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CREFC Spotlights Debt Market Woes: Weak Demand, Defaults, Servicing

The rapid increase in interest rates has left the commercial mortgage market to deal with fallout that includes waning borrower demand, preference for different debt products, rising defaults, and the decreased appetite from commercial banks.

The sharp increase in interest rates starting in the spring of 2022 has left many loans underwater as property values decrease and borrowers are unable to pay off maturing loans without putting up extra cash. If mortgage rates stay at 6 percent or higher, more than one-third of CMBS loans maturing by year-end 2024 could not be fully refinanced without debt-service falling to dangerously low levels, according to an analysis by analytics firm Trepp.

"No matter how well loans are performing, takeout financing will be difficult," said one panelist at last week's CRE Finance Council's Annual Conference in New York. "You can't see (mortgage) rates shift from 2.5 percent to 8 percent and not see meaningful consequences," said another.

Transaction activity was fueled by low mortgage rates in recent years, with many properties acquired at 4 percent yields. But acquisition yields are rising in sympathy with higher mortgage rates, resulting in lower property values. According to the Green Street Commercial Property Price Index, commercial asset values are down 15 percent from the March 2022 peak, with office (-27 percent) and apartments (-21 percent) as the worst-performing property types.

Demand shrinks at high rates

Commercial mortgage volume is well down in 2023. CMBS volume through early June was \$13.2 billion, down 74 percent year-over-year, according to "Commercial Mortgage Alert." Transaction activity has plummeted by more than 50 percent, and many borrowers are trying to find ways to extend existing loans rather than take out new ones at current rates.

The Mortgage Bankers Association's originations index fell 56 percent in the first quarter of 2023 compared to the same period a year ago, and that number will probably get worse in coming quarters, as many commercial banks are cutting back on lending in wake of the failures of several regional banks in March. Other lenders—such as specialty finance, private equity and CMBS programs—have dry powder and are willing to fill in the gap.