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We predicted the storm in commercial real estate: How bad was it? How did we do? And what's next?

BENEFIT STREET PARTNERS

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Michael Comparato
Head of Commercial Real Estate
Senior Managing Director
Benefit Street Partners

Two years ago, we wrote about a hurricane in the commercial real estate (CRE) space that was about to make landfall. "No one knows precisely where the storm"—a combination of higher interest rates, a pullback by banks and other lenders and a massive maturity wall of loans coming due—"will hit, or whether it will be a Category 3, 4 or 5. But it's coming, and there's no avoiding it." The storm, we predicted, would cause extensive damage. It would also create massive opportunities for CRE debt investors to "write some of the best risk-adjusted return loans that we've seen in decades," producing "equity-like returns."

Our forecast was on the nose. We were right about all of those things, and many more of the statements and predictions we made in 2023. In our view, we're now in the eye of the hurricane. The storm hit, and some areas of the market—especially anything tied to the office sector, as well as a big swath of CRE equity (even multifamily)—got walloped. Things feel calm at the moment, in the eye, with light winds, little to no rain and clear skies. But that's deceptive. The eye is surrounded by the most powerful parts of the hurricane, and we believe there's more damage to come. We also believe that there will be more opportunity in the space.

In 2023, we wrote about how lenders often "extend and pretend," a Great Financial Crisis (GFC)-era phrase for lenders lengthening loan terms and ignoring short-term declines in property values. Most lenders have been extending and pretending once again, rather than addressing key issues. We're in the eye because lenders have advanced the perception that there aren't big problems—with valuations, higher-for-longer interest rates and the maturity wall—when in fact, there are. But everyone will have to deal with reality eventually. When they do, we believe we'll be back in the storm, with all the losses and issues raining down on lenders, borrowers and parts of the CRE market.

In this paper, we'll take a look back at what we said in 2023, how things worked out, what we got right and what we got wrong—though we argue that those takes are more about timing than accuracy. We'll also discuss where things stand, the robust opportunity set that remains, and what to expect after the storm moves on for real.

Key takeaways

- Our 2023 white paper described an approaching hurricane that, true to our predictions, wreaked havoc on CRE and presented what we believe to be a golden opportunity to CRE debt investors. The storm's not over, in our minds. But the opportunity set in CRE debt remains.
- As we said in our original piece, property values declined, especially in the office sector. Banks continued to pull back on CRE loans, and others stepped in to the fill the void. And, a wide swath of CRE debt investors posted robust returns.
- We continue to believe that CRE debt is a more compelling option when compared to CRE equity, barring a rapid decline in interest rates, which we do not expect to see. In fact, after multiple years of CRE investors hoping for lower rates, it may be time to realize that the macro conditions that could cause rates to fall quickly would likely be devastating.
- We weren't perfect. "Extend and pretend" has gone on longer than we imagined, and banks have held up better than we thought. But were our predictions wrong, or just early? We think the back half of the storm will likely prove us right.
- As in many other areas of the economy, uncertainty reigns across the CRE universe as we look ahead. Nonetheless, we stand by most everything we said in 2023. We'll look at what's next in the space and offer some hints on how opportunistic investors can position themselves for the longer haul.

