

Uneven Global Office Recovery Is Squeezing Credit Quality

Global real estate chartbook

Ana Lai, CFA

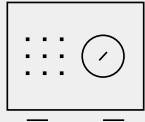
Oct. 3, 2023



Credit & Rating Trends | Ongoing Risks In 2023



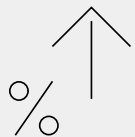
Higher-for-longer interest rates are exerting pressure on asset valuations, by pushing cap rates up, and weighing on debt service coverage ratios.



Access to funding has narrowed, especially as bank lending is tightening, which could affect refinancing plans and liquidity.

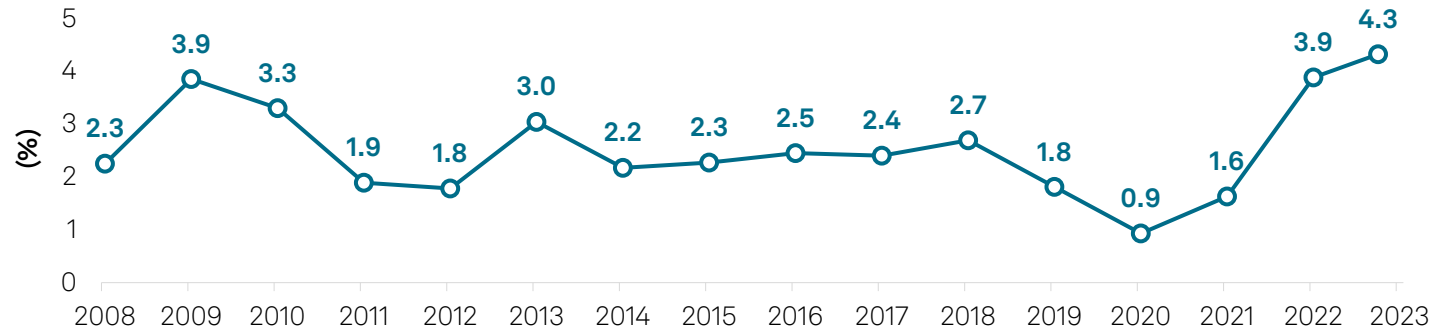


Office properties face pressure from hybrid work and slowing economic growth. A flight to quality will widen bifurcation of class A versus class B assets.



Inflation supports rent growth but, coupled with a weakening economy, can harm tenants' capacity to accept higher rents.

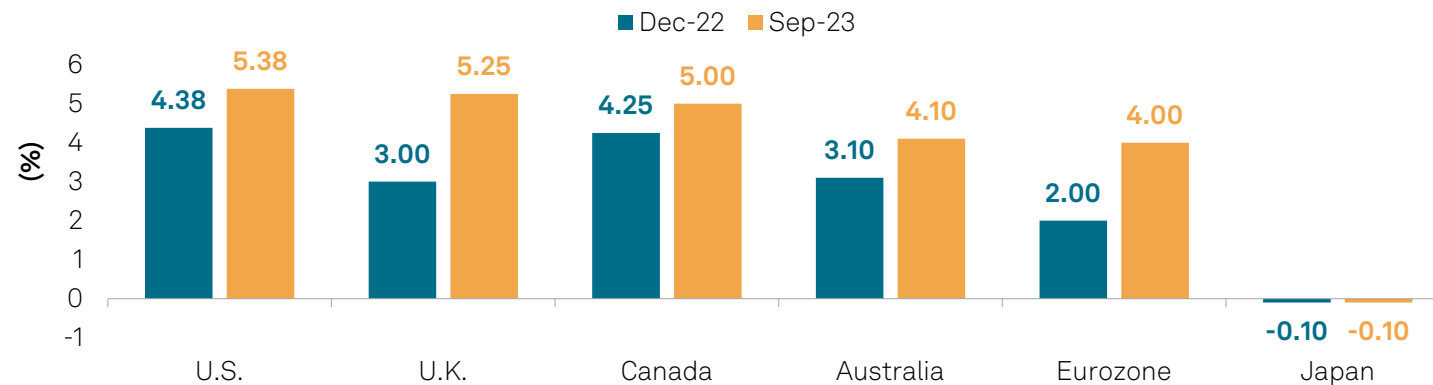
10-year U. S. Treasury note – historical data



As of each year end; 2023 data as of Aug. 22, 2023.

Sources: U.S. Department Of The Treasury. Daily Treasury Yield Curve Rates for 10 Year Treasury.

Major central bank policy rates

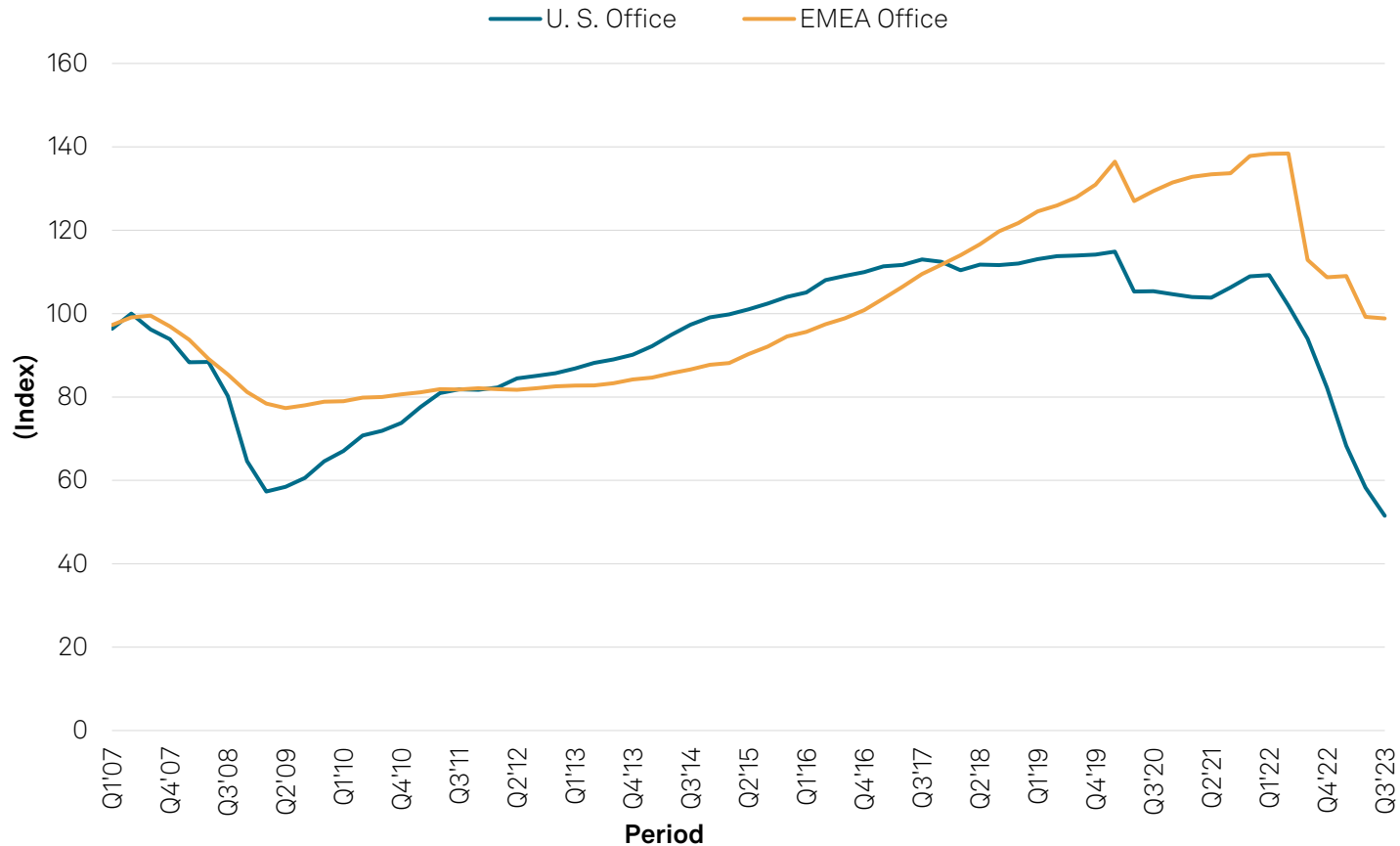


As of end September. Sources Central bank websites.

- Higher interest rates remain a significant headwind to CRE.
- We expect a higher-for-longer interest rate environment to exert pressure on commercial real estate (CRE), with values declining and tighter access to funding.
- Lenders' reduced appetite for CRE loans and volatile capital markets heightens refinancing risks in the next one to two years.
- We expect rates to peak in early 2024 and anticipate rate cuts to be slow.

Valuations | U.S. And EMEA Office CPPIs 2007-Present

GreenStreet Commercial Property Price Index (CPPI)

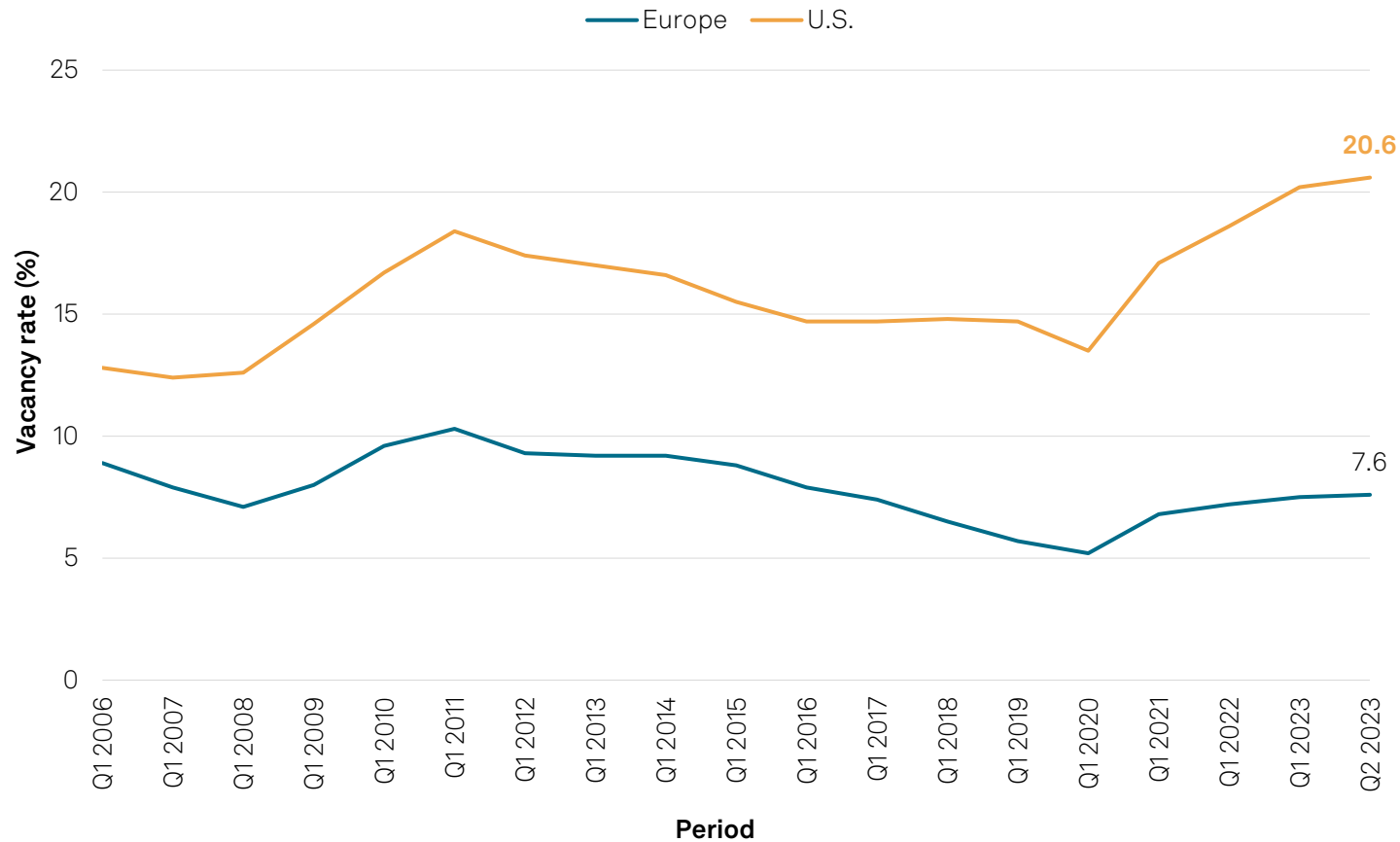


Source: Green Street Advisors, S&P Global Ratings.

- Higher rates are pressuring valuation across real estate globally.
- Changes in cap rates and net operating income are the primary drivers of shifting valuation.
- Office valuations have dropped in the U.S. and Europe steeply over the past 18 months or so.
- There is a sharper decline in the U.S. index given greater pressure on US office as the return to office has been slow. Office values are down 43% compared to overall pricing down 9% year over year.
- We expect occupancy pressure to persist in the U.S. along with slower rent growth as tenants resize their office footprints.

Office | Pressure Is Mounting, While Vacancy Is Still Low In Europe

European office vacancy remains lower than its historical peak (2011) and lower than in the U.S.

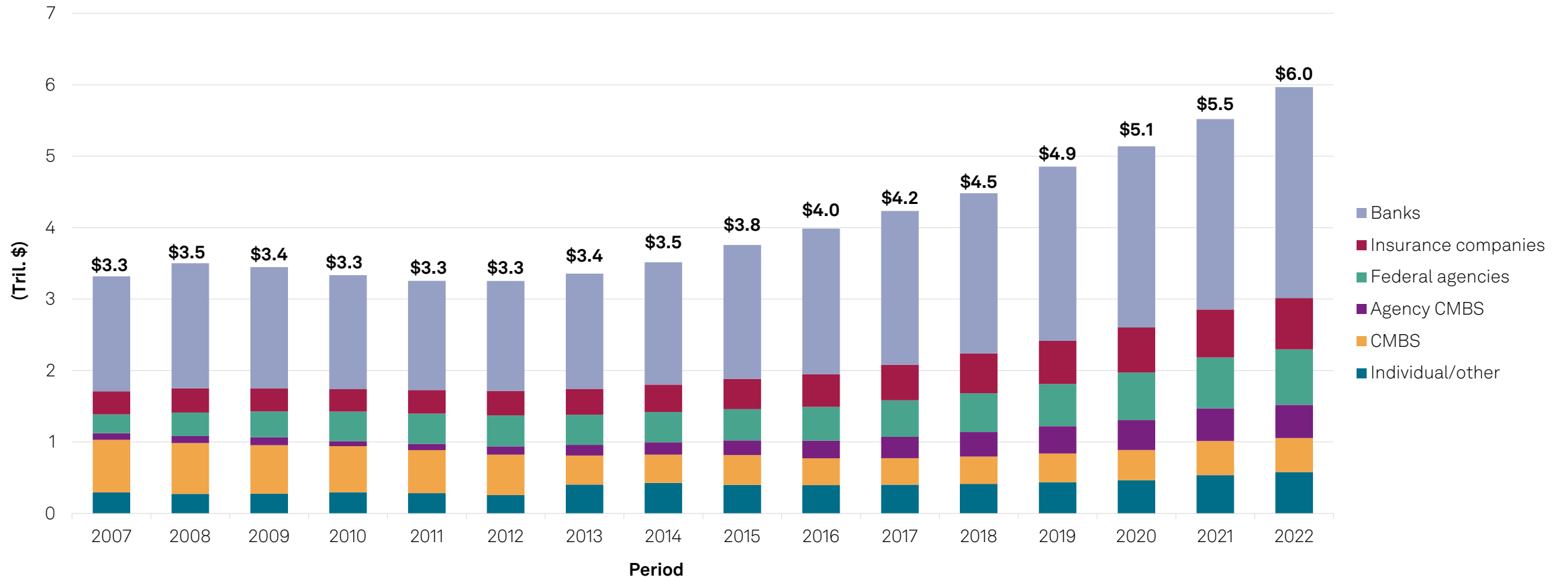


Source: S&P Global Ratings.

