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The 'Extend and Pretend' Real Estate Strategy Is Running Out of Time

Higher interest rates and soaring vacancies have brought the commercial property industry to the brink.

By Patrick Clark

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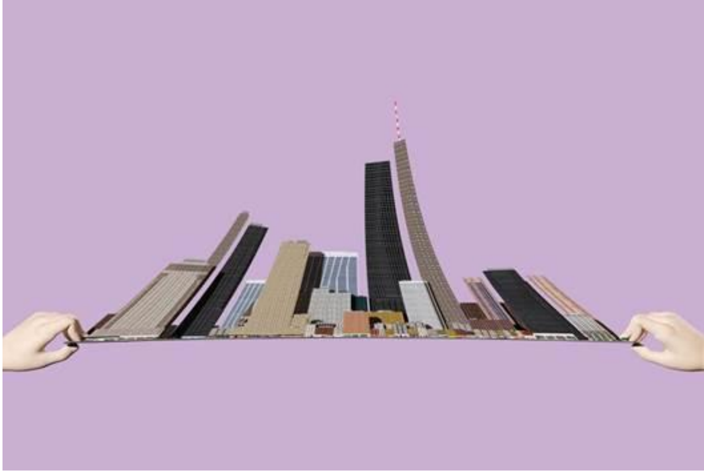
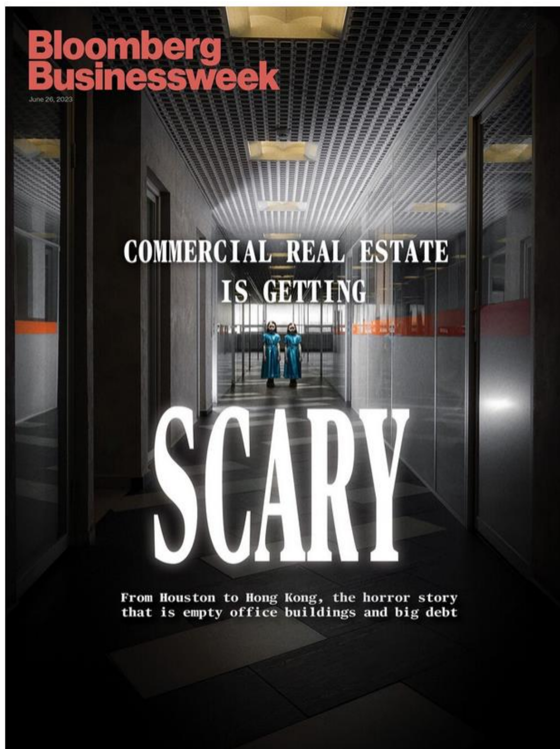


The high chieftains of real estate finance flocked to the Marriott Marquis in New York's Times Square in June at a precarious moment for their business. Commercial property transactions were stalled, squelching demand for new loans. And loans made during the mid-pandemic go-go days, when the world was high on government stimulus money, needed fixing. Yet many conferencegoers were upbeat, trading notes on a surprisingly resilient economy and the media's tendency to exaggerate the challenges. An after-party at Cipriani was "an absolute zoo," says Toby Cobb, a managing partner at lender 3650 REIT, as if the industry were operating at peaks last seen in 2006.

It's not that the market participants had forgotten the lessons of the global financial crisis that followed the 2000s boom. It's that they remembered them. Faced with delinquent loan payments, lenders decided to be patient: Instead of foreclosing on properties whose value was plummeting, they lengthened loan terms and ignored short-term valuations. They called it "extend and pretend," and it worked so well that when Covid-19 brought the global economy to a halt in March 2020, they turned to it again. A rolling loan, they said, gathers no loss.