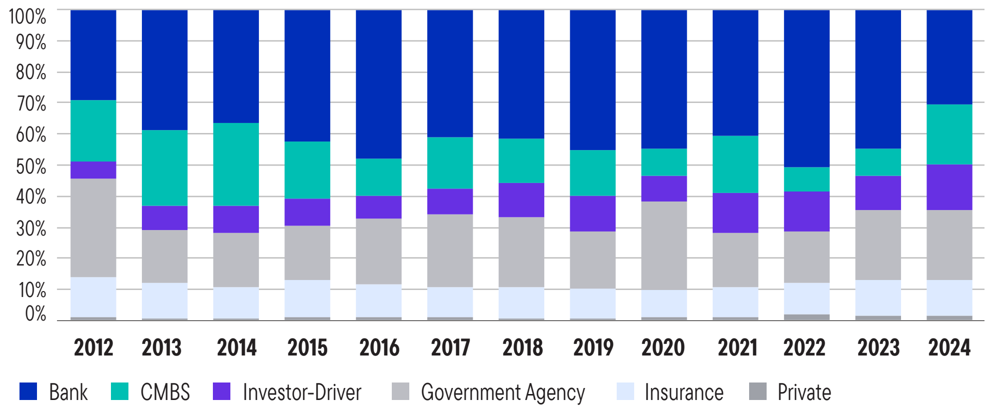
Nine things we got right

The italicized statements below come directly from our 2023 paper, followed by an explanation of what actually happened. Let's see how accurate we were...

1. There will be damage. CRE values declined precipitously across many asset classes. Values in multifamily, which we still view as a sweet spot in the space, fell 20% to 35%, depending on the market, asset quality and vintage. Primary markets and nicer, newer assets have held up better. Industrial/logistics assets declined roughly the same amount. Retail and hospitality values haven't dropped as much, but that's largely because they didn't rise as sharply as some asset classes (especially multifamily and industrial) during the US Federal Reserve's (Fed's) long-running period of ultra-low, zero-interest-rate policy, or ZIRP. As we predicted, office is an unmitigated disaster, with prices down 50% to 80%. However, the damage has not been as extensive as we expected, at least yet, due to lender behavior. (We'll cover this later, as we look at things we got wrong).

2. Some lenders will have to sit on the sidelines. That's especially true for those with excessive existing office exposure. Far more lenders exited the market than we ever anticipated. Regional and community banks disappeared for years. Publicly traded mortgage real estate investment trusts (mREITs), especially those with high office exposure, stopped lending as well. Life insurance companies (LifeCos) tightened credit standards dramatically but stayed open for exceptionally strong loans. All of that was expected. However, we figured private credit (debt funds, etc.) would stick around. After all, they are traditionally built to take risk in times of dislocation. For the most part, they did not. Only a handful played through, and they have been rewarded with some of the best credit returns realized since the GFC.

Loan Originations Continue to Move Away from Banks



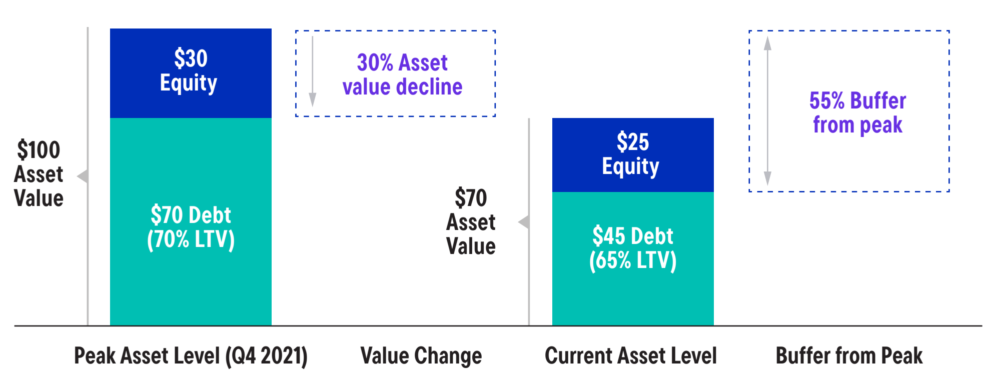
Source: MSCI Real Capital Analytics, 2024.

In 2024, total CRE mortgage borrowing and lending was $498 billion, up 16% from 2023, but still well below 2022's record of $816 billion, according to the Mortgage Bankers Association. What's interesting is that every lender group except banks saw their volumes rise in 2024. Bank origination volumes, which peaked at 50% in 2022, accounted for their smallest piece of the CRE debt pie since 2012.