- Vacancies are increasing across markets.
- The U.S. has the highest vacancy rate at about 20%.
- Vacancy in European office markets averages less than 8%.
- Key Asia-Pacific markets trend below 10%.

CRE Lending Market Participants In U.S.

CRE debt outstanding market share



Source: Federal Reserve.

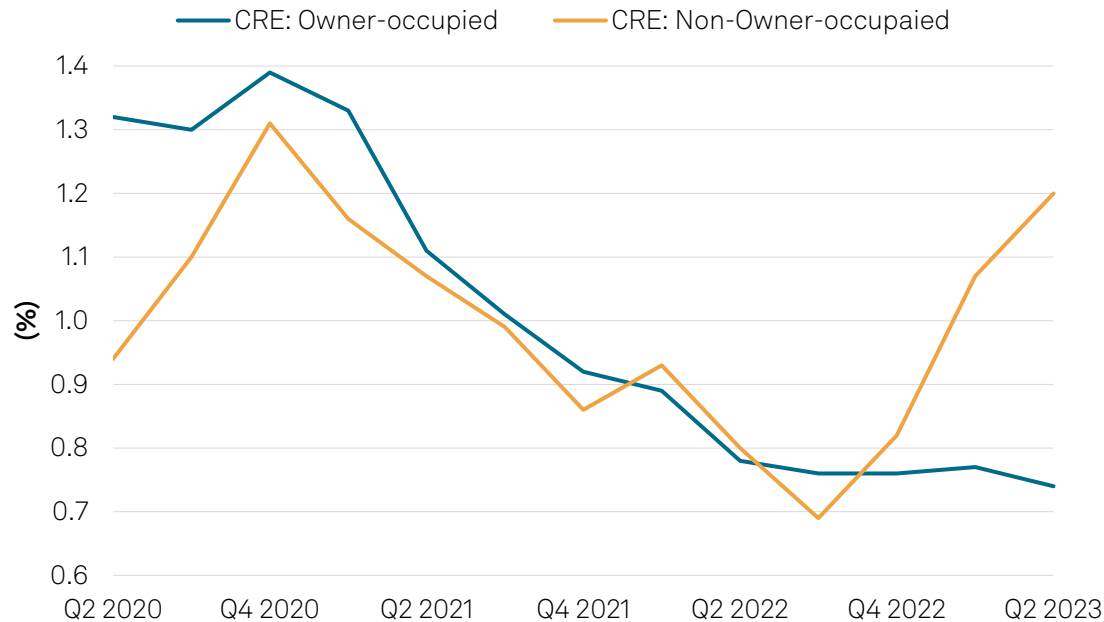
Banks Remain Focused On Office CRE

U.S. Banks | CRE Delinquencies Accelerated, But Exposures Are Manageable For Most

- Banks' broadly diversified loan portfolios and conservative underwriting should mitigate losses.
- Office could struggle long term, owing to secular changes in work arrangements.

CRE past due and nonaccrual loans

Loans of U.S. commercial banks at least 30 days past due



CRE--Commercial real estate. CET1--Common equity Tier 1. Sources: FDIC data and S&P Global Ratings.

Top CRE loan exposure of rated banks

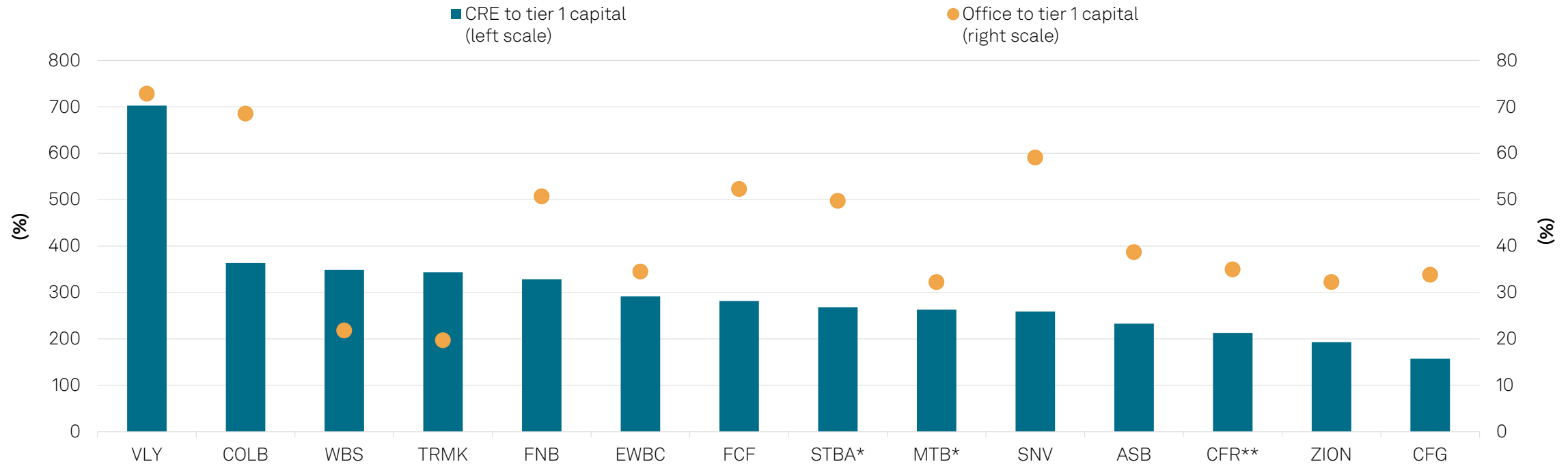


Data as of June 30, 2023. CRE--Commercial real estate. Sources: FDIC data and S&P Global Ratings.

U.S. Banks | Office Loans Are A Small Portion Of Banks' CRE Portfolios

- Offices typically represent less than one-quarter of total CRE loans at the median rated bank.
- For banks with elevated exposure to office CRE, the property's location and quality can be important differentiators of performance.

Office exposure for select rated banks with CRE/Tier 1 common capital >300% or office/Tier 1 >30%



Note: Bank CRE loans excludes owner-occupied. River City Bank does not provide a breakout but has CRE/Tier1 common capital > 300% *Office CRE allocation as of Q1 2023. **Office CRE allocation as of Q4 2022. Sources: S&P Global Ratings, FDIC data, and company Q1 2023 and Q2 2023 earnings presentations and 10-Qs.

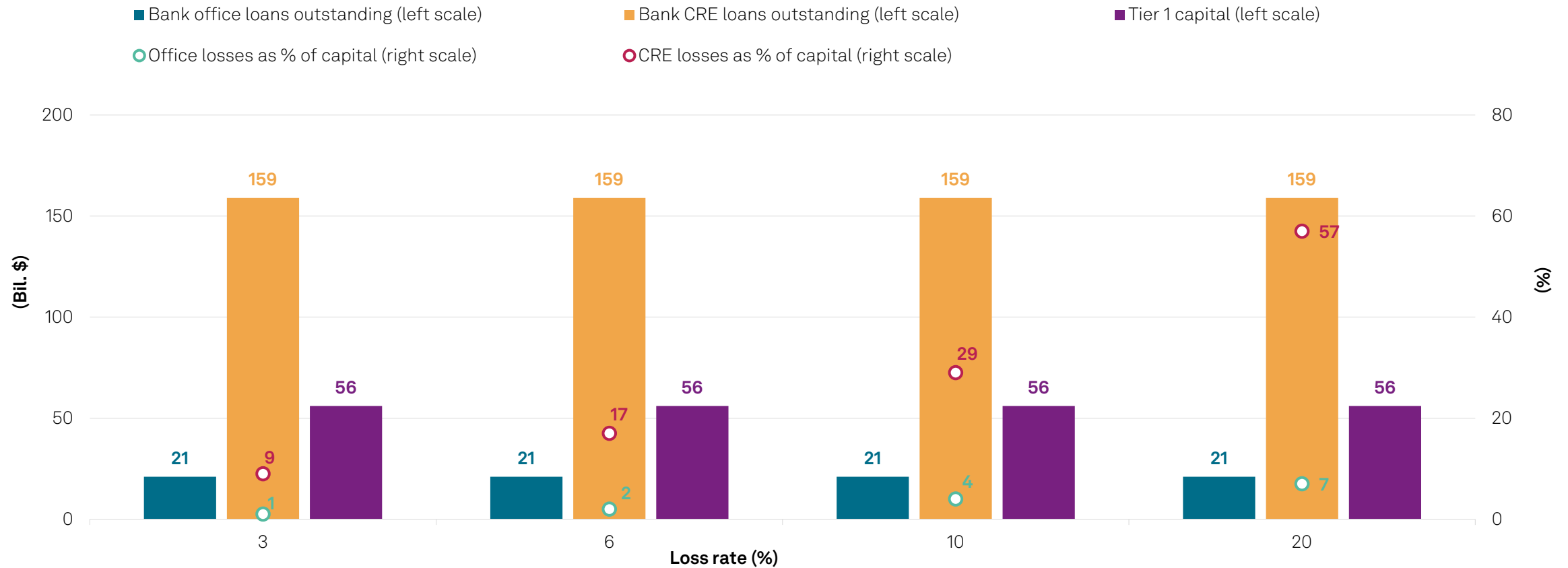
U.S. Banks | Commercial Real Estate To Total Loans

Displayed as % of total loans

	Construction	Multifamily	Non-owner	Farm	CRE not secured by RE	Total CRE
Large banks (> \$100 bil.)	1.9	3.7	4.8	0.1	2.4	12.8
Midsize banks (\$10-\$100 bil.)	7.6	6.9	17.2	0.7	1.0	33.5
Small banks (< \$10 bil.)	8.0	7.4	18.4	3.8	0.4	38.0

Source: FDIC and S&P Global Ratings. Data as of June 30, 2023

U.S. Banks | Stress Analysis Of Banks With More Than 30% CRE Exposure To Tier 1 Capital

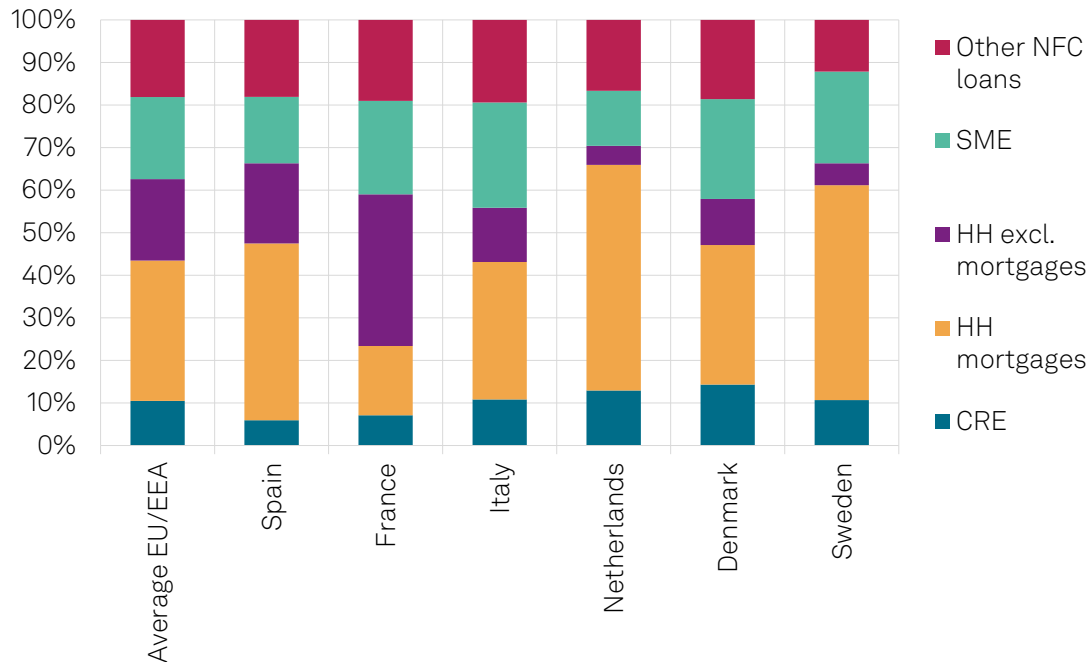


Sources: FDIC and S&P Global Ratings

European Banks | CRE Exposure, Concentrated At Larger Banks, Is Not Outsized

We estimate the EU's largest 33 banks hold around 75% of CRE bank lending

CRE loans represent around 10% of total lending for large EU banks



NFC--non-financial corporates. SME--Small and midsize enterprises. HH--Households. CRE--Commercial real estate. N.B.: In France, a large portion of residential housing loans are not subject to mortgage but rather to guarantees, and therefore are captured by the EBA in the category HH loans excl. mortgage. Source: EBA, S&P Global Ratings.

