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Waning demand amidst refinancing hurdles deteriorates the credit outlook of the US commercial real estate industry

by NUS-CRI Market Monitoring Team

- **NUS-CRI Forward PD suggests that financing challenges and worsening demand may raise the credit risk of the US commercial real estate industry**
- **The worsening credit risk outlook may also point to structural changes in the demand for commercial real estate property, as the pandemic has influenced a lasting change in lifestyles such as remote work arrangements etc.**

Unexpected persistence in inflation and the possible prolonged high-interest-rate environment are poised to worsen the credit outlook of the US commercial real estate industry. Though the industry's overall credit profile was relatively stable throughout last year, as suggested by the NUS-CRI Aggregate (median) Probability of Default (Agg PD) in Figure 1a due to the industry's relatively stable liquidity profile and low leverage levels, the initial uptick in H2 2022 came as a result of an increase in borrowing costs and a resultant decline in property values. This trend is likely to pick up momentum in the short term, potentially harming the industry's refinancing capabilities. This is suggested by the NUS-CRI Aggregate Forward 1-year Probability of Default (Forward PD[1]) in Figure 1b, where the Forward PD worsens substantially over the next 24 months into the BBB upper bound range as proxied by PDiR2.0[2]. The industry is likely to also face structural demand challenges in the longer term, however, in the short term, refinancing hurdles are more likely to be the leading cause of distress in the US commercial real estate industry.

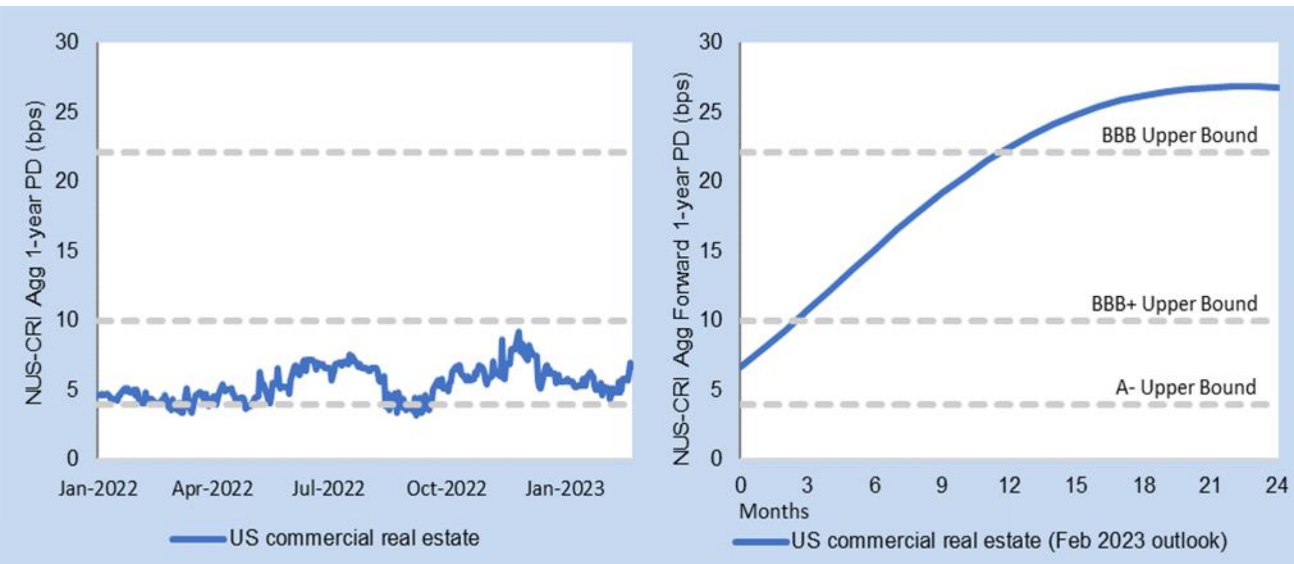

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for US commercial real estate industry, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for the US commercial real estate industry as of Feb-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Rising interest rate hikes by the Federal Reserve (Fed) have been pressuring the growth of the US commercial real estate market since the latter part of last year. 2022 saw a 10% drop in commercial real estate loans as heightened borrowing costs hampered activity in the commercial real estate market, further impacted by high-profile defaults. As of Feb-2023, sales of commercial mortgage bonds have also declined by close to 85% YoY,

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

falling to USD 4.27bn YTD in 2023, compared to USD 29.38bn over the same period last year (See Figure 2a). Capitalization rates have also risen due to a fall in property values, which has resultantly reduced the demand for refinancing commercial property loans. Investors are also pricing in higher credit risk for industry players, with the Bloomberg investment grade BBB commercial mortgage-backed security (CMBS) average OAS rising from 2.91% at the start of Jan-2022, to 5.25% in Feb-2023. The threat of heightened credit risk on the US commercial real estate industry is also suggested by the Forward PD in Figure 1b, possibly due to a sustained slowdown of near-term financing opportunities due to persistent inflation and the rising likelihood of further monetary tightening by the Fed.