3. There will also be opportunities, especially for nonbank lenders with capital available to deploy. … In the next 24 months, we believe [lenders] may write some of the best risk-adjusted return loans that we've seen in decades. We predicted well-positioned lenders would be able to lend through the correction, with the potential for equity-like returns. In our view, that's exactly what happened, right down to the gains. Through most of 2023 and 2024, annual returns were in the mid-to-high teens for multifamily and industrial loans with 65% to 70% loan-to-value (LTV) ratios, representing the loan amount compared to the value of the property. LTVs were still lower for hospitality, even after major price corrections. Our macro thesis was simple: For today's 65% to 70% LTV loans (signed in the wake of an approximately 30% correction in the multifamily housing market) to experience a loss, values would have to fall 55% to 60% from recent highs.

That's never happened. During the GFC, the peak-to-trough correction was approximately 35%.

Multifamily Value Decline



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4. But what if interest rates do not go back down? What if, for the first time in four decades, interest rates revert to the mean and stay there? Again, that seems to be deadly accurate. When Phil Connors, Bill Murray's cynical TV weatherman character in the 1993 movie "Groundhog Day," gets stuck in an endless repeat cycle of Feb. 2, he asks in a depressed tone, "What would you do if you were stuck in one place and every day was exactly the same, and nothing that you did mattered?" That's exactly how those who borrowed—or even lent, in many cases—floating rate debt in late 2021 and early 2022 have been feeling for the past two years. They've been hoping that interest rates would fall, which would make it easier to carry their debt service and help restore property values. But rates stayed much higher than they were during the ZIRP days. It's been Groundhog Day for two-plus years in CRE.

That said, the soft labor reports and major downward revisions to earlier employment data in the back half of 2025 drove the market to price in a fairly meaningful downward move in short-term rates for late 2025 and 2026. The Fed reduced its key rate in September, for the first time in 2025. The cut followed a sharp rally in 10-year Treasury bonds, as yields flashed below 4% in September (as they did, briefly, in April 2025). In our view, rates appear likely to be heading lower, and while rate cuts will certainly help on the margin, we believe the magnitude of the move will likely not provide a panacea for the industry.

5. If the investment horizon is less than five years, we find CRE debt to be more compelling than equity. The last two-plus years proved us to be right. We strongly believe we will continue to be right for the next two-plus years. Here's why:

Market Yield on US Treasury Securities, 2021-2025

US Treasury bond yields have surged higher since the Fed started raising interest rates, which is supportive of CRE debt.

■ Market Yield on US Treasury Securities at 10-Year Constant Maturity. (Quoted on an investment basis).

Source: Board of Governors of the Federal Reserve System (US) via FRED ©

- Unless the yield on 10-year US Treasury bonds absolutely plummets, it is nearly mathematically impossible for CRE equity to outperform CRE debt for the next few years. If the 10-year UST yield does fall off a cliff, it will likely be in conjunction with a significant negative macro event. So, for all you CRE folks praying for meaningfully lower rates, be careful what you wish for.
- Let's focus on multifamily, our preferred asset class on the debt side. There is no shortage of tailwinds, from multidecade lows in new construction starts to a housing shortage and plentiful capital. There are also headwinds, with higher interest rates, banks (which historically provide cheaper CRE debt) on the sidelines, and rent growth far outpacing personal income growth. The obvious question each potential CRE equity investor needs to make for themselves is, "Will the tailwinds be stronger than the headwinds?" In the short term, we do not believe they will.
- Shortly after our paper was released, another issue became a recurring theme on our earnings calls: negative leverage. In simple terms, that's when the cost of a loan is greater than the property's unleveraged return. Negative leverage has been persistent and unavoidable the last two years, and it's been a significant issue for equity investors. In our view, the market cannot truly get back to healthy conditions until positive leverage is back in the system. It may take 12 months or 10 years, but we will eventually return to a positive leverage environment. If not, we'll need to rewrite every business and finance textbook, because they don't allow for a safer investment (debt) to make higher returns than a riskier one (equity). At some point, we believe that capitalization (cap) rates will have to go up, and/or interest rates will need to come down. It will probably be a mix of both. One option is to just sit and wait, to let the compounding effect of inflation do its thing. But borrowers might not be able to stay solvent long enough to let that play out.
- The bottom line is very simple, in our minds: Unless and until positive leverage returns to CRE markets, CRE debt is going to be a better investment than CRE equity on a risk-adjusted return basis.