Banks in Germany and Sweden have higher exposure to CRE, though recent growth has been moderate

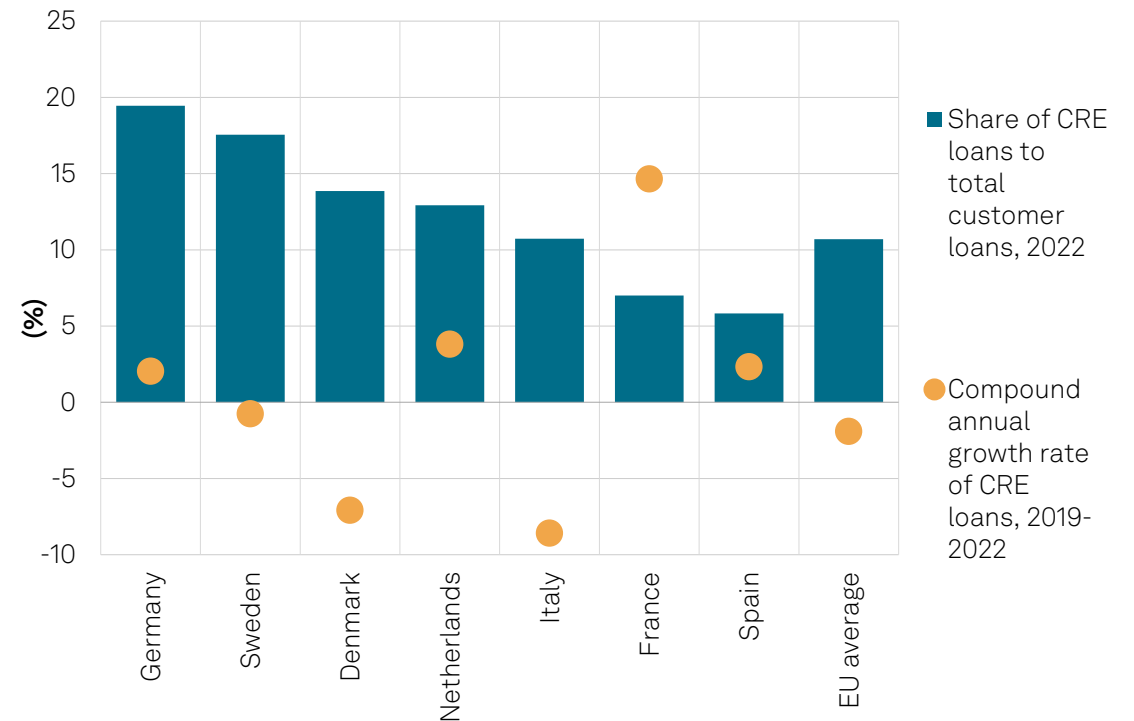


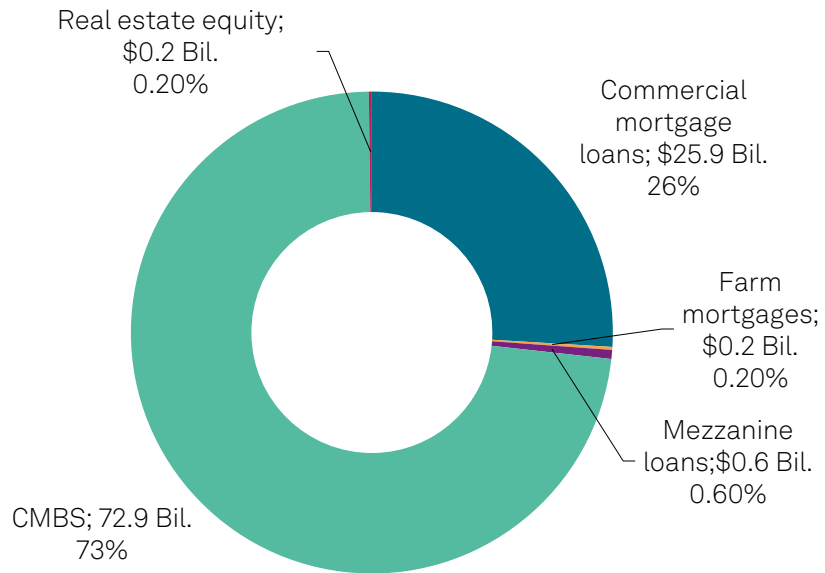
Chart shows relative exposure to CRE loans at large European banks at consolidated level, as of December 2022. Sources: EBA, S&P Global Ratings.

Insurance Exposure To CRE

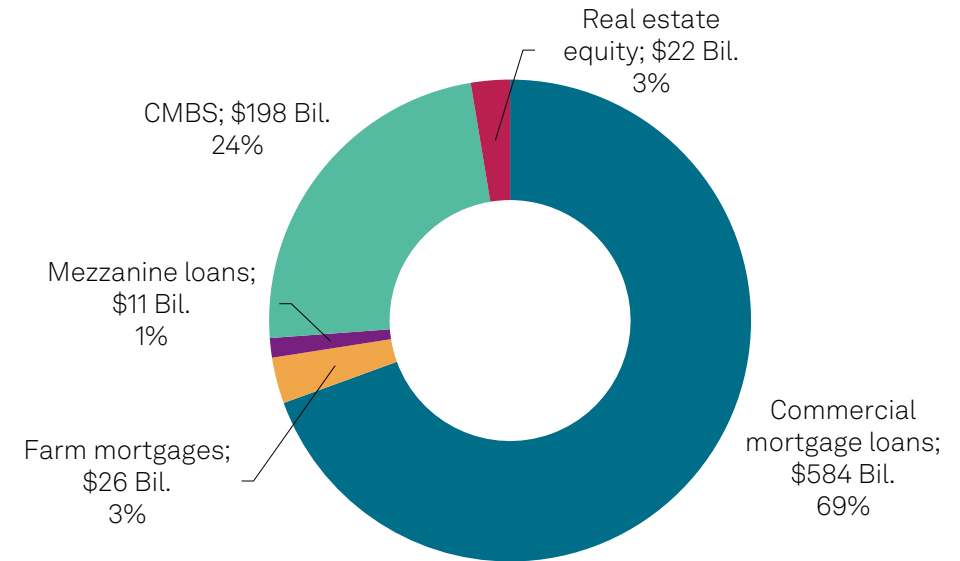
Total Exposure Of U.S. Insurance Companies To CRE

CMBS and CMLs totaled \$941 billion as of year-end 2022, of which U.S. life insurers hold the majority

U. S. P&C insurers' CRE exposure



U.S. life insurers' CRE exposure

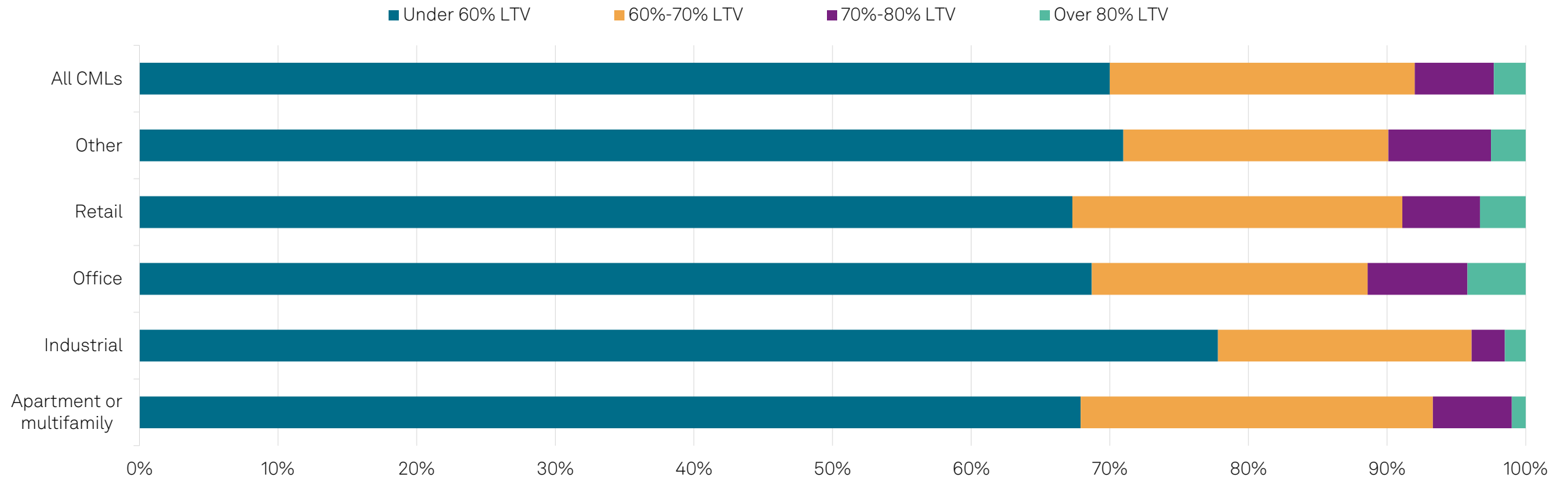


Data as of year-end 2022. P&C—property & casualty; CMBS—commercial mortgage-backed securities; CML—commercial mortgage loan. Sources: NAIC statutory filings for U.S. life insurance companies, S&P Global Capital IQ Pro, and S&P Global Ratings research.

Data as of year-end 2022. Sources: NAIC statutory filings for U.S. life insurance companies, S&P Global Capital IQ Pro, and S&P Global Ratings research.

LTV makeup of U.S. life insurers' \$584 billion of commercial mortgage loans

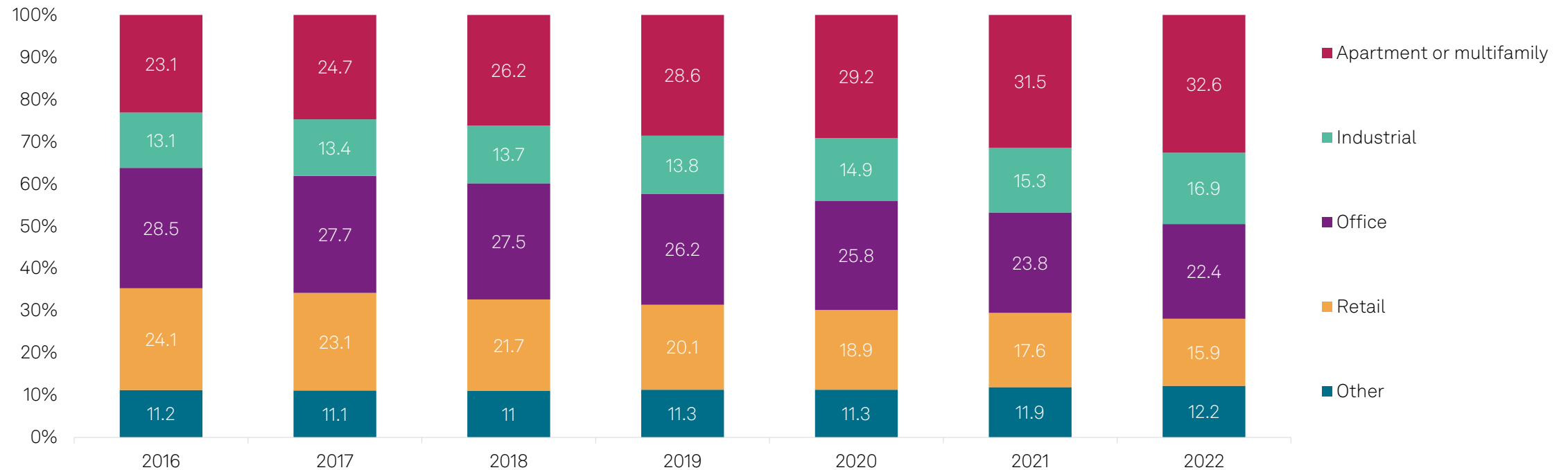
Insurers tend to focus on high-credit quality CMBS and CMLs to reduce capital requirements that lower credit-quality investments introduce.



Data as of year-end 2022. Sources: NAIC statutory filings for U.S. life insurance companies, S&P Global Capital IQ Pro, and S&P Global Ratings research. LTV—Loan to value.

U.S. Life Insurers' CML Property Type

Life insurers will continue tweaking the property-type allocations within their CML portfolios. They have gradually reduced exposure to retail and office, while increased industrial and multifamily CRE.



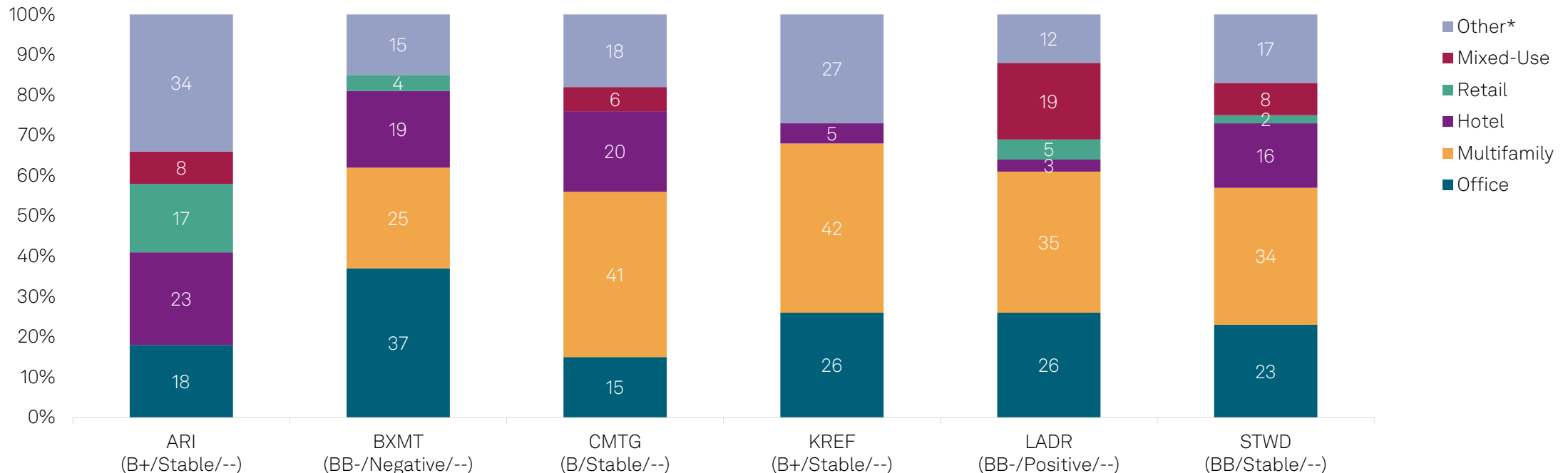
CML--commercial mortgage loan. Data as of year-end 2022. Sources: NAIC statutory filings for U.S. life insurance companies, S&P Global Capital IQ Pro, and S&P Global Ratings research.

Commercial Mortgage REITs

Commercial Mortgage REITs

- Most of the transitional CRE loan portfolio consists of post COVID-19 originations and are concentrated in the multifamily sector, an area that has performed well over the past two years.
- We expect companies will prioritize maintaining liquidity over new originations given the expected decline in property valuations and potential for margin calls.

Portfolio exposure based on carrying value as of June 30, 2023



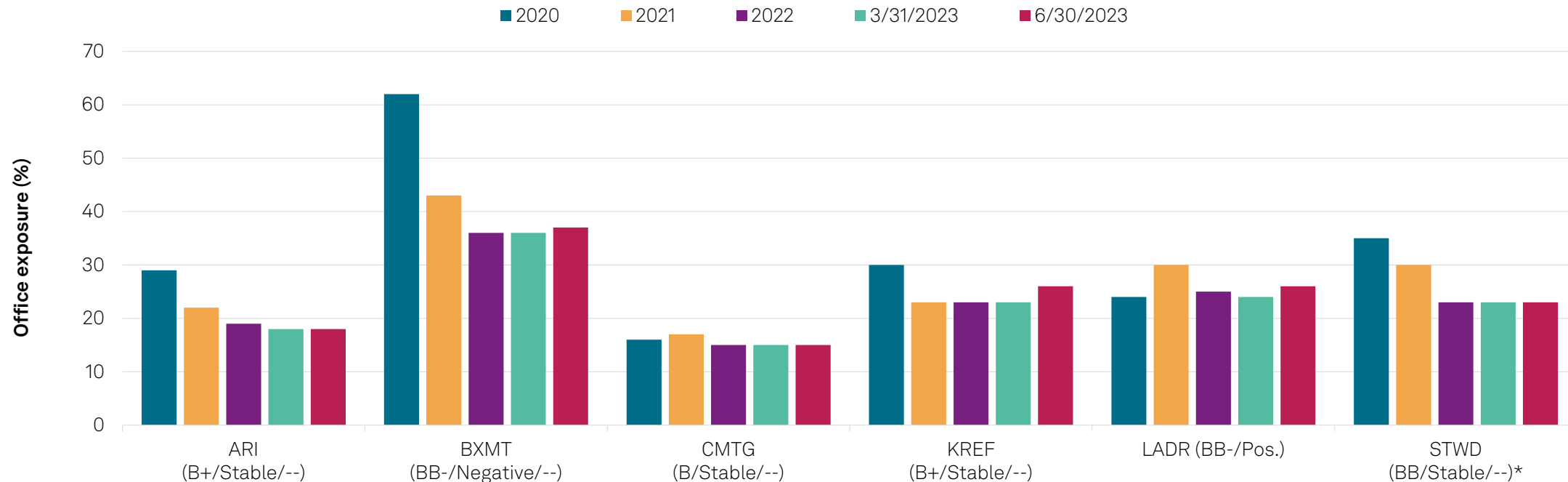
*Other includes condominium, life-science, mobile park, student housing, residential, land & development, and industrial.

