Zanetti Monday Missive 2023.07.31

Cat 5 Hurricane Warning For Commercial Real Estate

"We're in a Category 5 hurricane."
~ Real Estate Billionaire Barry Sternlicht of Starwood Capital

Hello Everyone,

We all know hurricanes wreak havoc on real estate. However, bad real estate loans have done far more damage than any hurricane ever has.

And that is our topic today. Bad loans.

CRE is not an acronym most Americans use very much. Unless, however, they are real estate professionals. CRE stands for Commercial Real Estate. Think office buildings, malls, dentist offices, etc. Not houses or apartment buildings.

Real Estate is not our beat here at Zanetti Financial. But we admire those specialists who navigate the extremely complex and ever-changing world of buying and selling properties. It is not an easy way to earn a living.

When, however, real estate crosses over into Wall-Street-Land, our ears perk up. And that is what is happening now.

Look at the below recent headlines that reinforce Mr. Sternlicht's Cat 5 quote.

- **Why Small Banks Are In Big Trouble: As Hedge Funds Pile Into The New "Big Short", The Next 'Credit Event' Emerges**
- **Regional Banks Scramble To Unload Commercial Real Estate Loans, Fearing New Crisis**
- **US CRE Prices Slide For First Time Since 2011 As 'More Downside Coming'**
- **"Nowhere To Hide In CMBS": CRE Nuke Goes Off With Small Banks Accounting For 70% Of Commercial Real Estate Loans**

We touched on this issue a few months ago. We warned. A confluence of events was on the near horizon. It was difficult to see a way out. And now the storm is here.

But first, a quick recap of the Commercial Real Estate landscape:

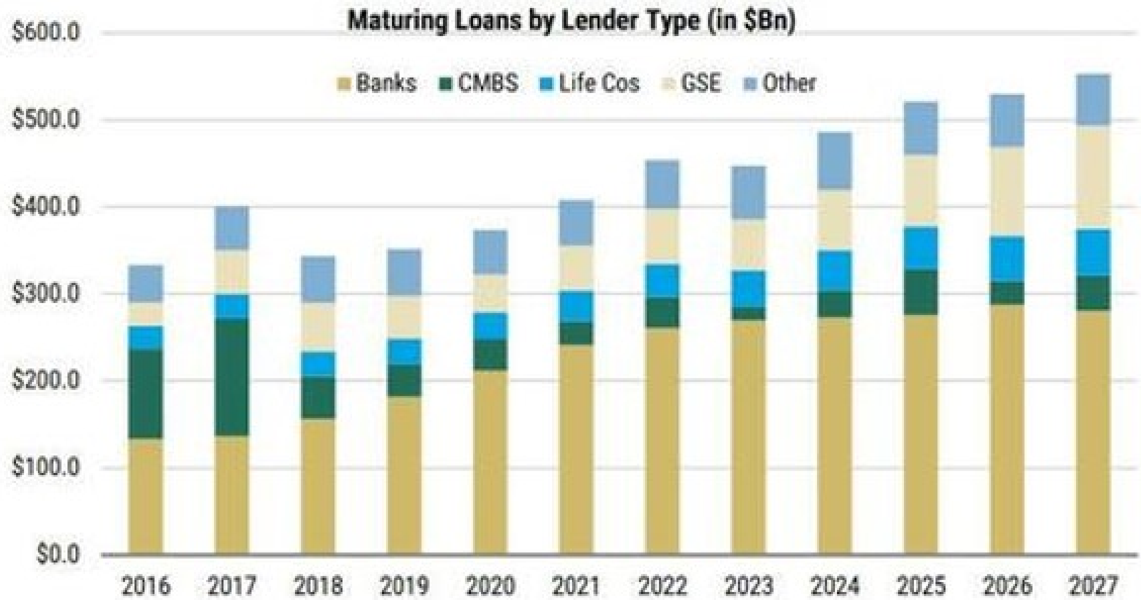
- The fuse was lit when Amazon (and other online retailers) crippled traditional "brick and mortar" stores and malls.