6. We continue to view newer-vintage multifamily located in primary and secondary markets as having the best credit quality and risk-adjusted returns within CRE credit. In our current view, the historical recession resistance of Class A and B multifamily offers relative insulation from some of the key issues in CRE, as well as long-term secular growth drivers. We correctly identified the most attractive new lending opportunities. Now those Class A and B properties in strong markets seem poised for recovery, in our view, especially as the oversupply problem dissipates, with new construction starts at decade-plus lows. We do not expect a "V-shaped" recovery, but a slow and steady increase in net operating income, based on natural rent growth and inflation.

7. While we believe the basic operational fundamentals of multifamily are superior to other CRE asset classes, one of the most compelling reasons to invest in multifamily is liquidity. In an otherwise illiquid asset class, multifamily meaningfully stands out because it can almost always be sold within 90 days or less, even if pricing is variable. This remains true, and probably even more so than it was in 2023. We continue to believe the combination of government-supported credit liquidity (via Fannie Mae, Freddie Mac and the Department of Housing and Urban Development) and multifamily's superior asset quality places the asset class far above other sectors. The human need for shelter cannot be "technology-ed" away. For decades, the United States has had a multimillion-unit housing shortage. The recent supply might have put a dent in that, but the overall housing shortage remains, and we see no way that will be fixed in the foreseeable future. In addition, affordability of single family homes remains at all-time lows, with home prices at or near all-time highs and mortgage rates at the highest rates they have been in decades. The unaffordability of homeownership has created millions of forced renters.

8. There are some broken properties, and possibly even a broken sector in the office market. Otherwise, it's more a case of broken balance sheets… Broken balance sheets will no doubt bring some pain to borrowers and some investors; however, they also will likely drive the opportunity set. All true. Office may well be a broken asset class. The issues there have largely not been addressed at all, as we see it. The apocalypse didn't happen, but it's still very much a possibility. That's one reason we're saying CRE is in the eye of the storm. We believe that office market sentiment is off the bottom and debt is more readily available, but bidding on office assets is still extremely limited and nowhere near the cap rates—or potential rate of return—being assumed by appraisers. Outside of office, it has been broken balance sheets more than broken assets, and sophisticated investors have been taking advantage.

9. It is very easy to take the position: "Values are down 20% to 30%, so this is a great time to buy." But, were these assets overvalued, and falling to a fair level? Or, were they fairly valued and therefore now undervalued? We believe it is the former, certainly in the shorter term. We do not see any near-term catalyst for a V-shaped recovery in CRE asset values. There has been little to no recovery in values, and certainly not one that connotes a "V." Multifamily values have largely been stagnant for the past two years and rates have gone nowhere. Most landlords are dealing with flat to marginally lower cashflows as a result of increasing concessions in connection with the supply wave. That supply wave is shrinking quarterly, and we are starting to see green shoots: The burning off of concessions has begun, and we've even seen rent growth in certain markets.

Two things we got wrong, at least for now

1. Lenders have delayed the real pain. In our 2023 piece, we predicted "extensive" damage, and while we were careful to avoid a specific timetable, we implied that the crisis would arrive quickly: "Time," we wrote, "is running out." We still believe that. Where we missed, arguably, is in the timing. We expected some extend and pretend, but there's been more than we thought. Equity holders have been hurt, but we expected to see more pain for regional and community banks, mREITs and other lenders by 2025. Kicking the can down the road and deferring unrealized losses has gone on longer than we anticipated. One might argue that the market has tolerated that. That said, mREITs have been among the weakest performers—in terms of both dividends and valuations—in a struggling REIT space. When management hasn't addressed the issues on their balance sheets, the market has said, "We know how bad it is. And we're going to pummel your stock." Some debt funds have closed their doors, unlikely to ever be heard from again. We assume dozens of others are in the same place, but it will take a few more years for that to flush through the system. Any active originator of mezzanine loans during the peak of market valuations has undoubtedly turned into an asset manager and no longer an originator.