Source: S&P Global Ratings.

Commercial Mortgage REITs

- While CRE lenders have scaled back on originating office loans, particularly for class B and class C office properties, they aren't immune to the ongoing risks related to transitional office loans.
- We continue to see credit quality, especially in office loans, deteriorate as borrowers have difficulty making interest payments or repaying maturing loans.

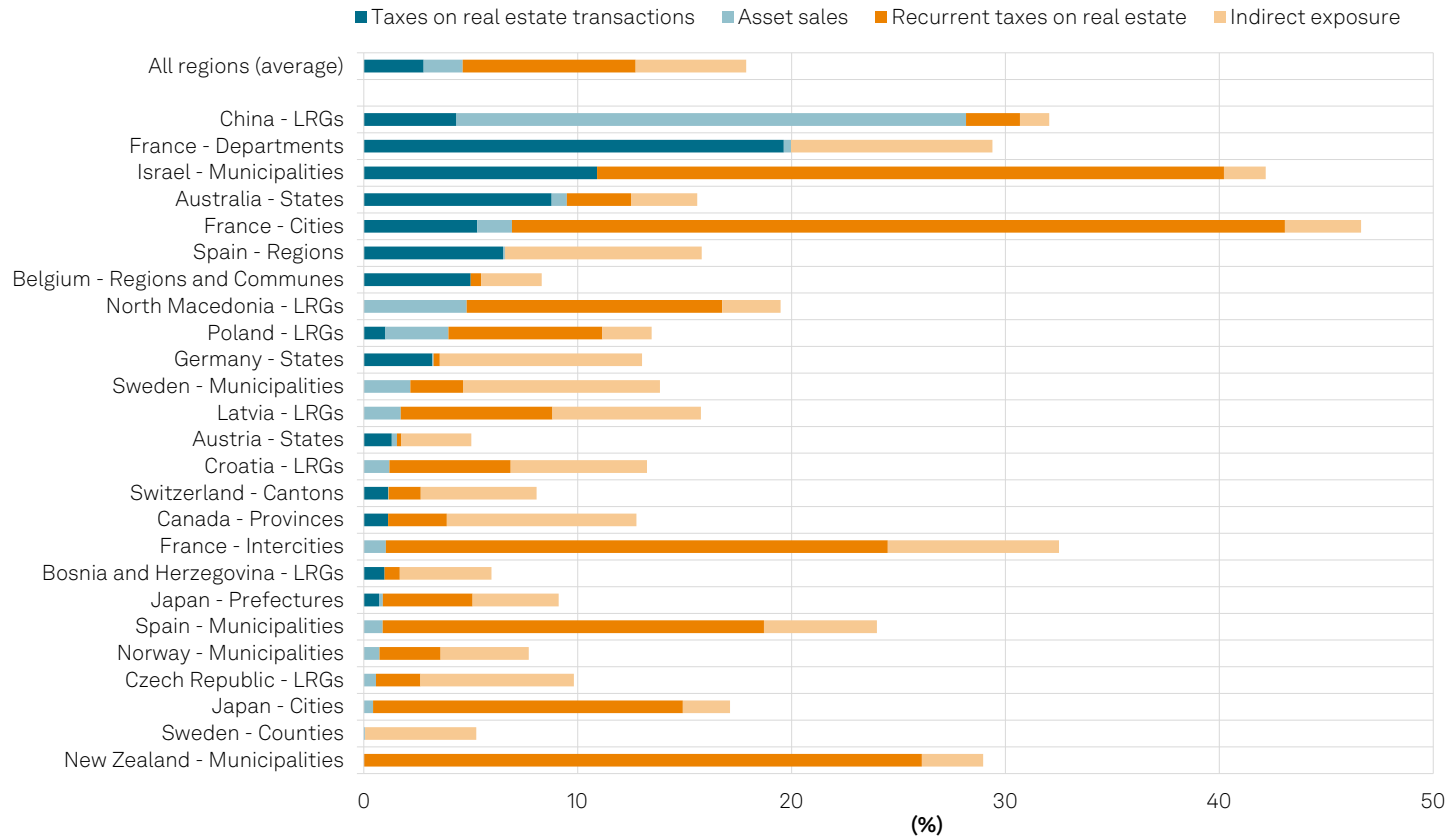
Decline in office exposure



*Exposure excludes residential loans, RMBS, properties and investments. Source: S&P Global Ratings.

Some Local Governments Are Vulnerable To Declining Property Market Values

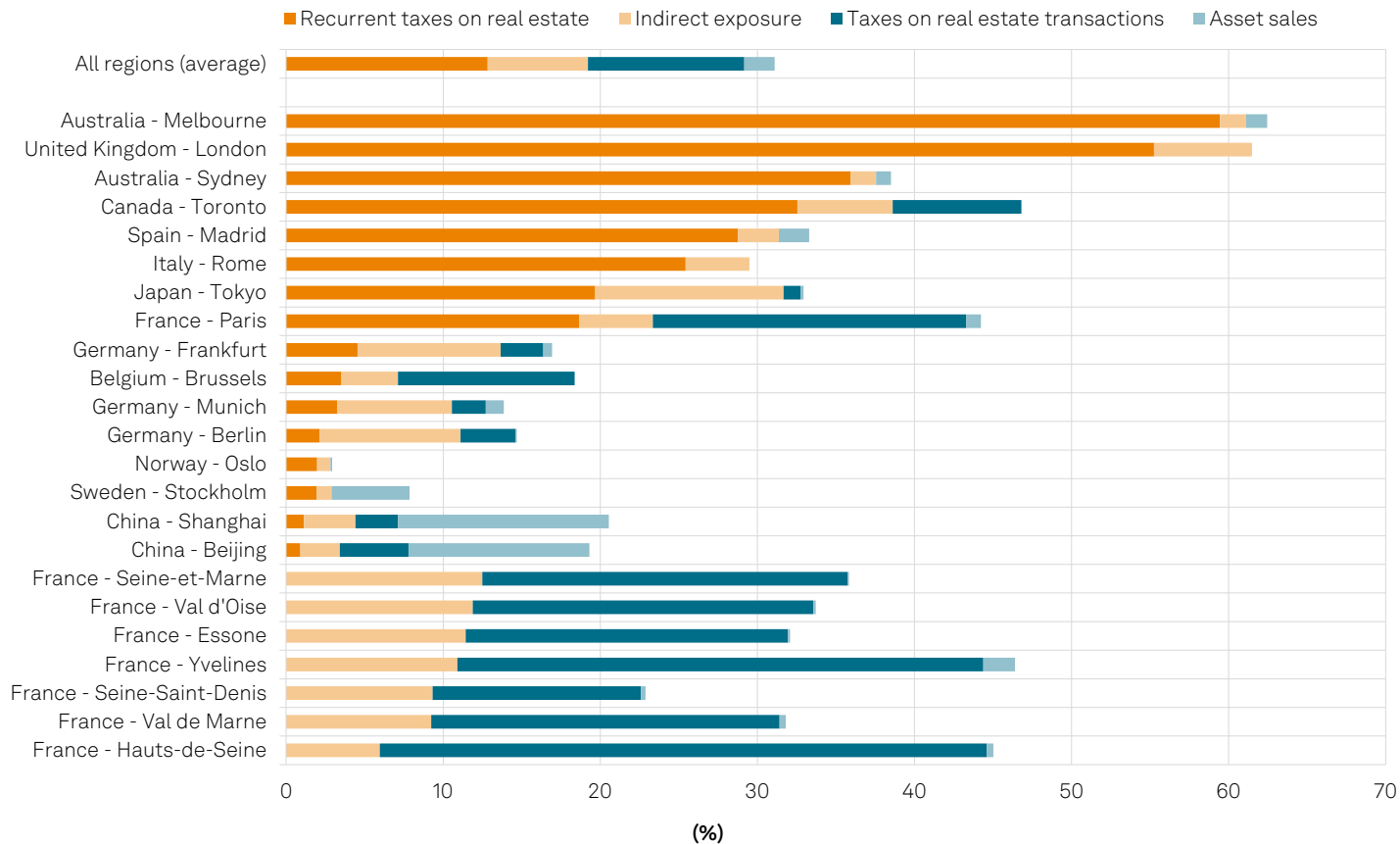
Chinese LRGs and French departments are more dependent on volatile revenues from the real estate sector



- Chinese local and regional governments and French departments are more dependent on volatile revenues from the real estate sector, taxes on transactions, and asset sales.
- French cities and intercities, and Israeli and New Zealand municipalities may suffer from a long-term downturn in the real estate market, as recurring taxes and other revenues from the real estate sector account for more than 30% of their revenues.

Source: S&P Global Ratings. French LRGs asset sales data as of 2021. All other data as of 2022. LRGs--Local and regional governments.

Local government budgets heavily depend on property taxes



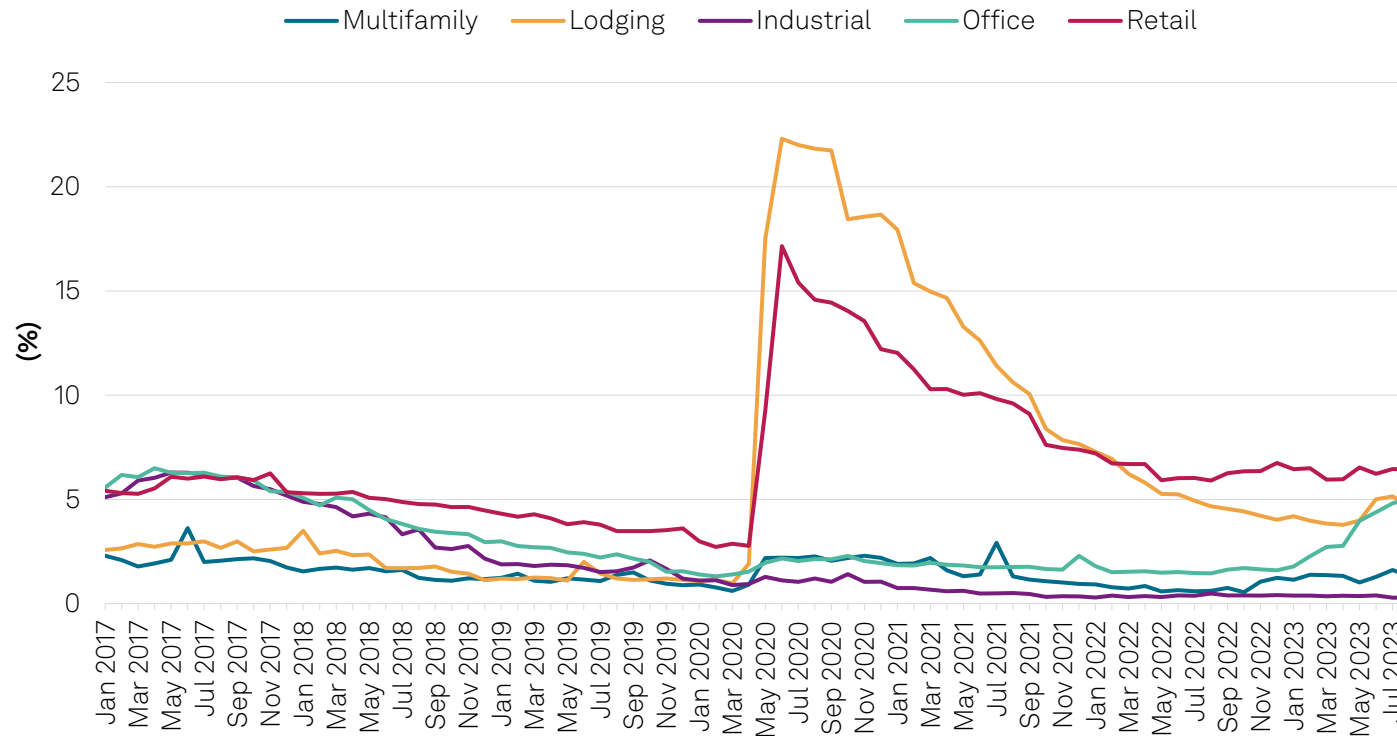
- Budgets of large metropolitan areas are particularly dependent on property taxes
- In Melbourne and London, real estate revenues account for more than 50% of total revenues, followed by Toronto and a few governments in Greater Paris area.

Source: S&P Global Ratings. Toronto and French metropolitan areas data as of 2021.

CMBS

U.S. CMBS | Delinquency Rate By Property Type

Office DQ now at 5%



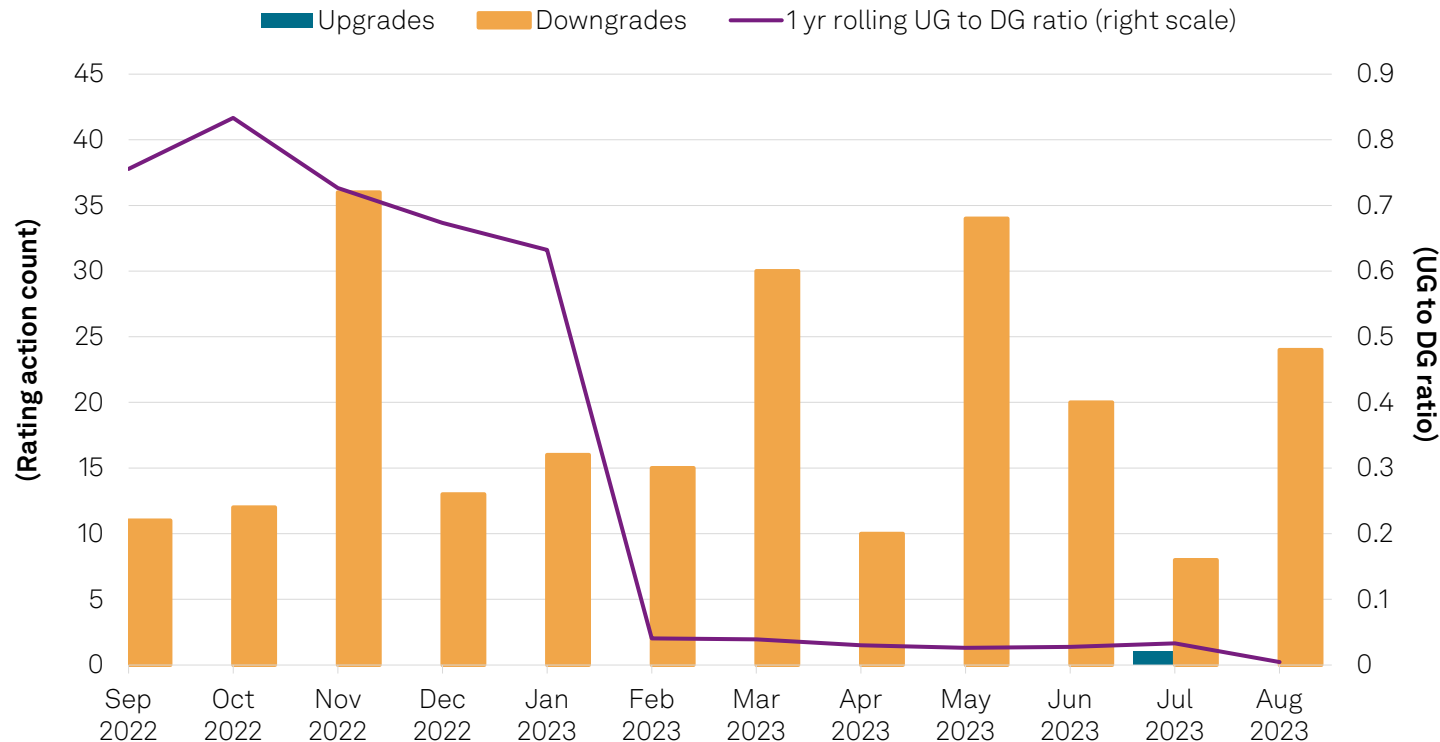
Data through August 2023 Source: S&P Global Ratings.

