specifically:

“A correction in property values could be sizable and therefore lead to credit losses by holders of commercial real estate debt.”

The good news is that banks have been dialing down their appetite for this line of business. The ratio of money that banks are lending compared to property values dropped to a 30-year low in commercial mortgages this spring.

Exhibit 4

![Average Loan-to-Value Ratio of CRE Loans]

Source: Ares Management, Federal Reserve
PNC— one of the largest U.S. banks—held an analyst day recently, and one of topics discussed was around lines of business (or sectors) it’s pulling lending away from.

PNC’s CEO stated:

“We’re not going to add to office exposure. There’s actually a lot of office deals we’d like to do, but the headlines of, ‘Hey, your office exposure went up!’ isn’t worth it, which is kind of the unfortunate truth about banking.”

Clearly, there’s so much negativity around office space that PNC doesn’t want to be associated with it. But the caveat would be that it sees interesting opportunities from a value perspective.

If PNC is seeing it, it’s likely others are as well. And it may imply that perceptions could be worse than reality.

Problems Are Showing Up in Prices
Peter Lynch, the famed Fidelity fund manager, was fond of saying, “If it’s in the news, it’s in the price.”

His rule of thumb was: If a story is on page one of the business section, markets generally reflect that news in stock prices.

Put simply, the front page of the newspaper isn’t fertile hunting ground for trade ideas.

Boston Properties— the largest publicly traded U.S. office REIT—stock price is down 55% over the past year, a significantly larger drawdown compared to a diversified real estate index, which is only down 15%.

Exhibit 5

Source: Morningstar. For illustrative and education purposes only.
Using data from Barron’s, Boston Properties stock trades for 9.5 times forward funds from operations (a popular valuation metric for real estate), versus a five-year average of nearly 22 times.

Prices seem to be reflecting how difficult this environment is for office owners.

**The Morningstar View**

Morningstar takes a value-oriented view towards sectors and real estate has not screened at attractive levels since 2016. For us, it’s not necessarily a house view that we don’t like real estate, rather we felt that there were downside risks given where interest rates sat (historically low levels) in recent years.

The impact of rising interest rates over the last 18 months has created significant earnings distress. First, it was retail malls and now it’s happening in office space. The good news is earnings distress can often precede compelling valuation opportunities.

That’s a bit oversimplified as some of the distress will likely lead to “zombie buildings” (like the San Francisco hotel’s) where the tenant simply walks away. “Bankruptcy” is a term we should probably get more accustomed to hearing.

But there’s an old saying, “you can’t go bankrupt if you don’t have any debt.” Real estate is an asset class that is synonymous with debt. For example, if a homeowner buys a house and pays 20% upfront as a downpayment, the other 80% of the purchase price is leverage.

Office towers are often valued in the hundreds of millions of dollars. Few investors can afford to pay all cash on values that large, which creates significant leverage.

For investors, applying a magnifying glass to leverage levels, or the amount of debt associated with a property, is one helpful filter to separate quality from junk.

Many real estate equities rely heavily on debt markets for funding, thus identifying real estate with conservative leverage levels becomes critical as funding dries up and valuations fall.

Refining the earlier quote, we think it will be hard for a building to go bankrupt if the leverage levels are conservative. If Morningstar were to add any real estate exposure, it would be done with those ideas top of mind.

The summary view is that much of the real estate distress is beginning to show up in prices. In some cases, prices may even reflect too much negativity.

But that’s the nature of markets—they tend to operate on a pendulum. Prices overcorrect in both directions (between overvalued and undervalued) and never seem to stop at fair value. After a long period of overvaluation, real estate prices may be headed towards a period of undervaluation.
Markets Are Cyclical, Real Estate Is Especially Cyclical

Every decade or so, commercial property values tend to experience a “reset.” Resets are typically preceded by overbuilding, movements in interest rates, turbulence in capital markets, or downturns in the economy.

Some combination of all these exists right now.

The good news is that most people are aware of them and discussing them regularly. Given that, it’s unlikely that commercial real estate is a proverbial black swan—something that catches people by surprise.

The story has been building for at least three years. And according to others, even longer.

Steve Schwarzman—founder of Blackstone, one of the largest global real estate investors—mentioned recently that his company has been diversifying away from office space for nearly a decade. Blackstone’s $585 billion real estate portfolio today “consist[s] of less than 2%” office space, compared with more than 60% a decade ago.

Negativity is filtering into the prices. And while it should never be said that all the negativity is priced in, it’s probably fair to say a large portion is being reflected.

The most logical point advisors can drive home to clients: The office sector faces a unique set of challenges that doesn’t reflect the broader commercial real estate category. Many other sectors within commercial real estate continue to have strong fundamentals.

The best path forward is likely owning and holding a durable portfolio. Diversification is generally discussed as something done among asset classes (i.e., stocks and bonds), but it can also be done within asset classes as well.

Going forward, some areas of commercial real estate will outperform, and some areas will underperform—the same as it ever was. III

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