

DIAMOND HILL

INVESTED IN THE LONG RUN

Understanding Uncertainty in Commercial Real Estate

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The rise of remote work and hybrid models and the impact on commercial real estate is weighing on the minds of investors in commercial mortgage-backed securities (CMBS). From our standpoint, we think what has happened with malls provides some perspective.

That's a story that has transpired over the past several decades with the rise of online shopping. Today, we can largely see how that has played out. A number of malls did not survive – but some did. Those that survived did so by evolving – changing into lifestyle centers and/or offering additional services and attractions shoppers cannot get online.

If we apply that thinking to CMBS, it's clear there has been a societal shift. Work from home is here to stay in some format – whether fully remote or hybrid. For example, even among the staunchest supporters of a return to the office in financial institutions, we see that a lot of back-office operation jobs have become fully remote. Effectively, people are not saying they don't need offices at all – they are saying they don't need as much. Or it needs to evolve to provide different functions. As investors, our job is to figure out which office is going to survive and even thrive, and what is the debt structure that makes the most sense in that changing landscape.

The big change we think we'll see is in how much these commercial properties are worth. Some decades-old, rule-of-thumb metrics – like cap rate (which uses net cash flow divided by the property value) for each type of property – just don't make sense post Fed-liftoff in the new interest rate paradigm. Think about trophy properties in New York which might have been trading at a 4% cap rate. With a 10-year US Treasury now close to 4%, no one is assuming a cap rate that low. Still, commercial properties are long-term investments. So if you assume a terminal Fed rate of 2.5% over the long term, what's a reasonable long-term cap rate? That's what investors are asking.

This could also take a long time to play out. If you own an office building that's fully occupied, you have current cashflow and probably reasonably cheap debt. That delays any coming pain. But eventually, some or all of the debt comes due, and you must refinance. Those waves of refinancing cliffs are coming, and as companies scramble to deal with more expensive debt financing, that is when losses will start to be recognized.



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Overall, a good question is, how different is this from the 2008 residential housing crisis? If you think about residential properties, for many homeowners, that is often a big chunk of their net worth. When housing prices fell and home equity was effectively wiped out for many, that was a huge change in circumstances. However, in the scenario with commercial real estate, we consider how much of the market these securities represent. CMBS are a relatively small percentage of the market and overall make up a small portion in most investors' portfolios. The spillover effect should be quite small when those refinancing cliffs come, and understanding which properties are likelier to survive should be a source of some interesting opportunities if we can look through near-term noise.

From an investor standpoint, this will take some time to play out, and the path interest rates take will impact a good amount of what happens – an aspect over which we have no control. So that gives us time to watch, assess the debt that is coming due, what the prevailing rates are for refinancing, and what alternatives are available to tide commercial real estate debtors over.

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