- The U.S. CMBS overall delinquency (DQ) rate fell by 19 basis points (bps) month over month to 3.6% in August, while the office specific rate rose for the eighth consecutive month, and now stands at 5%
- For some perspective, the office DQ rate ended 2022 at 1.6% (+340 bp a/o August), and the overall rate was 2.6%.

U.S. CMBS | Rating Performance Reflecting Sector Stress

U.S. CMBS rating actions

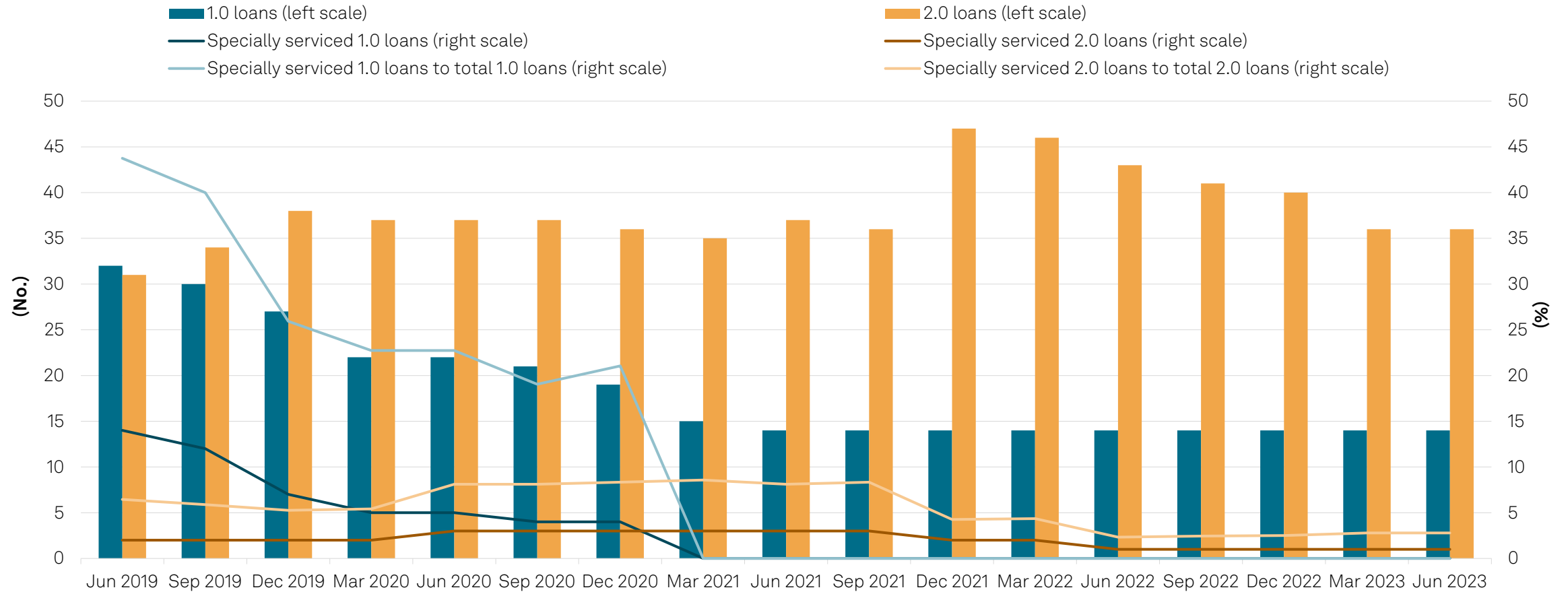
Trailing 12 months CMBS rating transitions (Sep 2022- Aug 2023)



Data as of August 31, 2023. UG--Upgrade. DG--Downgrade. Source: S&P Global Ratings.

- During the most recent 12-month period, we lowered 229 CMBS ratings and raised one.
- Downgrades were primarily in single borrower/large loan and legacy conduit deals.
- Underperforming office properties are driving many recent actions.

EMEA CMBS | Specially Serviced Loans By Vintage

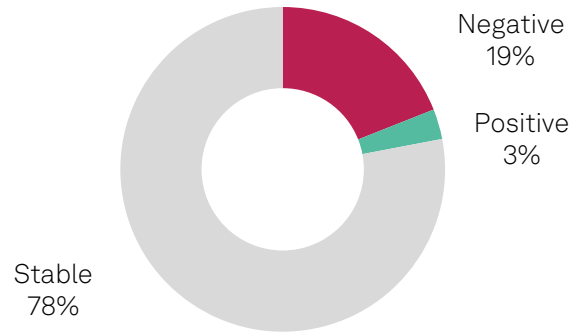


Source: S&P Global Ratings, [European CMBS Monitor Q2 2023](#), July 21, 2023.

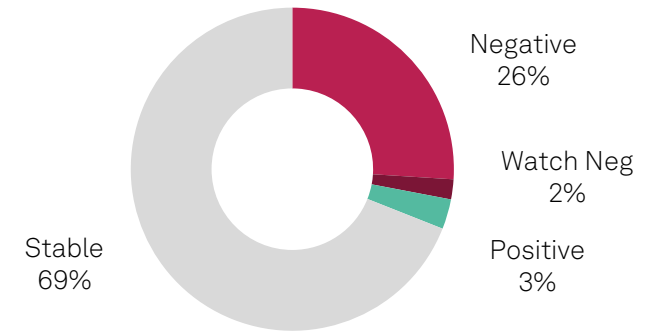
REITs

Credit And Rating Trends | Growing Negative Bias

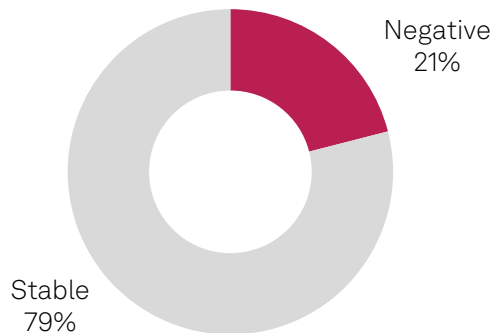
North America: 19% of ratings' outlooks are negative



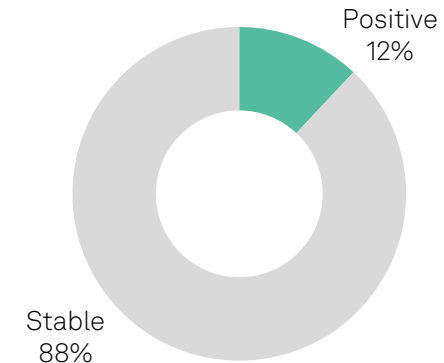
EMEA: 28% of ratings' outlooks and CreditWatch placements are negative



APAC: 21% of ratings' outlooks are negative

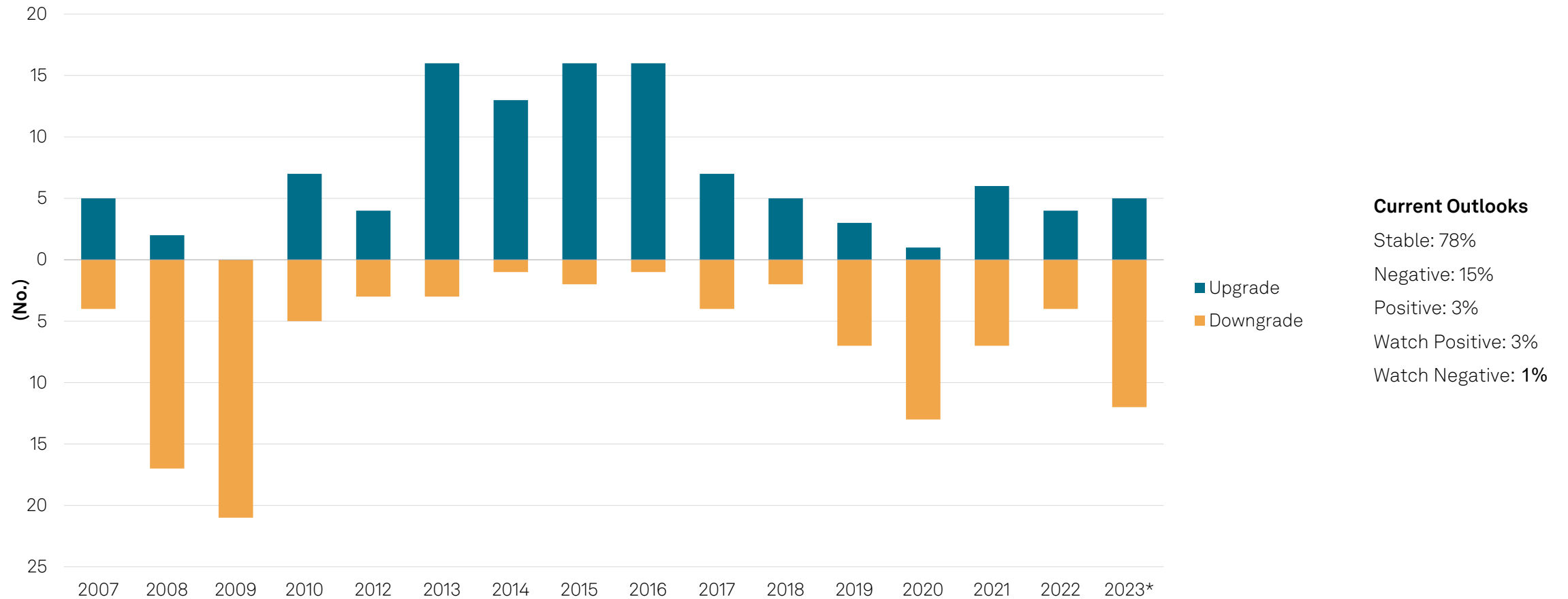


Latin America: no ratings' outlooks or CreditWatch placements are negative



Data through August 2023. CW—CreditWatch. Source: S&P Global Ratings.

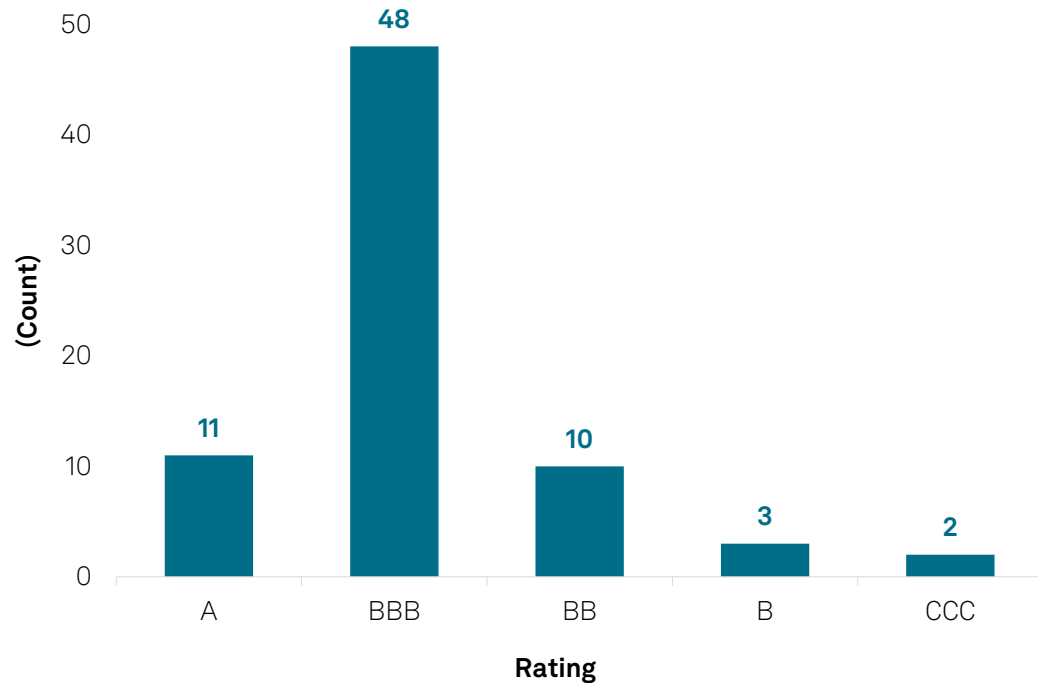
North America | REIT Rating Trends 2007 – Present



*As of Sept. 14, 2023. Source: S&P Global Ratings.

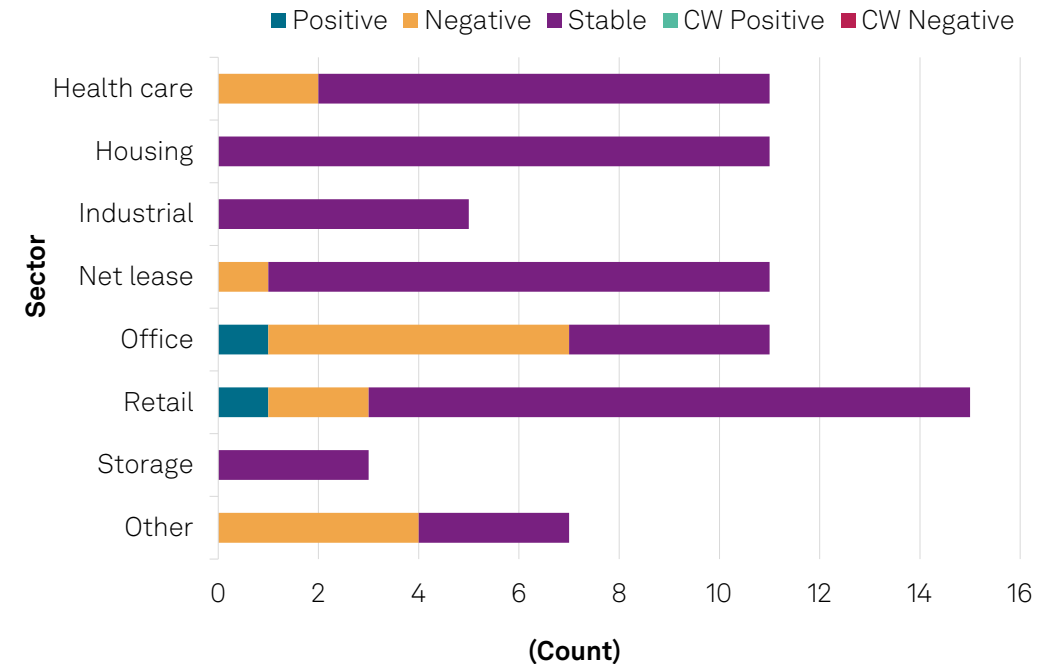
North America | REIT Rating/Outlook Distribution

REIT Rating Distribution
As of Sept. 21, 2023



Source: S&P Global Ratings.