2. The crisis for regional [and community] banks—a significant provider of CRE financing—has only accelerated already ongoing efforts to improve their balance sheets and tighten credit standards. Once again, we continue to believe that we weren't so much wrong as early. Regional and community banks continue to allow extensions and modifications that provide borrowers with more time. We have not seen the forced resolutions, nor the flood of assets from banks, that we thought we would. But those loans will have to be dealt with at some point. In October 2024, the New York Fed published a white paper about extend and pretend. The authors opened with, "We show that banks 'extended-and-pretended' their impaired CRE mortgages in the post-pandemic period to avoid writing off their capital, leading to credit misallocation and a buildup of financial fragility." That's euphemistic Fed-speak for "This is getting dangerous to the broader financial system." Do we think CRE debt could lead to a systemic issue in the banking sector? No, simply because the banks with the most CRE issues are regional and community banks.

The banks have essentially had no choice but to extend and pretend, especially if they're holding office loans that have seen exceptionally large devaluations. We believe that banks and other lenders will eventually be forced to divest assets and recognize losses. At some point, these have to get marked-to-market, and the losses must be realized. Regulators *will* step in and say to the banks, "Enough is enough. You need to deal with this." In terms of debt funds and private credit, investors will reach a point where they've had enough. At some point, they're going to say, "Mr. Private Lender, you originated a loan in 2021, and it's been four or five years. You keep telling us it's OK, but the loan hasn't been paid off. At some point, the loan has to be paid off, or you need to sell it, or foreclose."

Where do we go from here?

More damage still to come. Values across CRE are already meaningfully lower, but much of the pain so far has fallen on the equity portion of the capital stack. Lenders, by contrast, have not yet felt the full impact, largely because they have been shielded from facing reality. CRE mortgages are not mark-to-market assets. It can be easy to avoid those marks, but they have to be realized at some point.

Opportunity continues to knock. The opportunity is still there. It's not as robust as it was two years ago, because more and more people saw it and moved to take advantage. In the back half of 2025, CRE debt spreads were as tight as they've been in a very long time. That's good news for borrowers, but if lenders don't have anything in the creative toolbox, it will likely be very difficult to generate the credit returns of the last few years. Credit returns are still excellent, especially on a risk-adjusted basis, but they're no longer euphoric. It's still a very solid market, where one can write good loans and make solid returns. It's just not quite as good as it was for the past two years.

Maturity wall update. The maturity wall grows and grows and grows, but does it matter? Two years ago, we cited some $2.5 trillion in loans coming due from 2024-2027. We said, "Yes, the maturity wall is huge, and it appears unavoidable." We've since come to refer to the wall as a series of waves, but they remain both massive and unavoidable. It is difficult to pinpoint the size of the waves or when they will hit shore. As we've seen, in difficult markets, lenders view maturity dates as suggestions. Generally speaking, lenders will do anything to avoid marking down defaulted loans and/or taking ownership of properties. The maturity wall will continue to be a marketing talking point for lenders looking to raise capital. But, when all is said and done, we don't know how impactful maturities are, because they generally are not being enforced.

Long-term interest rates aren't likely to fall much. "Survive till '25" was a mantra for a lot of people in CRE debt. They were banking on lower interest rates to help fix their legacy portfolios. Well, it's 2025, and not much has changed. We believe rates are not going to revert to recent, historic lows anytime soon, barring a major crisis. Meaningfully lower rates would likely also come with a recession, trouble in the banking sector, or even more problematic geopolitical events. The United States is adding approximately $1 trillion to the national debt every quarter, and deficit spending is out of control.

