

**Exchanges at Goldman Sachs**  
**Navigating the 'perfect storm' in**  
**commercial real estate**

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**Allison Nathan:** The recent stress in the banking sector appears to have abated, but knock-on effects are pressuring another key corner of the economy -- commercial real estate. So could commercial real estate be the next shoe to drop?

**Jeff Fine:** Where we stand today is this nearly perfect storm of rates much higher, financing markets almost completely shut down, and we estimate that there's about \$4 to \$5 trillion of debt in the commercial and multifamily sectors, of which about a trillion of that is maturing in the next 12-18 months. We've got a big rightsizing in the

market that we're going to have to confront that is going to be the talk of the next 6 to 12 to 18 to 24 months in our space.

**Allison Nathan:** I'm Allison Nathan, and this is Exchanges at Goldman Sachs.

The turmoil that drove Silicon Valley Bank and Signature Bank out of business is now shining a spotlight on the commercial real estate market, which relies on small and regional banks for loans. So as these banks tighten credit, that could further disrupt a market that's already weighed down by office vacancies, rising interest rates, and mounting debt. To help assess vulnerabilities in the market and the broader outlook, I'm sitting down with Goldman Sachs Research's Lotfi Karoui, chief credit strategist and head of the credit research group, and Jeff Fine, global head of real estate client solutions and product strategy in the firm's Asset and Wealth Management business. Lotfi, Jeff, welcome back to the program.

**Jeff Fine:** Good afternoon, Allison. Thanks for having us.

**Allison Nathan:** So let's first just get a sense of the

commercial real estate, or CRE, market. Jeff, what does it look like and how big is it? Give us some context.

**Jeff Fine:** It's a huge market. The distinction that I would draw is between what we think of as broadly the commercial and multifamily, or housing writ large, markets and the personal home ownership market, which we think about as a separate category. So when we talk about the size of this market, we'll think about the investable asset categories of office buildings and retail and industrial and various forms of housing, whether multifamily or student housing or seniors housing. And altogether -- and the numbers are a little bit all over the place -- this is directionally the third largest market cap category in the investable universe. You have fixed income, you have equities, and then private real estate is generally thought of as north of \$20 trillion market. So really big, really important to the overall economy of the country and the world, just given the amount of foreign investment that we find in U.S. private real estate.

**Allison Nathan:** So commercial bank lending is under stress right now. Walk us through how we got here.

**Jeff Fine:** Sure. The story in modern time goes back to the pandemic. And we really have to look to what happened in 2020 when the global economy shut down and the U.S. pumped an awful lot of liquidity into the market in order to abate what was a pretty unprecedented period in this economic cycle. And by bringing rates almost down to zero, we started on what really became the story of this part of the market cycle.

And what we saw was markets beginning to recover because so much liquidity was pumped into the system in 2020, but by 2021, we saw inflation running in all different parts of the economy. And we saw that play through in the real estate market in a pretty significant way, both through the pass-through of inflation onto rents. So we saw, in certain categories, top-line revenues really skyrocket, increased by double digits off of where they had fallen to. Most pronounced in certain categories like housing and logistics.

A much different story for office buildings and for retail assets, but we also saw tons and tons of capital coming into our markets because, when rates reached sub 100 basis points, there was an enormous search for yield going

on all over the place. And so it really drove up our asset values to unprecedented levels. You saw that play through in the public markets. You also saw that play through in the private markets. And that ran its course for most of 2021.

What happened going into the early part of 2022, in response to those inflationary pressures, you saw the Fed start to act. And by beginning to meaningfully tighten and increase rates very quickly, you saw an immediate reaction to the public markets, where public market valuations really started to fall. You didn't see that filter through into the private markets right away. So the private markets continued to run for a period of time, until rates got to a point where the immediate impact was just a slowing of transaction volume.

So all of a sudden, toward the end of '22, you stopped seeing apartment buildings and office buildings and other assets start to trade, and that was in part due to the fact that rates were up. So we're at the point now where rates have gone up almost 400 to 500 basis points in the course of a year, which is nearly unprecedented in modern times. That's had a direct impact to valuations.

And then the final knock-on effect was the tightening of the bank and credit markets, which has made financing -- this otherwise highly financed asset category -- almost impossible. So where we stand today is this nearly perfect storm of rates much higher-- off of a base where rates were at nearly zero -- financing markets almost completely shut down. And again, just order of magnitude, we estimate that there's about \$4 to \$5 trillion of debt in the commercial and multifamily sectors, of which about a trillion of that is maturing in the next 12-18 months. We've got a big right sizing in the market that we're going to have to confront that is going to be the talk of the next 6 to 12 to 18 to 24 months in our space.

