RANGER GLOBAL

Commercial Real Estate Debt Distress: Banks & Private Owners' Problem, REITs' Opportunity?

April 2024

Through 2023 and into 2024 values of private commercial real estate has increasingly become more distressed. The total of this distressed value is approaching $100 billion, according to MSCI Mortgage Debt Intelligence in the charts depicted below (Exhibits A and B). Most of the distress is centered in office properties, for good reasons, followed by retail, hotel, and apartments.

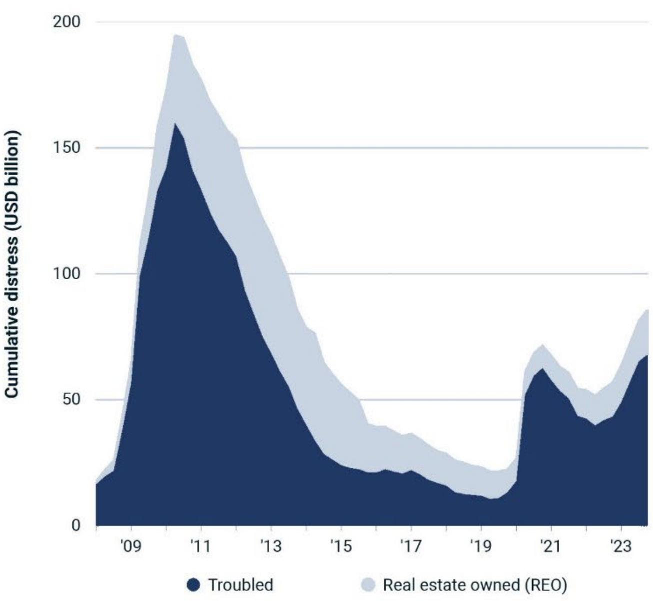

Exhibit A

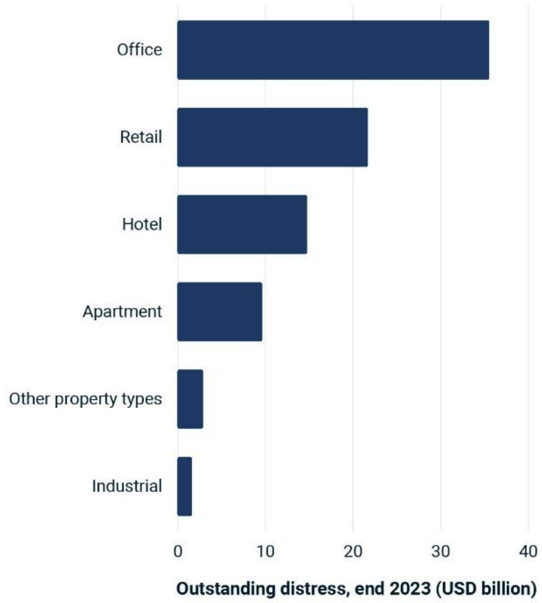

Exhibit B

Given appraisal-based (backward looking) valuation methodologies of real estate assets by private owners (i.e., banks, private equity, pension funds), privately held real estate price declines have thus far been limited and have materially lagged when compared to the price declines seen in listed real estate securities. As noted in Exhibit C, public listed securities valuation appears to have bottomed, while private real estate prices are continuing their decline.

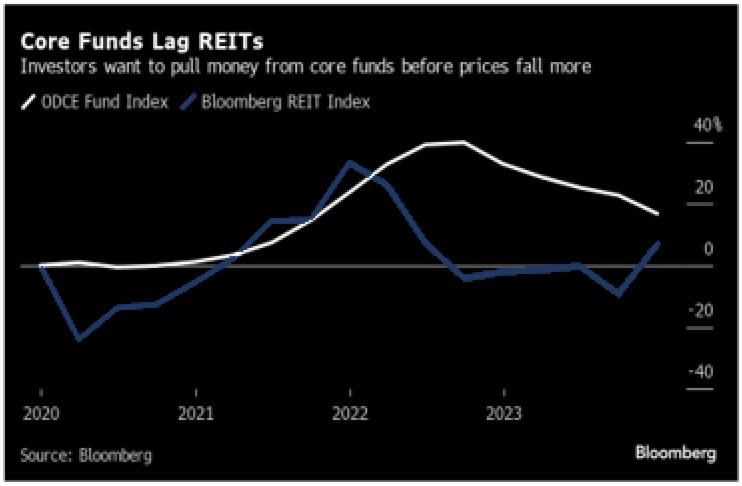

Exhibit C

Commercial Real Estate / CMBS Distress: Banks & Private Owners' Problem, REITs' Opportunity?