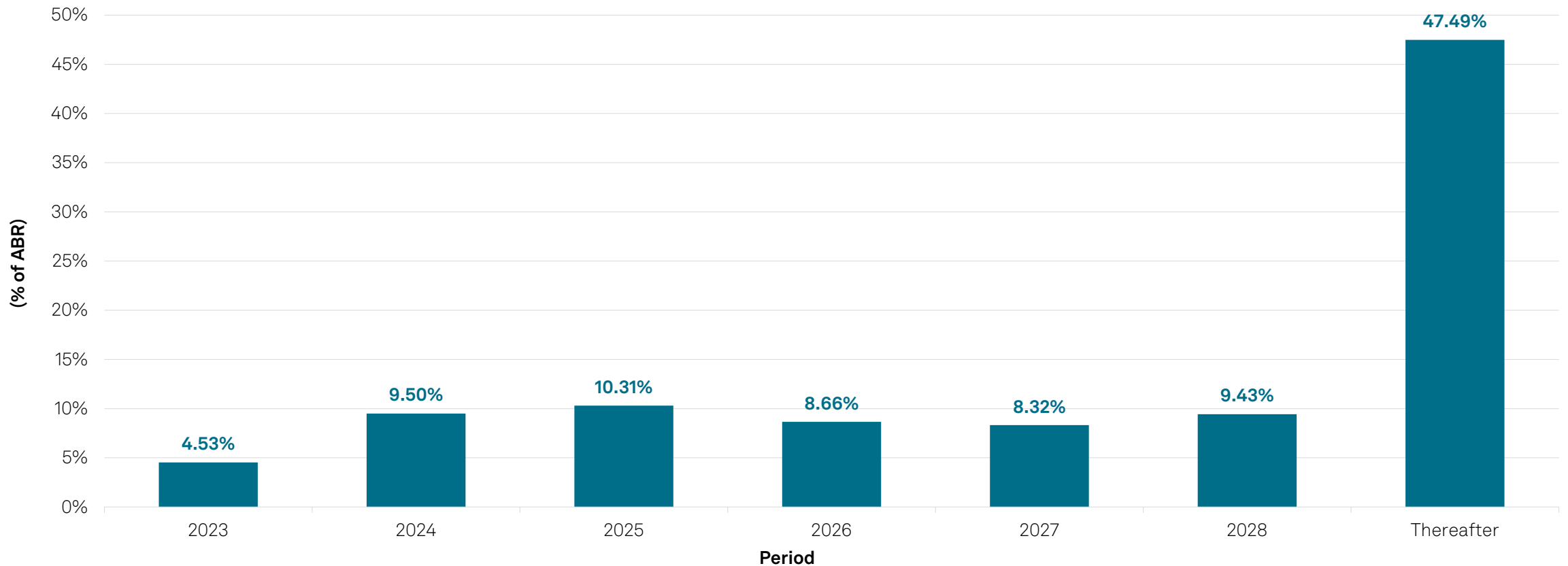
REIT Outlook Distribution
As of Sept. 21, 2023



CW—CreditWatch. Source: S&P Global Ratings.

North America | Average Office Lease Expirations As A Percentage Of ABR

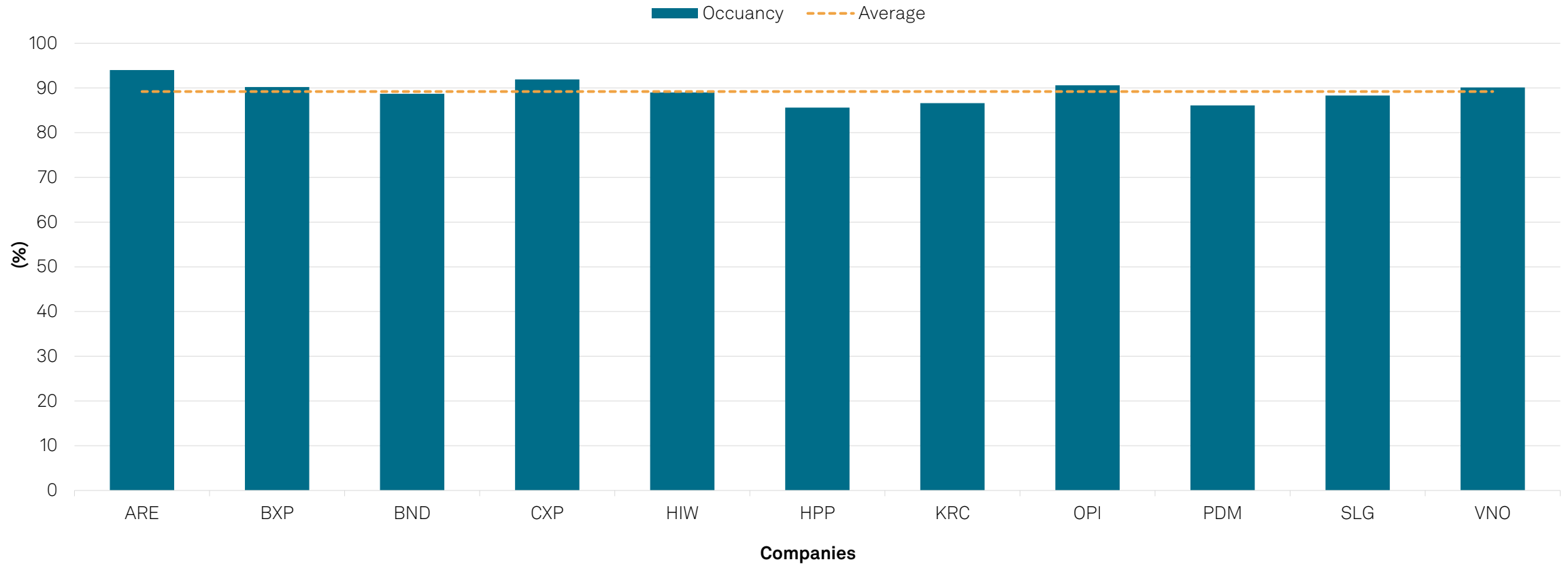
As of Q2 2023



Three of our rated office REITs report lease expirations as a % of total of square feet included in the data. ABR--Annualized base rent. Source: Company reports.

North America | Rated U. S. Office REIT Occupancy

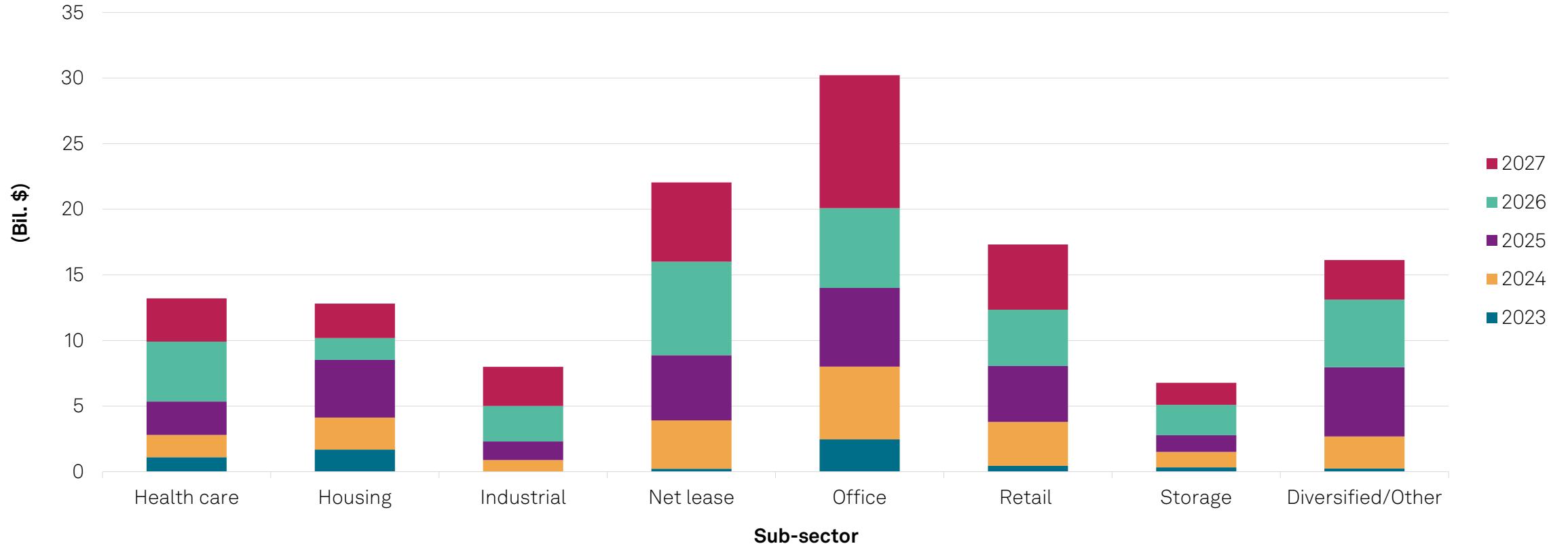
As of Q2 2023



Source: Company reports.

North America | REIT Debt Maturities 2023-2027

As of August 2023

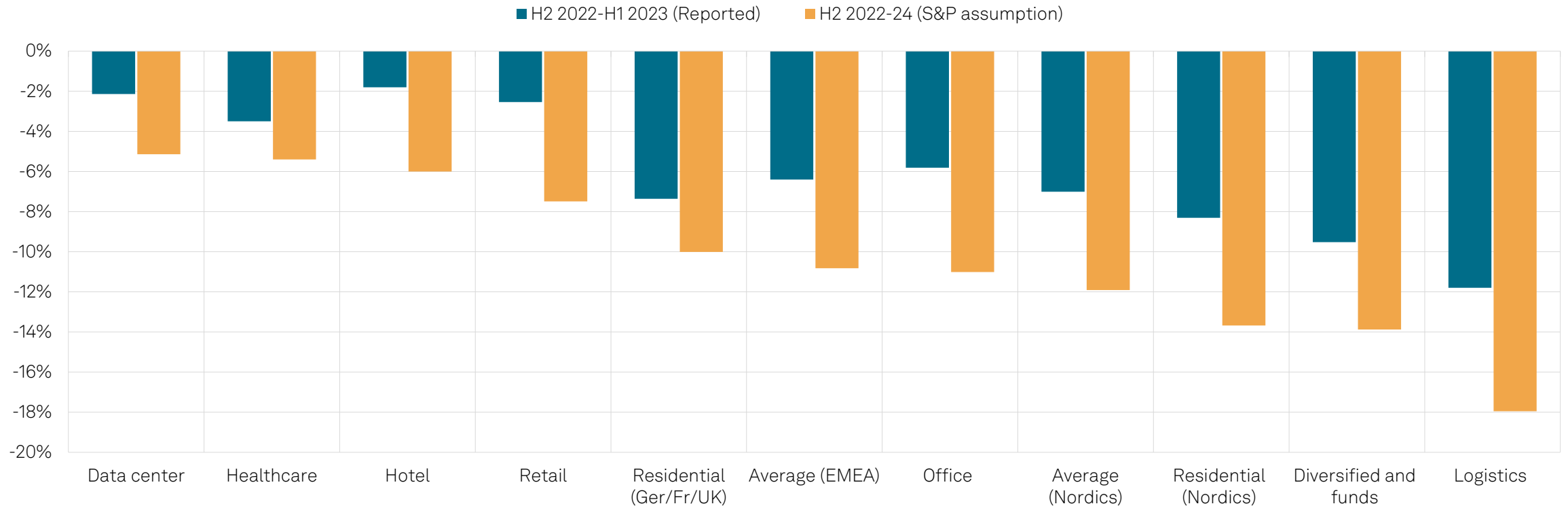


Does not include extension options. Source: S&P Global Ratings.

EMEA | We Assume Further Asset Value Corrections

Reported value declines are still below our assumptions

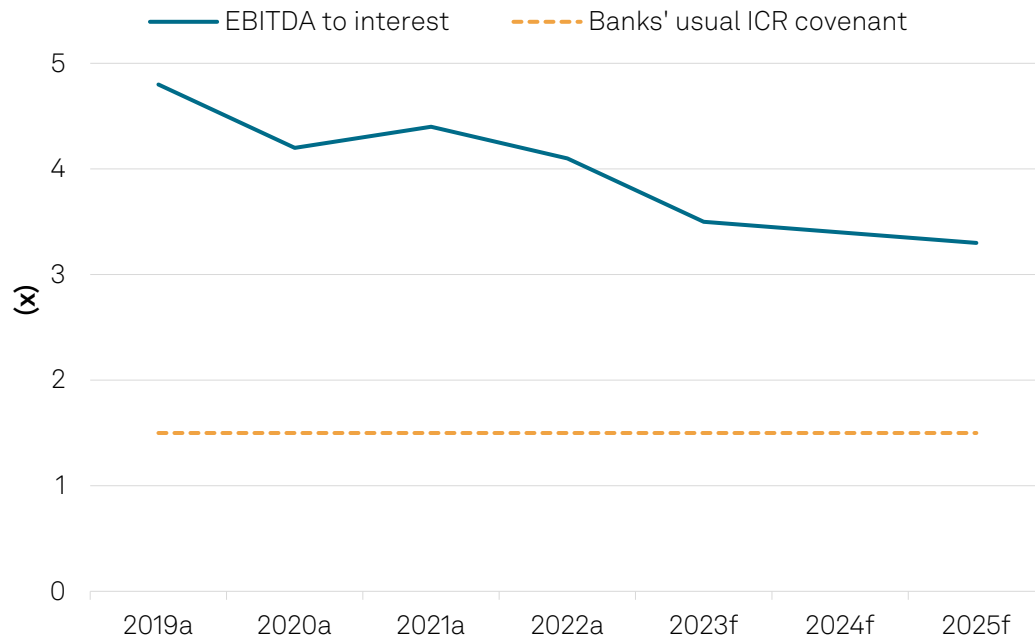
Valuation LfL growth since June 2022 for rated REITs in EMEA, reported versus S&P ratings assumptions, as of Sept 19, 2023



Source: S&P Global Ratings.

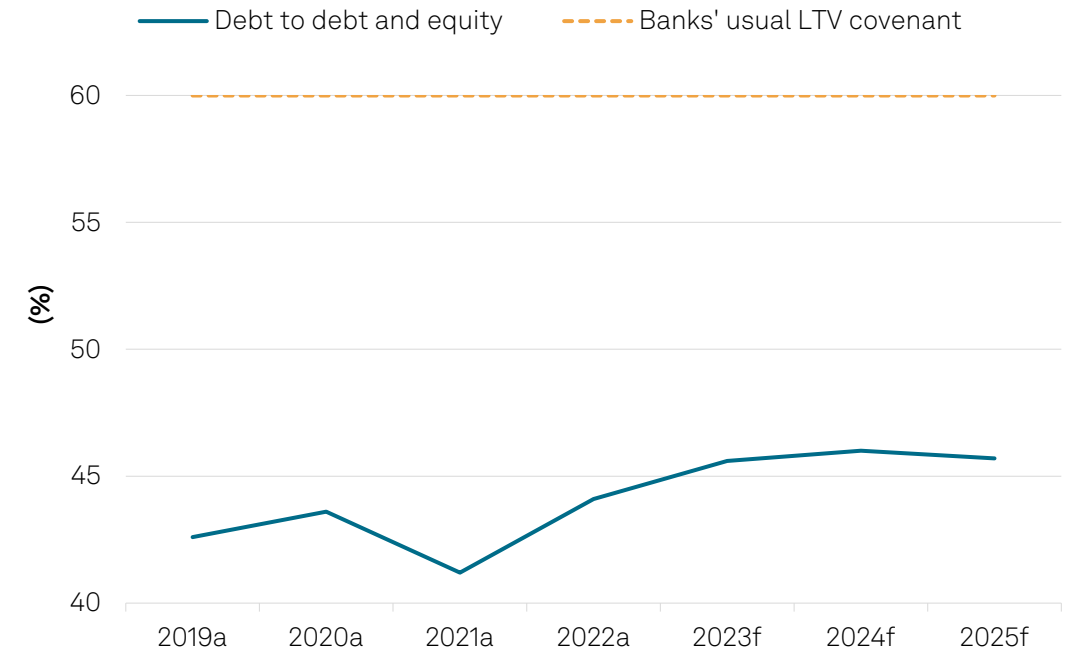
EMEA | Interest Coverage Will Remain Under Pressure In 2024, While Loan-To-Value Ratios Could Peak

Rising funding costs weight on interest coverage



Average adjusted ratios for REITS (EMEA) we rate as of Sept. 21, 2023. a—Actual. f—Forecast.
Source: S&P Global Ratings.