- Next, Covid sent millions of people home to work. Some returned to the office…but millions did not.
- Simultaneously, big cities decayed—rapidly. And city-leaders demonstrated little ability to deal with homelessness, drug use, violence, and theft.
- Thus, businesses departed---leaving millions of square feet of empty office space. (BTW, city leaders cannot tax empty office space.)
- Then, the Fed raised interest rates at the fastest pace on record. (Right. These buildings were not paid for with cash. Buyers got huge loans at super low rates.)
- Now the loans are coming due…at higher interest rates.
- Many current owners cannot afford the higher payments.

- Plus, banks are increasingly reluctant to lend money on empty CRE.
- Finally, with Artificial Intelligence looming, how much office space does AI need?

Look at the below chart. $2.5 trillion(!) of CRE debt must be rolled over in the next five years. According to Morgan Stanley, this massive debt maturity wall of CRE loans is **<u>the elephant in the room.</u>**

Exhibit 8: CRE Debt Maturities: $2.5tn in next 5 years



Source: Trepp, Morgan Stanley Research

So, what happens when properties cannot be refinanced? When loans cannot be rolled? Well, either the landlords walk away, or the owners sell at massive losses.

For example…

(The above Baltimore office building was purchased in 2015 for $66 million. It sold two weeks ago for $24 million. A 63.6% loss.)

Of course, banks do not want to own empty office buildings any more than the owners want to walk away.

So, who loses? The short answer is everyone. At least in the short run.

So, how does this impact Wall Street?

<u>It is the small and mid-sized banks that are the highest risk.</u>

Big banks like JP Morgan, Goldman, and B of A, did not make the majority of these CRE loans. The local and regional banks did. They financed these loans years ago--- at historically low rates. Now, the loans are coming due.

Will they be repaid?

No one yet knows the extent of the damage. But fear is in the air. The banks are on the hook. And not a good time.

Does this sound familiar?

This is what happened to the Savings and Loan (S&L) industry 35 years ago. The S&L collapse may not exactly parallel today's situation, but the results may be the same.

To cushion the S&L debacle, the US Government stepped in. The Resolution Trust Company (the RTC) was formed to oversee the disposal of the failed S&L assets. Foreclosed properties were sold for pennies on the dollar.

And, today there are no more Savings and Loans. Poof. All gone.

And this is what insiders are calling for today. A second RTC. Will small and mid-sized banks be the casualties?

And here is one of the ironies. It was Starwood's Barry "CAT 5" Sternlicht who started his career 30+ years ago by buying fire-sale RTC properties. He then flipped them 18 months later at triple the price to real estate giants like Sam Zell.

Now, Sternlicht believes his career is being bookended. He said, "You could see 400-500 banks that could fail. They will have to sell. It will be a great opportunity."

He may be right. Again, that is not our beat. Talk to those smart real estate experts.

Our concern is the <u>immediate</u> possibility of yet another banking meltdown. Investors do not like shaky banks. Risk premiums soar. The risk-off trade (meaning, "Get me into something safe!") becomes popular. In short, neither stocks nor bonds perform well when banks are crumbling.

That is when governments and politicians get scared…errr proactive.

They then compound an already bad situation. "We must do something!" is the cry. While behind the scenes, cozy bailout deals are cut for "friends and neighbors." The big donors win out. It is all very predictable.

And the money and capital flow up. Small and mid-sized banks get “absorbed” at cut-rate prices. This is what we just saw earlier this year with Silicon Valley Bank and New Republic. JP Morgan got them both…and under extremely favorable terms.

So, what does this mean to you?

Well, the last two times we had a banking/real estate crisis----S&L 1989-1990 and Lehman Brothers 2008-2009---commodities shot higher. By a lot.

I believe we will see history rhyme again.

Signed, Your If-87,000-New-IRS-Agents-Are-Looking-For-Missing-US-Tax-Dollars-They-Might-Want-To-Start-In-Ukraine Financial Advisor,

Greg

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