Lesson from Global Financial Crisis? REITs win, while commercial real estate distress peaks:

There will be hand wringing about the commercial real estate distress situation currently, to be sure. A day doesn't pass where we don't read about the woes facing commercial real estate in the Wall Street Journal or hear about it on CNBC. But history suggests that REITs have oftentimes appreciated during periods of rapidly rising private real estate distress.

As seen in Exhibit A, the CRE distress chart on the previous page, during the Global Financial Crisis, commercial real estate distress peaked in 2011 at nearly $200B. Contrary to what most observers might expect, from 2009 to 2011 U.S. REITs delivered a positive 81% total return! How is this divergent performance possible?

Listed real estate is forward looking:

Listed real estate securities are priced daily by market forces. In real time, investors discount the future into equity market price valuations. The public markets foresaw the coming distress in commercial real estate during 2008 and repriced listed real estate lower very quickly. During 2008, U.S. REITs declined 37%. This price correction positioned listed real estate to outperform private real estate from 2009 forward, when privately held real estate had yet to be re-priced.

REITS: real estate In trouble becomes real estate in transition:

Over the two years between 2009-2010, U.S. REITs raised over $81 billion of new equity capital as investors perceived attractive buying opportunities arising from distressed private owners of real estate assets. In fact, during this period there were nine REIT IPOs that came to the market. The answer to distress is, most often, recapitalization via new equity, and REITs have historically been the market's solution to access to this new equity.

At the start of 2011, the President and CEO of NAREIT, Steven Weschsler, put it best when he said, "In a commercial real estate marketplace in which many private owners have continued to find it difficult to raise capital to restructure highly leveraged balance sheets, REITs again demonstrated their cost-effective access to capital through the public markets."

We would expect to see a similar transition of assets from distressed private sellers to REITs as the current situation unfolds. We are clearly in the early stages of such transitions with a little over $5 billion of new equity raised by global listed REITs over the past seven months.

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REITs benefited more quickly from declining cost of capital:

The 81% increase in valuation from 2009-2011 provided U.S. REITs with an attractive cost of equity capital which was superior to their private equity counterparts, many of whom were dealing with legacy asset divestments. Further, the Federal Reserve rapidly decreased rates over this period, credit spread tightened as real estate fundamentals recovered, and REIT balance sheets improved. The current environment appears similar to 2009, with potential for the Federal Reserve to reduce rates in the future. Additionally, we are seeing early-stage primary equity issuance and improving real estate fundamentals for most asset types.

Commercial real estate distress is real for banks and private equity.

Outsized returns in real estate investments are often generated by investing at the bottom of a cycle and purchasing quality assets from motivated sellers. We saw this dynamic play out over 2009-2011, which led to a windfall for many of the higher-quality REITs. Although we don't have perfect clarity, we see many similarities currently to what transpired in the last real estate cycle.

About the Author

Todd A. Voigt, CFA© is a Portfolio Manager focusing on the selection and management of international holdings at Ranger Global Real Estate Advisors. Mr. Voigt has more than 28 years of experience in the global real estate securities industry. From 2014 through 2016, he served as the Portfolio Manager for a long-short real estate fund at WMD Asset Management. Previously, he spent six years at Cohen & Steers Capital Management, where he served as the Portfolio Manager for multiple global real estate securities hedge funds and UCITS, and eleven years at Cliffwood Partners, where his responsibilities included portfolio management and stock selection for global real estate securities hedge fund strategies and the short side of a 120/20 strategy.

Mr. Voigt graduated from Claremont McKenna College in 1995 with dual degrees in Mathematics and Economics. He earned the Chartered Financial Analyst designation in 2001.

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QuadReal, its operating companies, and partners share in their investment convictions, business values, and the commitment to take performance to the next level. QuadReal works with its partners to accelerate their growth and together cultivate value by unlocking innovation and sharing joint expertise. In addition to capital, QuadReal provides its partners with the in-house expertise of the broad-based QuadReal Resources Group.

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Defined Terms and Disclosures

Defined Terms

Bloomberg REIT Index: An Index comprised of publicly-traded real estate securities in the United States which have met certain financial criteria for inclusion in the Index. Each company must derive the bulk of its earnings through the ownership, management, or development of income-producing commercial real estate.

ODCE Fund Index:. The NFI-ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity, is an index of investment returns reporting on both a historical and current basis the results of open-end real estate commingled funds aimed at enhancing the transparency of the non-listed real estate investment industry pursuing a core investment strategy.

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