**Allison Nathan:** The amount of loans that are coming due, is that just bad luck? Or is that typical that we have these big tranches that come due every so often?

**Jeff Fine:** The floating rate CMBS is typically 2- to 3-year terms with extensions. And so it tends to come due in much shorter periods. So if you think about all the loan originations from 2021, which was a peak year, most of that comes due in '23 and '24. And that's the reason why

you've got so much pressure in that vintage.

**Allison Nathan:** Lotfi, let's bring you into the conversation. You follow the sector extremely closely. Jeff's laid out some of the background here. What else would you add?

**Lotfi Karoui:** The first thing I would say is echo what Jeff said, which is the speed at which sentiment has deteriorated has been quite striking. And we have to remember that about only a quarter or two ago, private real estate was praised actually for its ability to act as an inflation edge in a multi-asset type of setup. Most market participants looked actually quite comfortable with fundamentals in this sector. Unlike the run-up to the global financial crisis, we had a decade or so of very strict underwriting standards.

So beyond I would say the recent headlines which clearly have not been that helpful, I think it's the realization essentially that, more so than other parts of the credit universe -- whether it's corporate credit or household credit -- I think the commercial real estate space has had a tougher time essentially adjusting to the prospect of higher

for longer funding costs. But we've had the most aggressive hiking cycle since the onset of the Great Moderation. And that happened at a time when the asset class has been essentially dealing with downward pressure on net operating income, stemming from declining occupancy rates in some cases and then falling rent growth.

But more specifically, there's probably three other headwinds that I would highlight. The first one is, in the aftermath of the pandemic, we actually saw a pretty significant increase in floating rate debt issuance. So that created more vulnerability to the level of policy rates. And again, if you compare that vulnerability to other parts of the credit universe like corporate credit, you're just more sensitive to whatever the Fed does essentially in the commercial real estate space.

Number two, Jeff alluded to this, but the maturity wall was a lot more front-loaded in the commercial real estate space, where there's over a trillion dollars of maturing loans over the next two years. And that's actually pretty unique. In other parts of the credit universe, things tend to be spread out a little bit more evenly.



And then three, I think financing environment has turned a lot more challenging. Banks are laboring under a lot of pressure in terms of their balance sheets. But even if you looked outside of the banking ecosystem, the securitization market is another source of capital formation there. You look at new issue volumes of conduit CMBS, for example, they're down quite materially relative to last year in the tune of 75-80%.

There's a lot of things happening here, but I would say, at a high level, it's really the inability of the asset class to adjust to the prospect of a higher for longer cost of funding environment.

**Allison Nathan:** Correct me if I'm wrong, but it is a sector that is particularly leveraged to the smaller banks that have been in the spotlight, come under stress recently in the wake of Silicon Valley Bank and Signature Bank.

**Lotfi Karoui:** Absolutely. I think 70% of commercial mortgage holdings sit outside of the top 25 banks by assets. And so, yeah, it is very heavily dependent on bank lending, particularly small banks.

**Allison Nathan:** And are there sectors, sub-sectors within CRE that are most affected by these headwinds?

**Lotfi Karoui:** I think it's important to avoid a one-size-fits-all type of approach when you look at the CRE space. Office properties have come under a lot of scrutiny recently. In our view, that's the one type of property where you're seeing the most pressure on occupancy rates. You can look at some of the numbers and compare them to other types of property, but what you clearly see is that occupancy rates have been falling at a much faster pace for office properties.

And then rent growth has also been falling at a faster pace relative to other subsectors. And the office sector I think is probably the weak link in the system today, but other types of properties, while still facing the same headwinds in terms of falling rent income growth, are doing better. If I take multifamily housing as an example, you did have two years of strong appreciation basically in house prices, and that created a nice line of defense, in my view, against the prospect of rising default risk.

Industrial properties is another example. It's very cyclical obviously. And so if, for whatever reason, the cycle inflects can the economy goes into recession, I think sentiment will likely deteriorate there. But fundamentally, you don't have the same degree of vulnerability to spare capacity I think that you're seeing in office properties today.