Contributing to the industry's woes due to a worsening macroeconomic environment is the fall in sales throughout last year (See Figure 2b). The combination of depressed returns and higher borrowing rates has also materially increased the refinancing risk for the industry. Upcoming debt maturities pose a significant risk, especially as investors remain wary of underlying distress limit financing channels. The long-term nature of commercial real estate leases provides some respite, not pressuring the sector's relatively robust liquidity levels.[3] The industry's low leverage levels[4] have also helped anchor the sector's credit risk against macroeconomic shocks, as seen from the NUS-CRI Agg PD in Fig 1a.

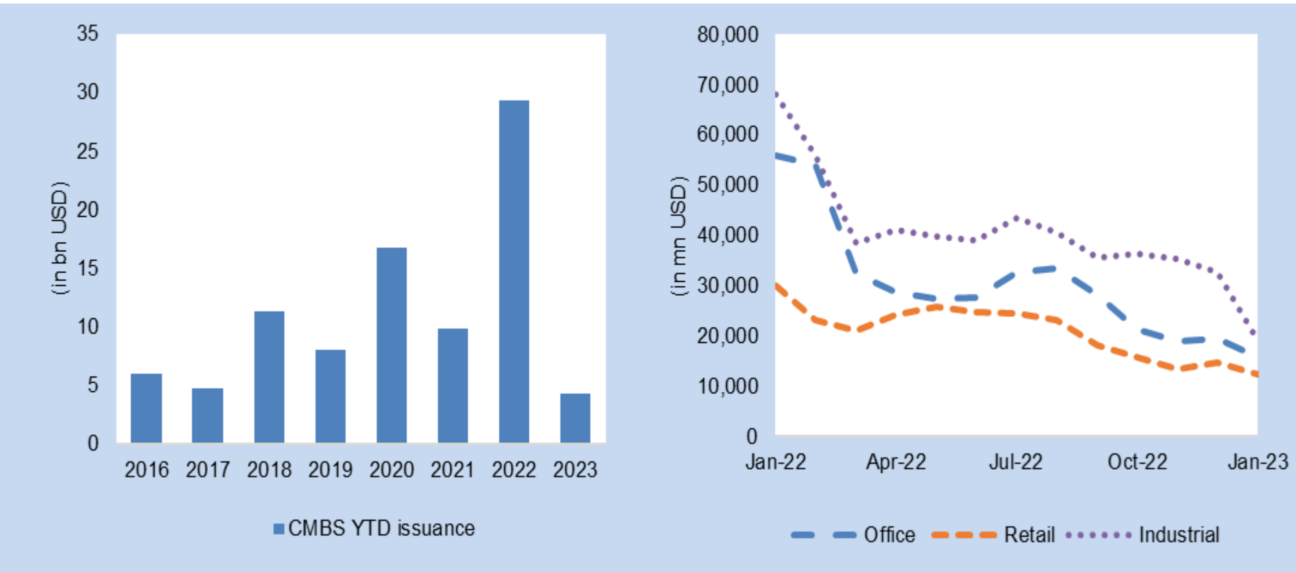

Figure 2a (LHS): Commercial mortgage bond YTD issuance data as of Feb 2023.Figure 2b (RHS): Monthly sales volume for different segments of the commercial real estate sector. *Source: Bloomberg, Real Capital Analytics*

Catalyzed by the pandemic, potentially permanent structural shifts in the demand for commercial real estate properties are evident. More and more people are choosing to work from home in metropolitan commercial districts compared to suburban cities, shop on e-commerce platforms, and engage in various activities online. Despite some stabilization in the number of employees returning to the office, the figure remains at approximately half the level seen before the pandemic. This trend is further indicated by the increasing number of struggling commercial real estate projects. As some commercial real estate tenants' leases expire without renewal, companies may face further cash flow problems, which may translate to higher delinquency rates.

Going forward, the default risk of the US commercial real estate industry could be dependent upon the speed of demand recovery. Should vacancy rates remain high, cash flow generated from existing property assets could remain hampered, leading to a potential liquidity crunch in the face of upcoming servicing obligations. Furthermore, access to financing for projects under construction might be hampered by heightened borrowing costs, especially in an environment where property values are decreasing. Therefore, though the industry is yet to bear the brunt of the current demand slowdown, the credit risk of the US commercial real estate industry may worsen as suggested by the Forward PD in Figure 1b.

[3] The median current ratio of the companies in our sample is 3.08x as of Q3 2022.
[4] The median debt to total capital ratio of the companies in our sample is 27.48% as of Q3 2022.