That hits differently when one writes out all the zeroes: It's $1,000,000,000,000 every 90 days. In our view, that means the supply of treasuries is likely to keep growing, and that points to higher-for-longer rates. While we anticipate short-term rate cuts from the Fed, and the likely appointment of a more dovish Fed chair in 2026, we believe the yield curve will likely steepen, but we will likely not see a meaningful reduction in long-term rates. That said, and this is very difficult to handicap, there could be a mandate by the Fed to buy the long end of the curve in an effort to get the 10-year UST meaningfully under 4%. If the biggest balance sheet in the world starts buying bonds again in an attempt to set yields, all bets would be off.

Extend and pretend likely comes to an end. We've been watching almost every lender—LifeCos, banks, mREITs and debt funds—play the game. Interest rate cuts, in our mind, are highly unlikely to help defend or fix a legacy CRE portfolio. We believe that soon enough, lenders will be forced to accept reality. It's time, in our minds, for everyone to flush out their losses, hit bottom across the space, and return to a healthier, better-functioning market.

Capital is plentiful. Untold billions have been raised on the CRE equity side, ready to pounce. Credit markets are experiencing incredible liquidity, and it's not limited to multifamily. Virtually every securitized product or structured financial instrument in the CRE universe—from collateralized loan obligations to commercial mortgage-backed securities (CMBS) and single asset, single borrower CMBS—has been flying off the shelves, with oversubscriptions for every tranche.

Multifamily oversupply is fading fast. Higher interest rates and record-setting new deliveries threw the supply/demand balance off, resulting in a wave of concessions, including a month or two of free rent. In markets such as Nashville and Austin, some properties were offering three months of free rent. We believe most markets are likely at the tail end of that supply wave, with concessions now starting to burn off and even some signs of positive rent growth. New construction has come to a screeching halt, with banks on the sidelines and existing properties selling for much less than replacement cost. It is hard to justify putting a shovel in the ground at the moment. Meanwhile, affordability is a concern, exacerbated by inflation, as rents have outgrown personal incomes. That could be a continued headwind for older and/or lower-quality properties, especially in a potential recession. In our view, patient landlords will likely soon be rewarded with rent growth for newer-vintage, higher-quality assets, though it will take longer for many properties.

Cap rate tiering is back. In 2021, we expressed "concerns about complacency in multifamily markets. Specifically, we saw a lack of cap rate tiering." We worried that, as prices rose in recent years, that lack "was not a healthy market dynamic." Now, cap rate tiering is back, based on market strength and vintage. That may be painful for some, especially those who bought in in 2021 and 2022, but we see it as the correct—and healthy—way to price multifamily risk.

Conclusion

Two years ago, all of our forecasting models were aligned, making our hurricane prediction a fairly easy call. Today, there's more uncertainty. These days, it's a bit more like wondering where the storm will track, where it will hit, and how much damage it will do. We don't know whether the back half of the storm will be mild or disastrous, but it's coming, with another wave of stress. In our minds, there's no avoiding it.

And that's perfectly fine. Corrections are a reality, and they are healthy. They can be painful, but also therapeutic. Markets do not function well without losses, and capitalism does not work without consequences, and whatever pain we do feel will be matched by a robust opportunity set.

As for the eye of the storm, enjoy it while it lasts. The first part of the hurricane damaged the equity portion of the capital stack, completely wiping it out in some cases. The back half of the storm will hit credit. Banks, LifeCos, debt funds and mortgage REITs will eventually mark their books to market, and there will be losses.

We view the order of magnitude as fairly easy to call: It will be worst in the office sector, which will combine with 1980s-and-older vintage, class B and C multifamily assets in secondary and tertiary markets to make up the majority of the pain. The balance of the multifamily market could well be next, followed by industrial/logistics, then retail and hospitality.

Still, the environment will continue to offer some of the best risk-adjusted returns CRE debt investors have seen in decades. The winners, in our view, will be disciplined and nimble. They will be selective, with a defensive mindset, but they will be ready to jump in when the time and the opportunity is right. Portfolio positioning will be a key. Meanwhile, choosing the right partner may be the most important decision any investor makes—regardless of where things stand in the market cycle.

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