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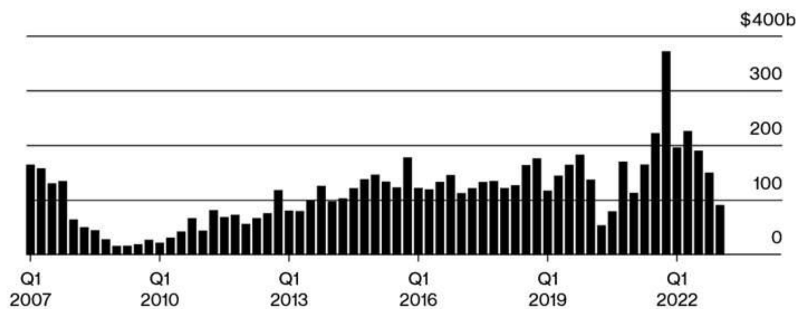
Yet in some quarters there are growing fears that this strategy might not work this time. The rapid increase in interest rates over the past year sucked air out of inflated valuations. As a result, landlords need to come up with more cash to offset the lower building value when they refinance their debt. At the same time, banks and insurers are under scrutiny from regulators and ratings companies over their real estate lending. And the pandemic accelerated changes to how people use offices, with uncertain implications for everything from downtown lunch spots to the tax revenue of major cities.

"The demand for commercial real estate debt is as big as I've seen in my career, but the supply is also more constrained than I have ever seen it," says Warren de Haan, a managing partner at Acore Capital, a commercial real estate lender with $20 billion under management. Landlords may be able to get loans, but at painful rates. "The problem is so big that there's going to be a decent subset of loans that can't be extended."

There's about $20 trillion worth of commercial property in the US, including offices, rental housing, warehouses and retail spaces, according to Keefe, Bruyette & Woods Inc. The crisis will affect each category differently. Lower-quality office buildings are headed the way of the lower-quality shopping mall: They're virtually unfinanceable and will likely remain that way until foreclosed properties are brought back to market at drastically lower prices. Other property types are in better shape, though owners who bought during the frothiest days of 2021 are in for a reckoning.

Commercial real estate values could fall 30% or more from peak to trough, says KBW analyst Jade Rahmani. This compares to a similar decline in the early 1990s, following the savings and loan crisis, as well as a 40% decrease after the global financial crisis.

US Commercial Property Deal Value



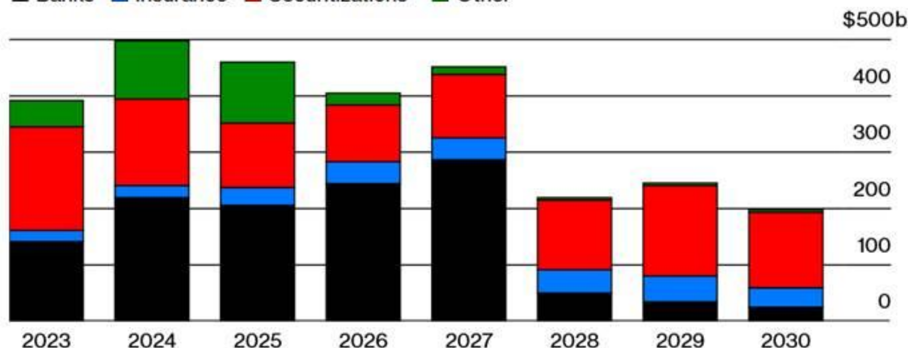
Falling values are only part of the problem. About $1.3 trillion worth of commercial real estate loans will come due by the end of 2025, according to MSCI Real Assets. Most borrowers will need new loans to pay off their old ones, and lenders are being much more careful than they were a few years ago. In the worst-case scenario, borrowers can't refinance, banks report losses and—in a repeat of what happened at Silicon Valley Bank and First Republic in the spring—nervous depositors start pulling their money out, sending banks to the edge.

Real estate is cyclical. Building a skyscraper typically takes years, and a lot can happen from the time a developer puts capital at risk to when the property starts generating returns. Higher inflation can enhance the performance of real estate investments, because it helps landlords raise rents while debt costs stay fixed. But periods of easy lending tend to sow the seeds of future distress.

In the 1980s, higher interest rates pushed small lenders to make risky loans in hopes of generating the returns they needed to retain deposits, and new tax rules inflated values—until another set of tax changes deflated them. Fifteen years later, Wall Street went all in on securitizations, chopping up loans into pieces and packaging them to create securities that could be sold to investors—supposedly spreading out and limiting the risk to any one loan defaulting. In both cases, a reckless pursuit of profit exploded into a financial crisis.