LTV (or D/D+E) could plateau 5ppts higher than 2021's level

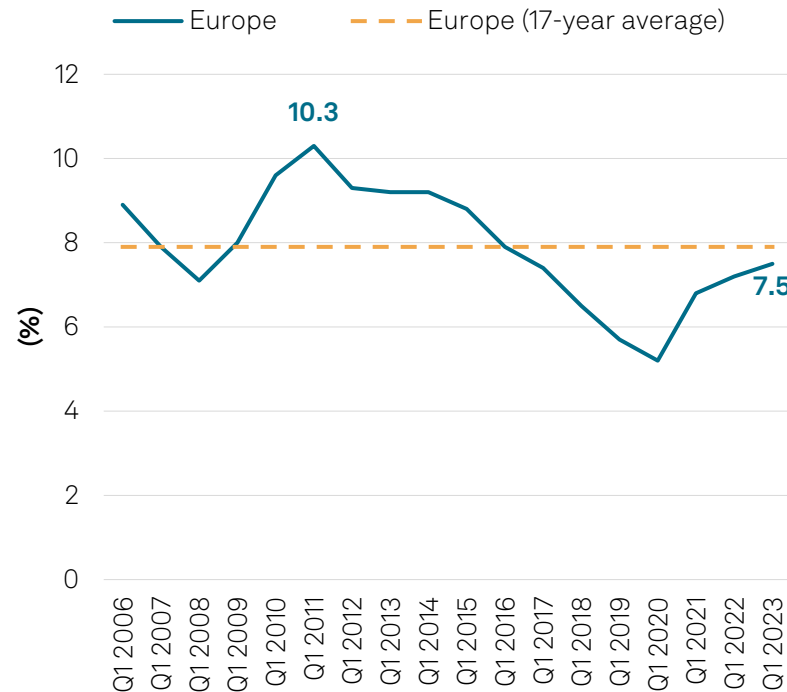


Average adjusted ratios for REITS (EMEA) we rate as of Sept. 21, 2023. a—Actual. f—Forecast.
Source: S&P Global Ratings.

EMEA | Office Pressure Is Mounting, Though Vacancy Still Appears Low

European office vacancy is growing but remains well below its historical peak (2011)

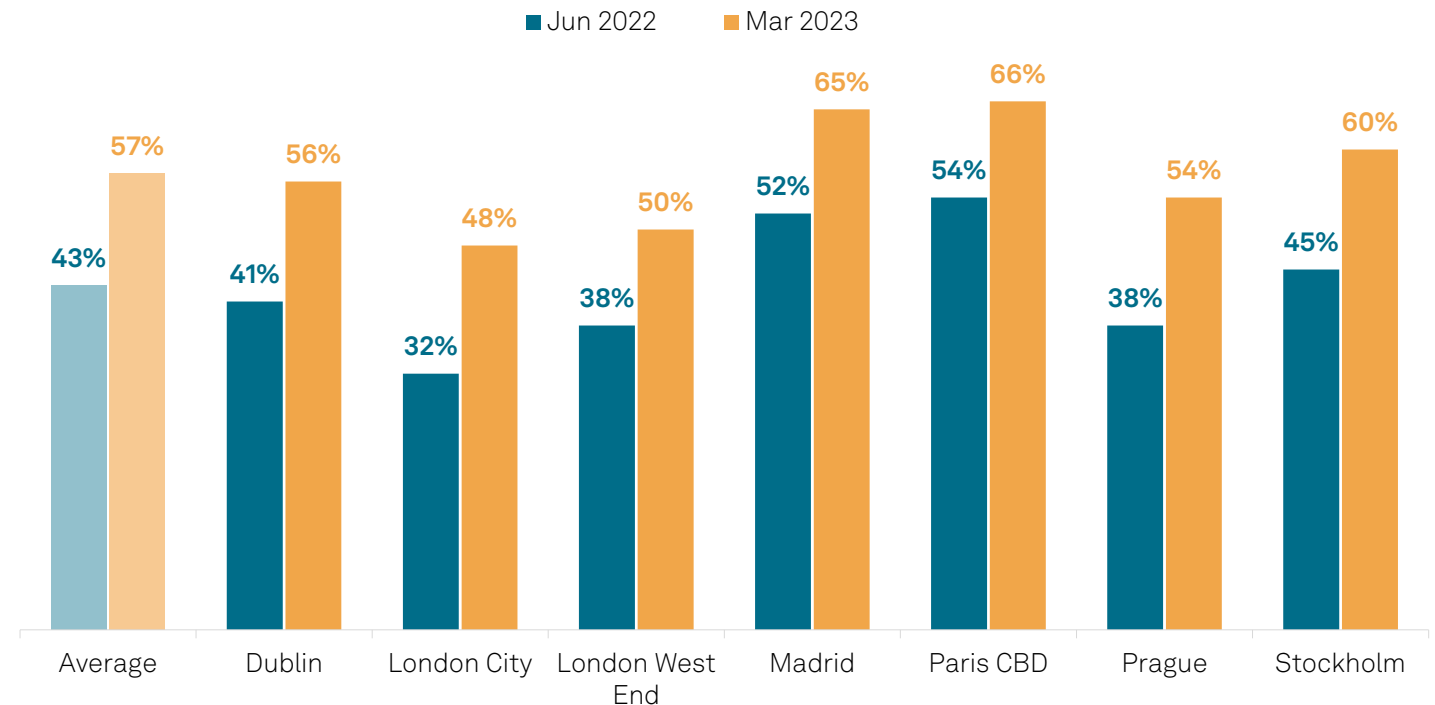
Financial vacancy



Source: JLL report dated April 19, 2023, JLL US Office Outlook dated July 24, 2023, JLL office property clock Q2 2023, and data reported by S&P rated REITs of May 31, 2023.

Office utilization continues to recover slowly

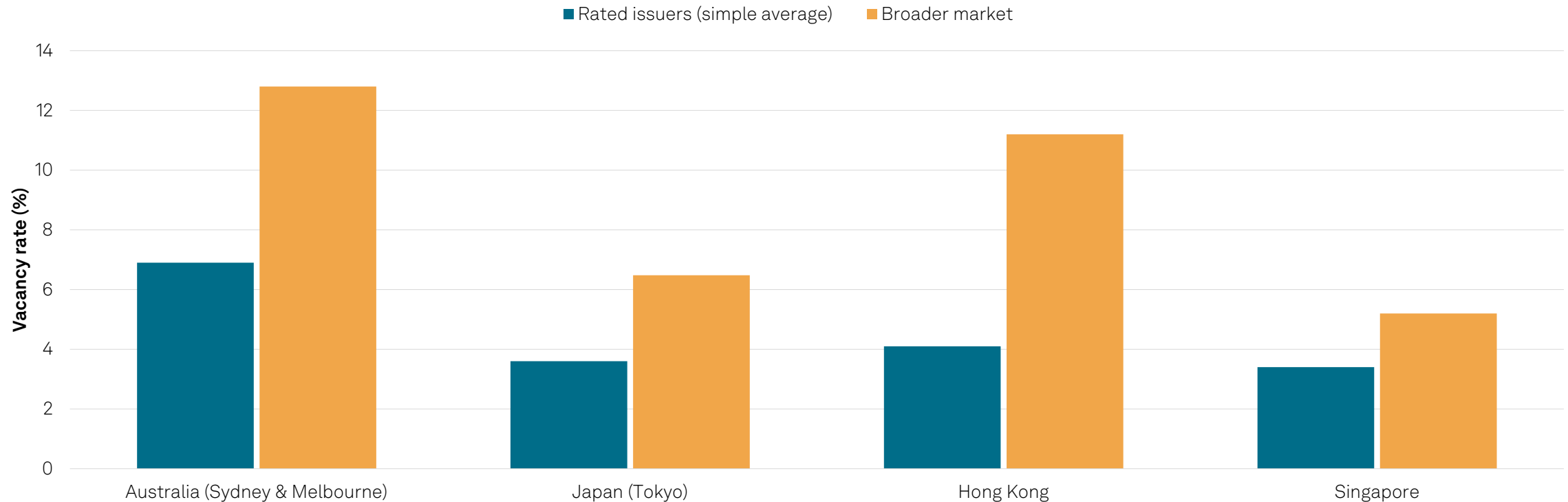
Average number of office workers over the course of a working week (excluding bank holidays) for a sample of fully let, multi-let office buildings located in the central business district (CBD) of selected European cities.



Source: Data from Savills' reports "European office occupancy rates continue to recover", June 2022 and "European Office Occupancy", March 2023.

APAC | Rated Asia-Pacific REITS And Landlords Can Deal With Stresses Better

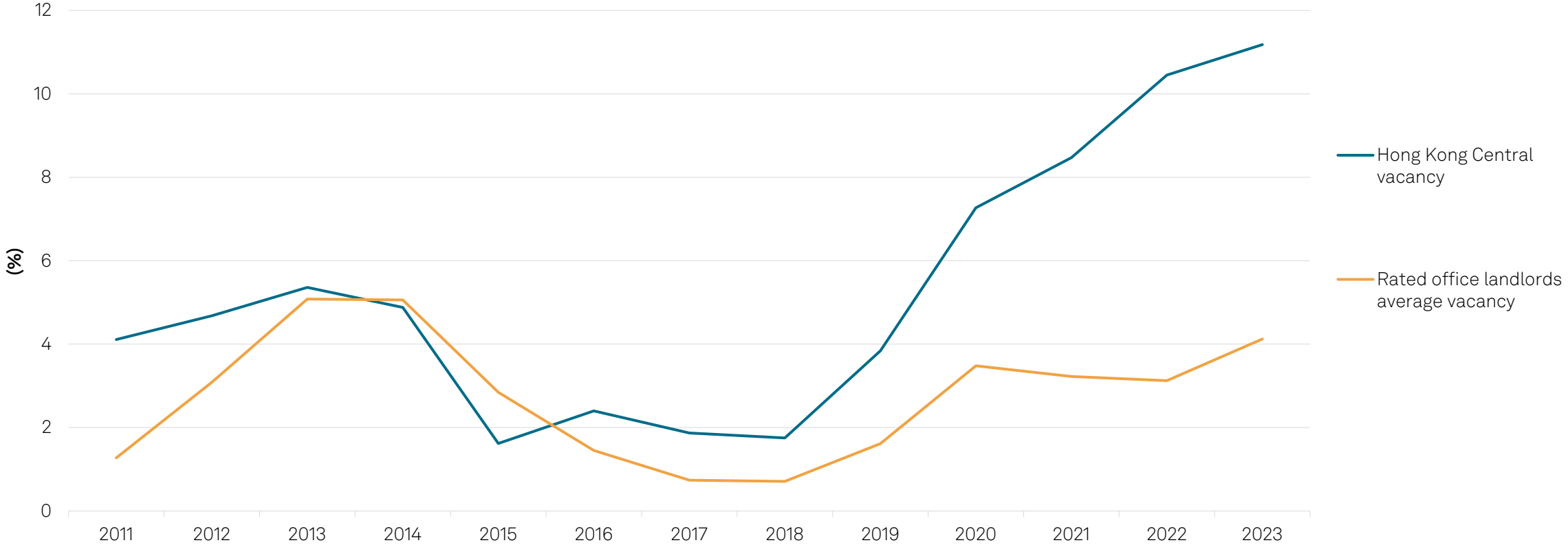
Thanks to flight to quality, high-quality tenants, well-laddered lease profiles, disciplined financial management
Prime/grade A office vacancy rates across all countries



Source: Australia (average of Prime Grade Sydney CBD and Melbourne central business district [CBD] H2 2022, Colliers); Japan (Tokyo Central 5 Wards June 2023, Miki Shoji Co.); Hong Kong (Overall Grade A June 2023, Colliers); Singapore (Core CBD Q2 2023, CBRE).

APAC | Hong Kong - Rated Office Landlords Have Lower Vacancy Rates

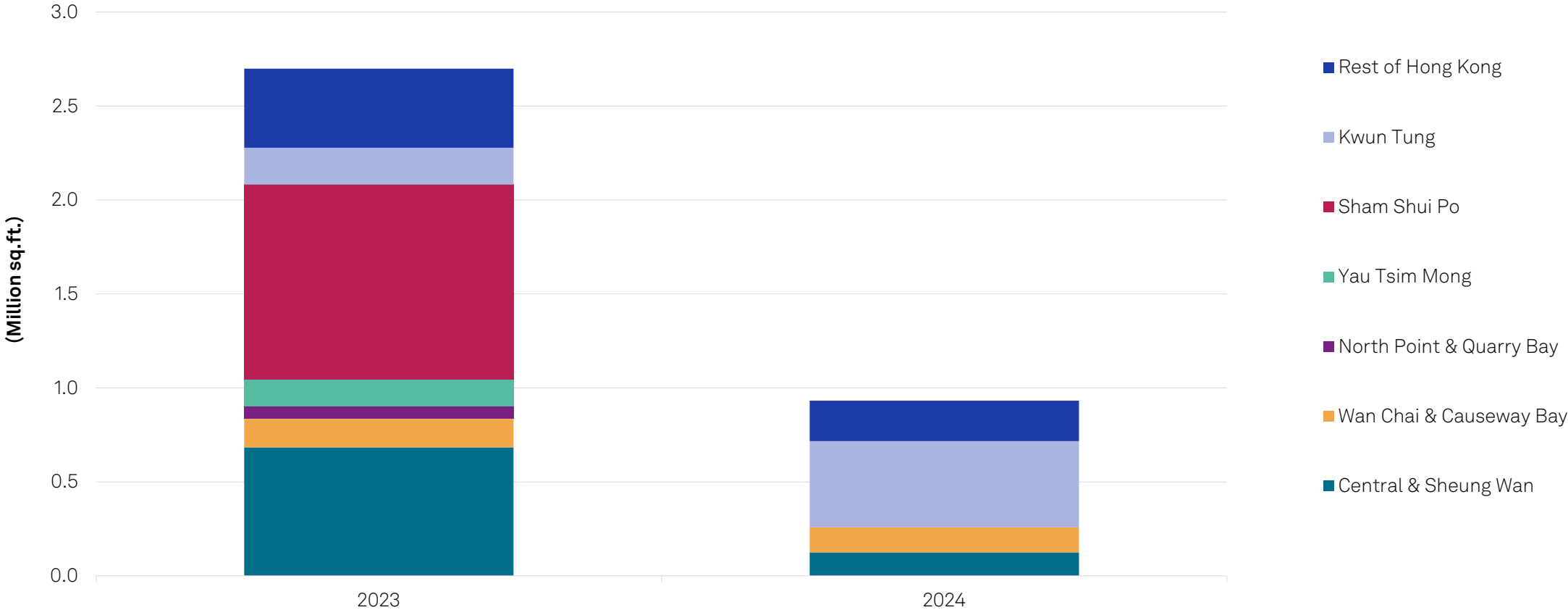
Comparative vacancy rates in Hong Kong's central district



Source: Company disclosures, Colliers International, S&P Global Ratings.