**Jeff Fine:** One of the things that we saw coming out of the pandemic was a real bifurcation in the market between new properties and older properties. Sustainability became a feature that a lot of tenants as well as the capital markets cared about. So part of the challenge that you're dealing with right now in the market is you've got a lot of old inventory. You have a lot of assets that were built in the 1950s and '60s that have been under invested in. That's where the big supply overhangs sit right now. And so when you juxtapose that with this sector bifurcation that we've seen also where office was probably the biggest casualty of the pandemic, where housing and logistics were the darlings in the aftermath of the pandemic because you could really pass through a lot of the inflation that we were seeing in the market and the supply-demand fundamentals looked a lot better, you're now starting to see, as we confront some economic headwinds, some slowing growth.

And I think that's giving people pause because investors were of the view that the good categories were going to continue growing forever, and the tougher categories were going to have a tougher go of it. And I think now we're facing different challenges in different sectors, but the underpinning of a 500-basis-point higher base rate across the board and not having that double-digit rent growth across the board in certain categories to out run that rate hike is just making the near term very disconcerting for lots of investors.

**Allison Nathan:** And so if we think about these most vulnerable subsectors in particular, what is the outcome here? Are we going to see a further drop in valuations?

**Jeff Fine:** My personal view is I think you will see a further drop in valuations. I think the public markets reflect more of a price correction than the private markets have to date. I think the slowing transaction volume has masked the fact that trading levels have already started to deteriorate. The big question is: What do lenders do when these loans start maturing and there is an inability to refinance?

Because in many cases, the age-old notion of the bank just

takes back the keys to the property, in a lot of cases, these assets are more liabilities than they are assets. They need capital injected into them to fund base building work, to keep them leased. And banks aren't in a position right now where they are prepared to both take the assets back and continue funding the costs needed to stabilize these assets or to fundamentally reposition them.

So think old office building into a new residential building. That takes a lot of capital. So I think over time there's going to have to be a very organized public and private partnership to figure out a careful unwind of this current dynamic. Otherwise, we have a very messy situation on our hands.

**Allison Nathan:** Who's really motivated to lead that effort? That feels like a pretty complicated road to go down? So what do you think is the most likely scenario?

**Jeff Fine:** From my standpoint, I think commercial owners are clearly incentivized to figure out solutions to not see equity values deteriorate materially. I think banks should be motivated parties to not see the fates of Signature Bank and others become their fates because the direct mark to

market on a lot of underlying loan positions don't tell a great story just based on where the capital markets stand today. And while it's deeply unpopular, some amount of government support in order to keep the capital markets liquid for commercial real estate is really important.

As we've seen in prior periods of crisis, when you zap the bank market, the bond market, capacity in the insurance market to finance commercial real estate, especially in the face of debt coming due, the outcome can be really upsetting to the overall economy. And so, while it's not something people want to think about and contemplate and map out a plan for, I do think it's important that we start trying to understand what that unwind looks like, going from a zero-rate environment to one where rates are more normalized.

**Allison Nathan:** So it seems pretty clear that delinquencies in this space are going to rise. So Lotfi, if you think about the read-through for losses on CRE loan portfolios, what would that really mean? And is there a historical precedent that we can use as a guide?

**Lotfi Karoui:** I do think it's important to be a student of

history a little bit, but the history will tell you that losses play out over a certain number of years. They're closer to being a slow burn as opposed to an abrupt increase. And so you go back to the last two decades, which is pretty much since the birth of the CMBS market as we know it today, you can take the worst cohorts of CRE loans that was ever originated. And that's probably a combination of the 2007 and 2008 cohorts. And if you follow the trajectory of cumulative losses after that, it basically took four or five years for losses to materially pick up.

And that lead-lag relationship reflects the fact that it does take time between the moment the loan is defaulted on and then the moment the various claimants get paid. Now, could this time be different? I would say the good news is that whatever issues we're going through right now, they're not symptomatic, in my opinion, of years of loose underwriting standards. And that's really a key difference between the current environment and the run-up to the global financial crisis or, prior to that, the run-up to the S&L crisis.

If anything, I would say that lending standards post global financial crisis have been quite tight. We've introduced risk

retention rules. Debt servicing coverage ratios have been increasing. And so in general, I would say credit quality is stronger today relative to where it was 15 years ago.

The bad news, however, is that the cyclical challenges are a lot more pronounced this time around. But if you take office properties as an example again, I think this sector has never been more oversupplied than it is today. And so the risk of a negative feedback loop where landlords are forced to lower rents or accept lower square footage from tenants, which in turn will pressure net operating income and then drive valuations even lower, I think that negative feedback loop risk is quite high.