This time the root cause is different. Regulations put in place following the global financial crisis sought to curb Wall Street's risk-taking. At the same time, 15 years of ultralow interest rates increased demand for the relatively safe, higher-yielding investments available in commercial real estate.

Maturing US Commercial Property Loans



Then the pandemic hit in March 2020, and commercial real estate suddenly lost its status as a low-risk investment. Social distancing measures sapped consumer demand at retail shops, restaurants and hotels. Mass furloughs followed, raising fears that millions of Americans would struggle to pay rent, and financiers worried that mall owners, hoteliers and apartment landlords would miss debt payments.

Policymakers acted to defuse that crisis, authorizing huge stimulus spending and lowering interest rates even further. Flush consumers started new households and shopped more online,

Lenders have seized office buildings such as the former Denver Energy Center, seen here in April 2022. *Photographer: Thomas Gounley/BusinessDen*

sending rents for apartments and e-commerce warehouses soaring. From March 2020 to July 2022, property values surged 30% in the US, where buildings representing three-fifths of the world's $33 trillion in real estate assets are located. "It felt like we were dealing with a very fit athlete who had a heart attack and six weeks later was running marathons again," says Acore Capital's de Haan.

But the moves that averted the first crisis set the stage for the current one. Higher housing costs and increased consumer spending helped push inflation to levels not seen in four decades. In response the Federal Reserve reversed course and started rapidly raising rates. Higher borrowing costs slammed the real estate market to a halt, with sellers demanding the same exorbitant prices established during the pandemic boom and buyers arguing that increased mortgage rates meant prices had to come down.

Commercial mortgages function differently from the 30-year fixed-rate loans that form the bedrock of the US housing market. Investors borrow for shorter periods and structure loans with large balloon payments at the end. They're designed to be refinanced, and if they aren't, the owner FedExes the keys back to the lender. By the end of last year, the industry was bracing for jingle mail.

Cracks began to show in late 2022, when investors started to take their money out of real estate investing vehicles run by Blackstone Inc. and Starwood Capital Group. Brookfield Asset Management, one of the world's largest property owners, said it was struggling to refinance some Los Angeles offices, risking foreclosure. Even Sun Belt apartment buildings were showing some weakness, and Wall Street was paying attention. A March report from KBW warned there'd be "no soft landing for commercial real estate." It was among the most read research reports in the company's history.

The US economy is strong, with consumers keeping demand high for rental housing and e-commerce warehouses. Some nonbank lenders are finding that not only can they impose higher interest rates, but they can also be choosy about which properties they back. Other investors are planning to profit by scooping up distressed properties at cheap prices, in the manner of the recently deceased real estate magnate Sam Zell. His thesis was that an adept manager could position a building to benefit from the next runup in rents. Optimists say investors have plenty of cash available for bargain-hunting.

But skill alone won't be enough to work through the biggest issue facing commercial real estate today: the strain on banks. Regional and community banks hold about $2.3 trillion in commercial real estate debt, according to Moody's Investors Service. Many of these smaller lenders are already facing a crunch thanks to the effect of fast-rising rates. One risk is that banks trying to cut their real estate exposure will have to offload their loans at significant discounts—even if the loans are not in trouble, they were made when rates were low, so a buyer wouldn't touch them without a discount. This could initiate a vicious cycle in which banks mark down the value of their loans and investors punish them for it, putting the banks under even more pressure.

Some 500 to 1,000 smaller banks could disappear because of insolvency or consolidation, says Scott Rechler, chief executive officer of real estate giant RXR and a Federal Reserve Bank of New York board member.

Gavriel Kahane, a managing partner at Arkhouse Fund, spoke on Zoom on a day when Canadian wildfires were encasing New York City in an orange gloom. He has some of the same views as the more bullish lenders at the real estate finance

conference: Even the worst office building could find tenant demand at the right rent. Buildings financed during pandemic peak values faced challenges, but most loans originated earlier have benefited from a runup in value.

“Everything is shrouded in smoke today. It’s super eerie, almost as if the buildings are on fire,” Kahane says. But the smoke would eventually clear. Probably. If lenders can hold on long enough for borrowers to find their next mortgage. The problem comes when lenders are forced to realize current values. In other words, when they stop pretending and can’t keep extending. “What happens then is really scary,” he says.