APAC | Hong Kong - New Supply Will Pressure Rents In 2023-2024

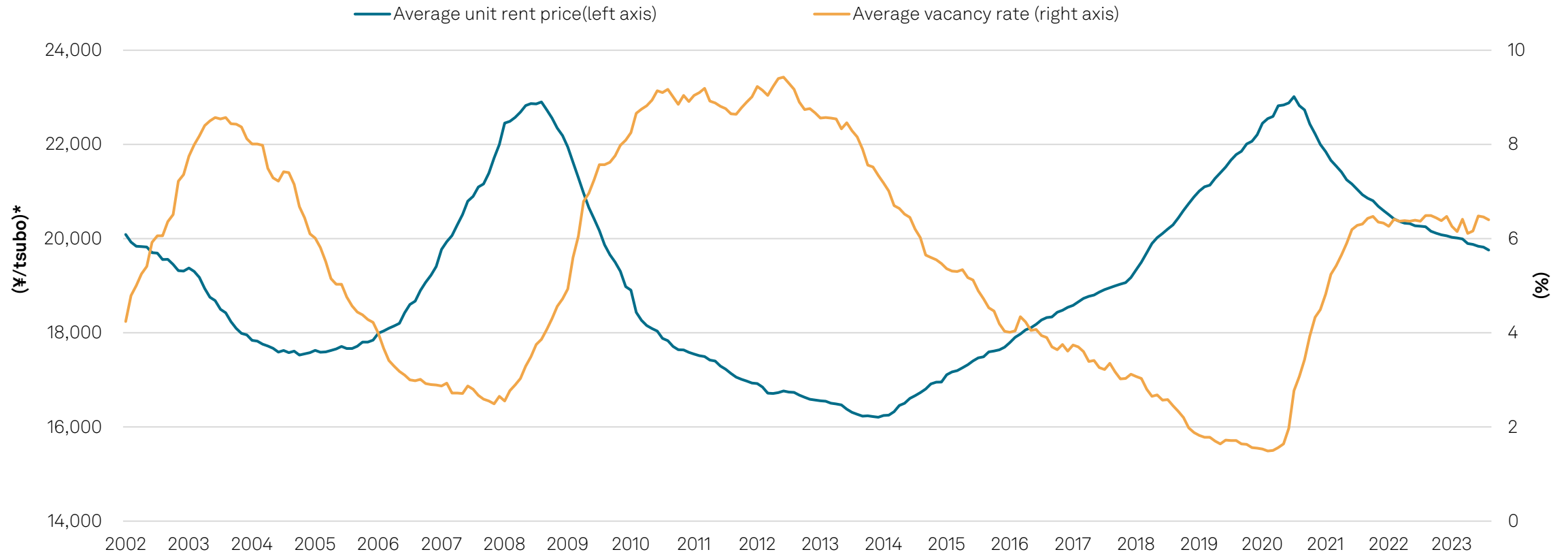
Bulk of new grade A office supply in 2023 and 2024 is focused on noncore areas outside central



Source: Hong Kong Rating and Valuation Department, S&P Global Ratings.

APAC | Japan - Office Leasing Market Is Likely To Remain Under Pressure

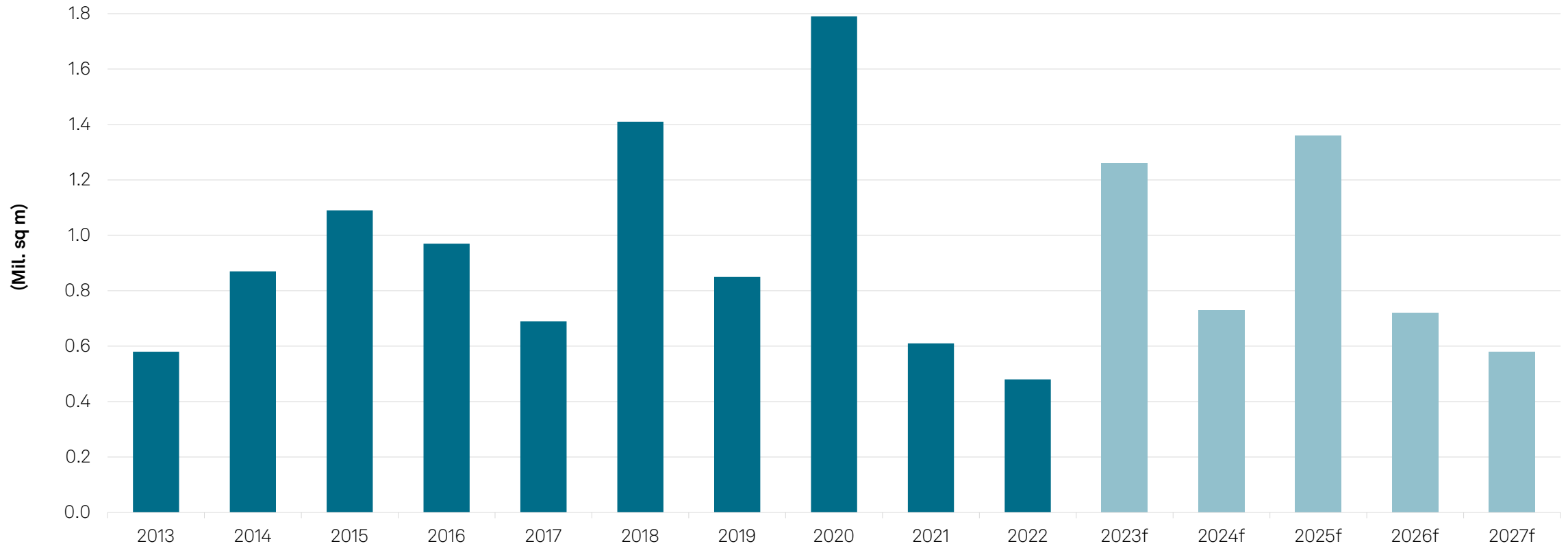
Average vacancy rate and average unit rent for Tokyo's business district



*One tsubo is about 3.30578 square meters. Sources: Miki Shoji Co., S&P Global Ratings.

APAC | Japan - New Supply Is Rising Again

New supply of large-scale office buildings in Tokyo*



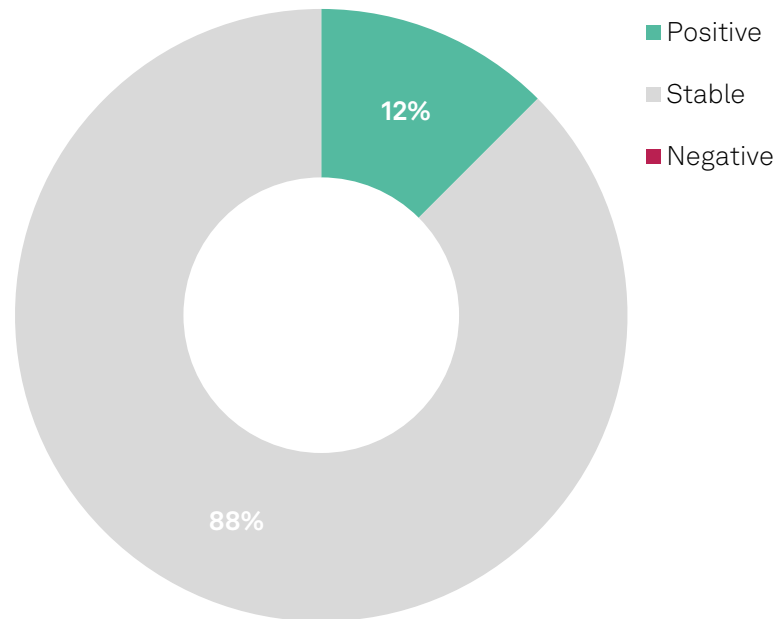
*Research subject buildings: Buildings with a total office floor area exceeding 10,000 sq m. sq m—Square meters. f--Our forecasts.

Sources: Mori Building (as of May 2023). S&P Global Ratings.

Latin America | Real Estate Operators

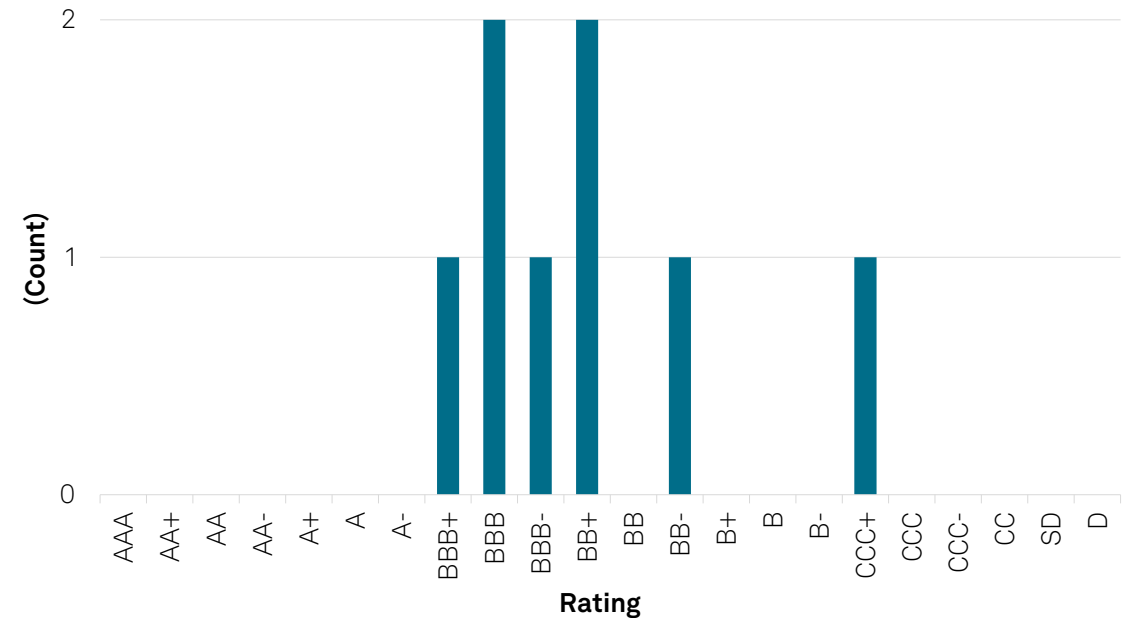
- LatAm real estate portfolio mostly geared toward industrial assets (63%) and retail/office (37%), in terms of number of ratings.
- Exposure to office represents less than 2% of the total GLA of our rated portfolio, mostly located in Mexico City.
- We expect rating stability over the next 12 months, without large debt refinancing risk in the portfolio. Only one entity rated 'CCC+' will have to refinance a secured bank loan due June 2024.

LatAm real estate operators outlook bias 88% of ratings with stable outlook



Source: S&P Global Ratings.

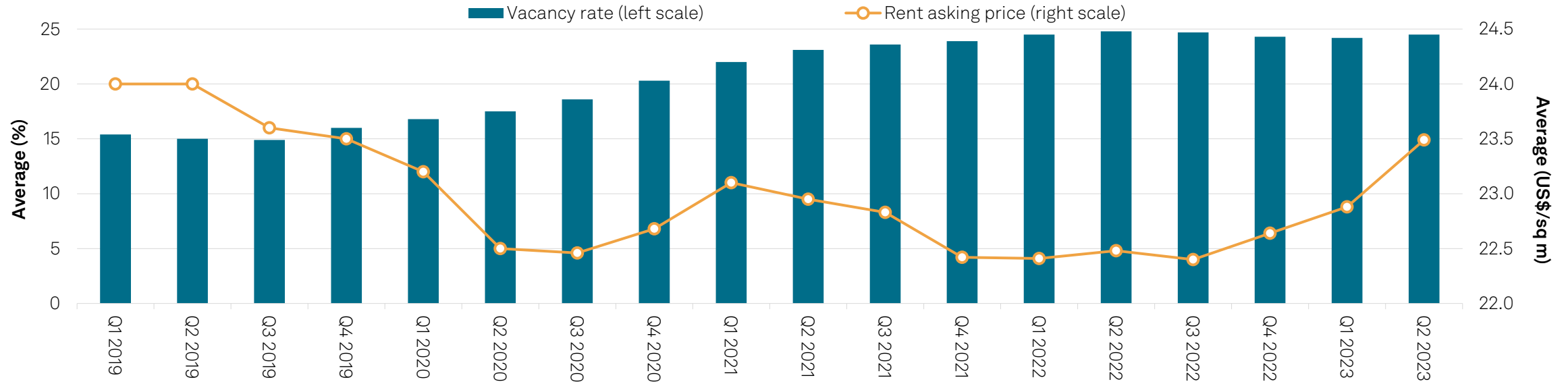
LatAm real estate operators rating distribution



Source: S&P Global Ratings.

Latin America | Mexico City Office Space A/A+ Properties Remains Under Pressure

- Hybrid work models and high inventory levels have kept vacancy rates near 24% over the past two years, close to 60% above pre-pandemic level.
- Vacancy rates were near 24.5% in Q2, incorporating new office space GLA supplied. We expect office space developer to slow down construction activity given still-high level of inventory and fragile demand overall, but moderate tailwinds could stem from job creation in the service sector, spurring demand.
- Leasing spreads shifted negative from flat on a real basis.
- We expect office landlords to increase capex and maintenance spending to retain existing tenants and attract new ones.
- Some cities in Mexico, like Monterrey, are showing early signs of recovery, driven by nearshoring and improving economic conditions, seen in gradual declines in vacancy rates. In Q2 2023, Monterrey office space had vacancy rates near 18% versus about 21.4% in Q2 2022.



Source: S&P Global Ratings.

Analytical Contacts

Primary Contact

Ana Lai

+1 (212) 438 6895

ana.lai@spglobal.com

Secondary Contacts

James M Manzi, CFA

+1 (202) 383 2028

james.manzi@spglobal.com

Stuart Plesser

+1 (212) 438 6870

stuart.plesser@spglobal.com

Carmi Margalit

+1 (212) 438 2281

carmi.margalit@spglobal.com

Gaurav A Parikh

+1 (212) 438 1131

gaurav.parikh@spglobal.com

Senay Dawit

+1 (212) 438 0132

senay.dawit@spglobal.com

Mathias Herzog

+49 693 399 9112

mathias.herzog@spglobal.com

Osman Sattar, FCA

+44 20 7176 7198

osman.sattar@spglobal.com

Felix Ejgel

+44 20 7176 6780

felix.ejgel@spglobal.com

Frank Delage

+33 14 420 6778

frank.delage@spglobal.com

Simon Wong

(65) 6239 6336

simon.wong@spglobal.com

Alexandre P Michel

+52 55 5081 4520

alexandre.michel@spglobal.com

Michael H Souers

+1 (212) 438 2508

michael.souers@spglobal.com

Research Contributor

Sumedha Chavan

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