The flip side of that is that it could actually reduce borrowers' incentives to just do the amend-and-extend process that typically takes place. And so it could ultimately result in a loss cycle that is a little bit more front-loaded than usual. But I would say history would tell you that losses play out over many years; they don't materialize instantaneously.

**Allison Nathan:** And obviously such a critical part of this, as we've been discussing, Jeff, is the financing



market. What do you expect broadly on that side of things?

**Jeff Fine:** I would say bank balance sheets have been in the process of starting a slow unwind now for some period of time. That's obviously there's a heightened focus on that in what we just went through with Silicon Valley Bank and Signature Bank, where people are trying to get their houses in order, understanding that underlying collateral is facing headwinds right now.

Because of what we've seen happen in the broader economy and the general contraction in the overall market, it's exacerbated this problem of space need. And so to the supply overhang that Lotfi's suggesting, right? We've seen major tenant contraction. We've also seen alternative use of space, so lots of people still working from home, lots of cities where people have not come back into the office. And so lenders are acutely aware of that.

So even if there is a capacity to lend, I think lenders are going to be very careful of lending into situations where they don't believe in a positive forward for the underlying asset. And we need liquidity in our markets, even for the

toughest categories, to avoid a hard landing. But then I do think we need to figure out how we over index going forward to the types of assets being invested in that have a future. And we're spending a lot of time thinking about the future of cities right now within our business. And the city from 50 years ago with lots of office and not enough housing looks a lot different going forward.

And so we're trying to figure out is how do we get from point A to point B? How do we finance our way through it and then operate into a better market? If we can't figure out a way in which to reignite our debt capital markets, it's going to continue to put added pressure on the system, which is not a great thing.

**Allison Nathan:** And given the size of this market and the amount of stress it's under right now, Lotfi, are there implications more broadly for economic growth?

**Lotfi Karoui:** The immediate implication is obviously reduced credit availability via the banking channel, but banks have been in focus as a potential channel for contagion. As we said earlier, smaller banks are particularly vulnerable to losses, and that will likely fuel

more pressure on balance sheets and further reduce credit availability in the broader system.

Is this another 2008 type of moment where we get caught into a vicious circle of leveraged losses leading to end our capitalized balance sheets and further reducing credit availability in the system? I think the bar is actually quite high for that for really two reasons.

One, outside of office properties, actually fundamentals are still quite healthy. There are obviously some cyclical headwinds that we have to deal with. This is an issue that is primarily affecting office properties.

And then if you look at the broader credit complex, whether it's corporate credit or household credit, things also still look fine. We're still in an economy that is at full employment, where the unemployment rate is at historically low levels. And never say never, but I do think that the bar is quite high to see a full-blown contagion scenario via the banking channel system.

I guess the other channel through which you could have contagion is via the investor base, but half of the CRE

loans outstanding is owned by the banks. The other half is owned by investors that own other types of fixed-income securities. And so if we have a front-loaded loss cycle this time around that looks a little different from what we've had the last two decades, that could put pressure on investors' asset portfolios and then, in turn, cause them to cut risk on other pockets of fixed-income markets. That's an indirect spillover effect. That's something that we need to keep an eye on, but that would be the other channel through which you can get, maybe not contagion, but pressure on other assets stemming from losses in the CRE space.

**Allison Nathan:** So we still are focused on this risk of recession. What would a recession mean for this sector at this point?

**Jeff Fine:** I think a recession is never a good thing for underlying fundamentals. There's a consequence to companies' ability to pay, companies' ability to grow, upward pressure we're able to put on rents, notwithstanding that inflation has caused a real slowdown in new starts and will likely lead to fewer new deliveries in the next few years.

But the one thing from a rates perspective that it could involve is easing once again, which, if rates start coming down, that is going to have some positive impact on some of the dimensions that we've talked about today.

Obviously, there's another side to that dynamic which isn't great.

We have a lot of people with divergent views right now on inflation and whether the numbers that are reported are the right numbers, or whether, when you look through to the underlying drivers of that inflation, we're really starting to see inflation curbed and whether we overshot a little bit on the tightening. And if that's the case, then one could see in the face of recession a case for easing which would lighten the burden a little bit. Wouldn't help with some of the unfortunate categories right now, but certainly it'd be mark to market from where we were to where we are that would ease up on a little bit.

