S&P Global Ratings

Real Estate

Higher-for-longer interest rates are a headwind

This report does not constitute a rating action

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What's changed?

Sharp increase in interest rates will slow external growth. The impact from the rate increases will be felt across the sector and pressure asset valuations. The sector is adjusting to the "higher for longer" environment by slowing external growth plans, while debt issuance remains low due to wide bond spreads.

Heightened refinancing risk. Banks' tighter lending standards, coupled with earnings pressure for some companies, have led to increasing refinancing risk, particularly for many office REITs and lower-rated credits.

Growing negative rating bias. Weaker fundamentals in the office sector have driven the growing negative rating bias. With about 14% of ratings on negative outlook vs. 7% on positive, we expect more downgrades than upgrades over the next year. Office REITs face significantly higher downgrade risk than other subsectors given that about 50% of the office REITs have negative outlooks. Four office REITs have become fallen angels within the last year and there could be more over the next 12-24 months.

What to look out for?

Higher funding costs pressure cash flow metrics. We expect debt service coverage metrics to deteriorate as REITs refinance their low-coupon debt at materially higher rates. We expect a deterioration in fixed-charge coverage ratios while total debt to EBITDA may take longer to recover given earnings pressure.

Shifts in refinancing strategy. Rated U.S. REITs face about $14 billion of debt maturing in 2023 and $23 billion coming due in 2024—and the maturity walls expand in the subsequent years. With largely unencumbered balance sheets, refinancing options likely include secured funding, given the volatility and higher expected coupons in the unsecured bond market. Added exposure to secured debt could put holders of unsecured debt at a disadvantage and could result in notching down of unsecured debt.

Recovery of leasing activity could be slow for offices. Given secular and cyclical headwinds, we expect leasing activity to remain weak. High exposure to lumpy near-term lease expirations could add pressure to occupancy and rent. We expect higher concessions, including tenant improvements and additional free months of rent, to weaken cash flows.

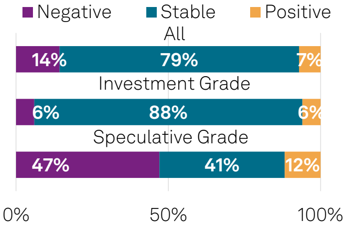
What are the key risks around the baseline?

Weaker economic and job growth. While the U.S. economy remains resilient and our baseline forecast no longer assumes a recession, we now expect a period of slow growth and higher-for-longer interest rates. This scenario could hurt rate-sensitive sectors such as real estate, prolonging the downturn.

Asset valuations could erode further as real rates rise. Transaction volume remains muted and we're currently in a period of price discovery. As pricing expectations are reset, we expect the entire office real estate stock will face declines from rising rates and risk premia, as property-level cash flow comes under pressure. Lower-quality office real estate is facing materially greater pressure than the REITs we rate.

Rating Trends

Outlook Distribution

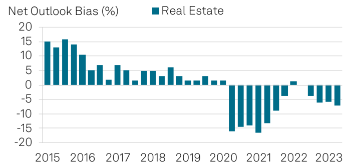


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	67	17	84
Downgrades	1	6	7
Upgrades	2	0	2

Ratings data as of end-Jun 2023. * Year-to-date. Current ratings only.

Ratings Outlook Net Bias



Related Research

[Real Estate Monitor: Tightening Access to Capital Heightens Refinancing Risk](), June 5, 2023

[Stressful Conditions For U.S. Commercial Real Estate Are Raising Refinancing Risk](), June 5, 2023

[Real Estate Monitor: Rising Rates Driving Rental Housing Resiliency](), March 30, 2023