Credit News

Developing countries’ debts mount as pandemic and strong dollar hit finances

Feb 23. The Institute of International Finance has revealed that developing countries’ debt rose to a record high of USD 98tn at the end of 2022, a concern for potential sovereign defaults in the year ahead. The combined government, household, corporate, and financial sector debts of 30 large low- and middle-income countries had risen from USD 75tn in 2019 before the pandemic began. Government debts alone accounted for almost 65% of GDP, increasing by 10 pct over pre-pandemic levels, to reach the highest year-end total ever. A strong dollar against most emerging market currencies has led to extra funding costs for low-income countries. (FT)

Vietnam property debt crisis deepens as major developer delays bond payment

Feb 23. Vietnam's property debt crisis has escalated as Novaland, the country's second-largest developer, has delayed repayment of a USD 42mn note and asked bondholders for an extension or to convert the principal into its real estate products. It is the latest in a series of Vietnamese developers that have been late in repaying their debt, pointing to a wider financial strain in the sector due to an anti-corruption campaign that unsettled investors and led to a decrease in new bond issuances. The debt woes in the industry, with billions of dollars of bonds due this year, could trigger a broader crisis in the Vietnamese banking sector and economy. (BT)

Hong Kong banks hit by China property exposure

Feb 22. Hong Kong-listed banks have increased their expected losses due to their exposure to mainland China's struggling commercial real estate sector. HSBC Holdings reported an increase in expected credit losses and other impairment charges to USD 3.6bn for 2022, up from USD 1.1bn for the first half and a positive USD 928mn for 2021. The Chinese property sector, along with other factors such as economic uncertainty, inflation, and supply chain risks, was blamed for the increase. HSBC's total exposure to mainland real estate was USD 16.8bn, and around 60% has been classified as "substandard and credit impaired." However, the bank's net profit for the full year rose 18% to USD 14.8bn, and it will resume quarterly dividend payments this year. (Nikkei)

Office landlord defaults are escalating as lenders brace for more distress

Feb 21. There has been a surge in the number of large office landlords who are defaulting on their loans. The office building industry has been a source of increasing concern throughout the pandemic, with low return-to-office rates leading to high vacancy levels in many cities. The spike in interest rates last year raised the costs of buying and refinancing properties, putting pressure on property values. Banks are preparing for an increase in problematic loans backed by office buildings. The growing number of distressed office buildings suggests that the expected strong return to the office is unlikely, as the rate of employees returning to the office has stabilized at approximately half of the pre-pandemic level. (WSJ)

World Bank touts an ESG bond it says is ‘immune’ to greenwashing

Feb 23. The World Bank has raised USD 50mn through a bond structure designed to be immune from greenwashing concerns. The five-year bond will fund a project manufacturing water purifiers to provide clean drinking water to approximately two million children in Vietnam, thus reducing greenhouse gas emissions. Instead of regular coupon payments, investors will receive semi-annual coupon payments linked to the verified carbon units (VCUs) generated by the project. The World Bank is planning more deals later this year, which may be larger in size. The deal has attracted the interest of asset managers globally, with potential for carbon to become an asset class. (BT)

South Africa expands public borrowing to relieve Eskom debt (FT)

Egypt seeks USD 1.5bn in Islamic debt sale as payment looms (Bloomberg)

Bond yields are jumping at Federal Reserve phantom shadows (BT)

Regulatory Updates

Japan govt bond breaches yield cap, BOJ steps in with buying, loans

Feb 22. Japan's 10-year government bond yield has breached the Bank of Japan's policy band for a second straight session, reaching 0.505%, its highest level since January 18. This has prompted the BOJ to intervene in the market with emergency bond buying and loan offerings. The move follows investors renewing their attacks on the BOJ's ultra-loose interest rate stance, with many expecting the central bank to abolish its yield curve control policy after incoming governor Kazuo Ueda takes over in April. The BOJ has bought JPY 300bn (USD 2.2bn) of JGBs with maturities of five to 10 years and JPY 100bn of bonds with maturities of 10 to 25 years. (Reuters)

China injects USD 29bn into banking system while holding rates flat

Feb 21. The People's Bank of China decided to maintain its benchmark lending rates for the sixth consecutive month, prioritizing liquidity injection to support the economy. The central bank added a net CNY 199bn (USD 28.9bn) via its medium-term lending facility for commercial banks this month, the third straight month of net increases. The sluggish real estate market remains a concern, with the government hoping to spur developers to complete delayed projects to restore trust in the sector. (Nikkei)

Turkey Cuts Rates Despite Risk of Stoking Post-Earthquake Inflation (WSJ)

U.S. Regulators Warn Banks of Heightened Liquidity Risks in Crypto-Related Deposits (WSJ)

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