**Lotfi Karoui:** No, I would agree with that. I think a recession would definitely exacerbate some of the downward pressure that we're seeing on the profitability. Now, it would also depend on the severity of the recession,

on the length of the recession, but a recession is, first and foremost, a cyclical shock. And so that will lay more on profitability.

The trade-off, however, is that you'll likely get some relief on the funding side as well. My best guess is that relief will primarily benefit high-quality borrowers as opposed to low-quality borrowers, but that's a trade-off, which is relief on the funding side versus further pressure in terms of profitability.

**Allison Nathan:** So is there a bright spot here at all?

**Jeff Fine:** You're seeing capital around the world mobilize to try and take advantage of the private credit opportunity both in corporate but as well as in real estate. And for a lot of investors, it's the other side of the trade, right? So for people whose yields have gotten squeezed by higher operating costs and higher debt service costs, being a lender in the floating rate space is really attractive right now. And people are earning double-digit type returns, lending into this otherwise completely illiquid market right now. And so it's not going to completely offset. You can't make up for all of the regular-way debt that needs

replacing through private markets, but it's a really interesting supply-demand play that a lot of investors are taking advantage of right now.

**Lotfi Karoui:** I actually think that's a great point. It's not a perfect substitute to bank capital, obviously. But relative to 15 years ago, we have new sources of capital formation that we didn't have. And if anything, that sort of creates a good line of defense against potentially super tight lending standards in the banking system because we're seeing the same dynamic in corporate credit. Like, direct lending is a new thing, right? Like, it's worth \$600 billion of capital that wasn't there. But these guys lend to middle markets and small companies and, to the extent that everything that's happened the last five weeks is bad news for small companies that don't have access to capital markets, I think relative to 10 years ago, we're in a somewhat better situation today.

**Allison Nathan:** So what is the market looking for in terms of signs of stabilization? What are you both watching to see how this evolves? Jeff, maybe start with you.

**Jeff Fine:** Yeah, I guess from my perspective, Allison, I still think we're in the early innings. I think we've got to see how this maturing debt plays through. I think we have to see what the deflating balloon looks like once it's fully right-sized for this now normalized rate environment. And I think the credit markets, which tend to have a detachment point that is a 60%, 65%, 70% level for most commercial transactions, need to adjust. And I think what that's going to entail is degradation of a lot of value in the private markets. I think it's going to create a lot of disruption and dislocation, again, if not properly choreographed. And I think it's going to create a once-in-a-decade or once-in-a-generation investing opportunity for people who come in and buy at those resetting values with a new forward look.

But they're going to need financing to facilitate those transactions. And there's going to be a lot of both equity value as well as credit value likely wiped out in that process. And I think this could take several years for us to go through, even if the capital markets start functioning at a more normalized level.

We just went from, again, zero interest rates to 500 basis



points higher in a matter of a year. And 2021 was a super high transaction year where a lot of activity in both the sales market as well as the financing market took place. And so you can't just flip that on a dime and expect there not be meaningful value deterioration along the way.

**Allison Nathan:** Lotfi, what are you watching?

**Lotfi Karoui:** I think we need to watch the ability of the asset class to essentially digest the most aggressive and front-loaded hiking cycle that we've had the last 40 years. And I think that process will take at least a year and a half to two years. We have a trillion or so of loans that are maturing within the next 24 months. We need to see where capital is going to come from.

And then after that, I'll go back to the point that we made earlier, which is dispersion is likely to be remain very high. And so I think the entry barrier to deploy capital into the space is probably a little higher. This is closer to being a micro trade as opposed to a big macro trade because, on the macro side, if you look at CMBS spreads or CMBX spreads, they're already pricing in quite a lot of damage. And so I do think that the alpha-generating opportunity

will take time to emerge, and I think it will likely emerge at the micro level; i.e., driven by bifurcation by property types, sometimes even within the same space, so even within the office property universe I think there's going to be significant bifurcation.

**Allison Nathan:** Lotfi, Jeff, thanks for joining us.

**Lotfi Karoui:** Thank you.

**Jeff Fine:** Thank you.

**Allison Nathan:** And before you go, we'd like to introduce a new podcast from Exchanges at Goldman Sachs that will be launching this Friday. It's called The Markets. Each week, in just 10 minutes or less, we'll be breaking down the key issues moving markets that week, giving you the information you need to stay ahead. Listen to The Markets, your go-to source for insights on global markets.

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