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Silicon Valley Bank fallout spells additional trouble for commercial real estate industry

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Those interviewed by *The Business Journals* indicate a range of implications should be considered for commercial landlords, developers and investors, groups that've already faced challenges in recent months as the cost of financing has continued to rise and demand for space has weakened.

An economist with CBRE Group Inc. (NYSE: CBRE) wasn't made available for an interview by deadline. A written statement by Richard Barkham, global chief economist, head of global research and head of Americas research at CBRE, submitted to *The Business Journals* said SVB failed because of a business strategy that left it exposed to sharp and sudden increases in interest rates, and that most large U.S. banks are not in danger.

"This is different than the global financial crisis," Barkham wrote. "However, smaller banks, particularly those with a high proportion of lending to real estate, could be vulnerable."

The failure of SVB on March 10 — followed this week by New York-based Signature Bank and Silvergate Bank out of San Diego — came after it used short-term deposits to buy long-term bonds, when interest rates were at record lows before the Federal Reserve's more recent, and aggressive, interest-rate hikes to tame inflation.

But SVB customers — many of whom were in tech and innovation, a sector of the economy that's recently been under stress — increasingly sought to withdraw funds from the bank. To cover deposits, SVB sold bonds, the values on which had dropped significantly, thanks to higher interest rates. That triggered a run that culminated in federal regulators taking over the bank late last week, after the bank wasn't able to raise cash needed to cover the outflows.

Long-term investment products purchased by SVB included mortgage-backed securities, which are bundles of real estate loans and other debt.

Tougher access to loans

The most obvious implication for commercial real estate: lending access will become more difficult.

Banks typically capture or contribute to about 40% of total commercial real estate lending activity, according to Cushman & Wakefield PLC (NYSE: CWK), referencing data from MSCI Real Capital Analytics.

In an emailed response to questions, Abby Corbett, global head of investor insights at Cushman, said the liquidity situation at hand didn’t have to do with underlying credit liquidity issues. (A Cushman economist wasn't available by deadline for a phone interview.)

As for real estate groups, the best approach is to remain calm, Corbett said, and to recognize distinct differences in conditions today versus during the global financial crisis.

"Not only has the Fed stepped in rapidly to create a program to help banks address short-term liquidity issues, but the commercial banking system remains relatively liquid and well capitalized at the moment," Corbett said. "Banks’ risk-based capital ratios ... are still in good shape."

She added the recent events were also not brought on by a systemic or widespread credit crisis related to the default or underperformance of bank loan portfolios, although Cushman does expect more turbulence ahead. For the moment, though, the ramifications from SVB's failure will be tighter financial market conditions and heightened uncertainty on the path of the Fed, Corbett continued — both of which directly affect commercial real estate.

Unlike the 2008 global financial crisis and other recessions, real estate wasn't the cause of this meltdown but is going to bear the brunt of it, said Susan Wachter, Albert Sussman professor of real estate and professor of finance at The Wharton School at the University of Pennsylvania, and co-director at the Penn Institute for Urban Research. That's because regional and super-regional banks — the ones facing the most scrutiny right now — disproportionately lend into commercial real estate.

Banks weakened by the current crisis will see their growth curtained, Wachter continued, including their ability to lend to real estate.

"This will make it not only pricey to refinance and to get new loans, but it’s also ... going to restrict lending capacity just at a time when, for the soundest of the sectors, there needs to be access to lending," she said. "This is a process that will unfold over time, and the banks will lack the capacity to refinance and extend (loans) as they have through previous crises."

Seth Weissman, a partner at Jeffer Mangels Butler & Mitchell LLP in Los Angeles who specializes in real estate law, said any time the financial health of banks is put under a microscope, that tends to staunch lending in commercial real estate.

Banks will be relooking at real estate deals they’ve been in negotiations on — something that had already been happening for several months, thanks to inflation and higher interest rates. But the bank failures will exacerbate that scrutiny, Weissman said.

Ramifications for debt maturities

About $1.1 trillion in commercial mortgage loans are expected to mature in 2023 and 2024, up from $750 billion the prior two years, according to Cushman. This week's news is raising additional concerns about how those loans will get refinanced.

"A lot of people are asking the question 'what happens if,'" Weissman said. "(There are) a lot of questions about handing back the keys ... do the banks and lenders want the assets? Are they willing to work with the borrowers? Are we going to end up in a 2008 or 2010 situation with extend and pretend?"

The office market, already under pressure, is likely to face even more stress in the wake of the SVB meltdown. Wachter said so much new financing is needed to repurpose a huge amount of office real estate that's expected to hit the market in the next few years. But because lenders, and even equity sources, are tightening up, where that financing will come from is uncertain.

Corbett said lending conditions have already been already tight, and maturing loans face not only higher interest rates but also, depending on the sector, weakening net operating income conditions, making it that much harder to service their debt obligations.

"Unless owners, investors or the funds such properties are backed by can put up much more capital to reduce the loan balance enough to make the numbers work, then the owners can get themselves into a precarious position, either being forced to sell or being forced to look for outside debt or equity capital," she said.

But, Corbett continued, simply because a few banks have faced trouble doesn't inherently raise the risk of defaults at large.

Krystle Moore, principal and broker at San Diego-based real estate lender Pacific Shore Capital, said deals in the commercial real estate market have been at a standstill since late 2022, as pricing hasn't budged enough in response to rising interest rates. The concern now for real estate investors is whether any deals in the works are actually going to go through.

Other potential CRE impacts

Development, already having slowed in many markets, including San Diego, will likely be stymied further, Moore said.

"It was really halted because of rates but any lenders doing construction likely aren’t interested in it right now," she said. "No bank is looking to do a land loan for you, even if it is entitled."

Earlier this week, Moore said she had heard from clients wanting to pull funds out of banks identified as under stress, including San Francisco-based First Republic Bank. But most real estate owners and investors have been through financial crises before and, therefore, tend to work with a diverse mix of institutions, Moore added, including bigger banks that haven't been in the crosshairs this week.

Barkham said real estate capital values, which had already been falling, will be further pressured by an even more tightly constrained credit market. And, in a report issued Wednesday, Cushman said now is the toughest lending environment since the global financial crisis, except for 2020, when deal flow completely shut off at the onset of the Covid-19 pandemic.

In particular, the bank fallout will have ramifications for new construction. Most developers obtain construction loans from regional banks with which they have a longstanding relationship.

"When you talk about things like construction loans, the regional bank is the lifeblood of most developers," Weissman said.

Corbett said it's yet to be seen in the data whether, or how, construction loans will be affected by the recent bank issues, but said lending on new development has been relatively muted anyway, given the broader economy, higher construction costs and rising interest rates.

A number of commercial tenants are also backed by lines of credit from banks, some of which have included SVB. Especially for startup and growth-stage companies in industries like biotech, which typically don't have a long financial track record, letters or lines of credit are frequently used to secure deposits for leased space.

Weissman said the recent meltdown has prompted the question among landlords of whether those lines or letters should be replaced, or if companies will even be able to draw on those mechanisms.

Corbett said banks, broadly speaking, remain liquid and well-capitalized, and a widespread credit crisis isn't happening to undermine that liquidity. She added lines of credit should continue to be considered by owners, and are very common in times of uncertainty.

"Lending conditions may tighten, particularly in the very immediate term as the banking market reestablishes their footing after this shakeup, but the recent events have not fundamentally altered the overall conditions facing banks," Corbett said.

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