

A photograph of a blue industrial building with yellow metal stairs and railings. The image is used as a background for the document.

February 20, 2025

Global Credit Weekly:

The (ongoing) CRE
recovery

BlackRock®

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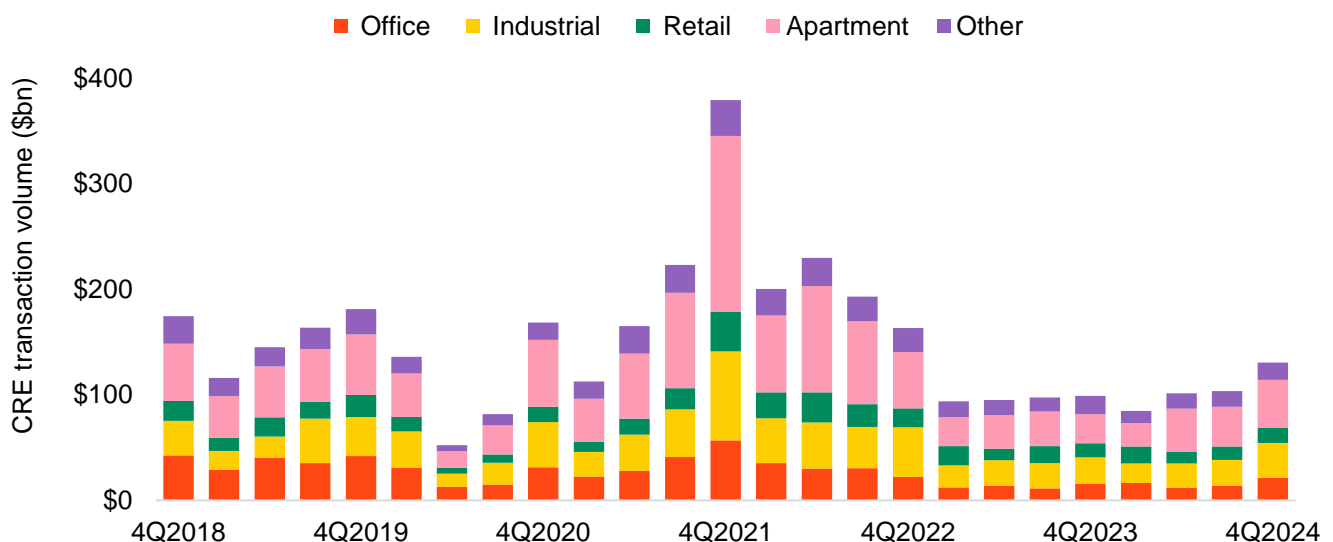
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Key takeaways

- Over the past few quarters, market participants have been closely monitoring pockets of the commercial real estate (CRE) universe – namely, office – for signs of a trough in property values. In this *Global Credit Weekly*, we provide a temperature check on CRE's ongoing recovery.
- The most recent data illustrate a modest pickup in transaction volumes and continued stabilization in property prices among many categories – including office. We see scope for an additional rebound in aggregate CRE transaction volumes in 2025, driven by (1) incremental clarity on the macroeconomic landscape (i.e., confidence of avoiding a U.S. recession), (2) increased acceptance of structurally higher interest rates, and (3) further normalization of post-pandemic disruptions. Transactions are necessary, in our view, to provide the price discovery “clearing levels” in the most challenged segments of the market.
- That said, significant dispersion *across and within* CRE categories remains. Office is an example of this: while Class A properties have been relatively insulated from the myriad of headwinds (excess supply due to structural shifts in office usage, higher rates, tighter lending standards), additional “lumpy” and “embedded” losses are expected as Class B and C properties work their way through the system. Indeed, while the *rate of growth* in distressed CRE is slowing, an abundance of loan modifications in recent quarters suggests the full extent of the CRE distress cycle has yet to be seen.
- Finally, we also document a potential “regime shift” in the investor approach to CRE. Increased acceptance of a structurally higher interest rate backdrop has seemingly encouraged investors to focus on fundamental asset-level performance, such as income generation and potential for income (i.e., rent) *growth* when underwriting. This compares to the historical focus on property price appreciation due to yield compression (and mirrors a similar trend in corporate credit).

Exhibit 1: 4Q2024 CRE transaction volume had the highest Q-o-Q growth rate since 4Q2021
U.S. CRE transaction volume by property type, in \$ billions



Source: Real Capital Analytics, BlackRock. Captures data through 4Q2024. Other include hotels, development sites, and senior housing & care. Q-o-Q is quarter-over-quarter.

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A temperature check: The (ongoing) CRE recovery

Over the past few quarters, market participants have been closely monitoring pockets of the commercial real estate (CRE) universe – namely, office – for signs of a trough in property values. Due to their unique positioning, office properties have been impacted by overlapping headwinds, including structurally higher U.S. interest rates, post-pandemic shifts in property usage, and tight (albeit moderating) bank lending standards.

While these headwinds are formidable, resilient U.S. economic activity has been an important mitigating factor, given CRE's cyclical nature and sensitivity to job creation (across multiple sectors). In aggregate, CRE has shown signs of a modest recovery in recent months, including a pickup in transaction volumes and continued stabilization in property prices across many categories. Encouragingly, even office properties have experienced this, though to a lesser degree than other property types.

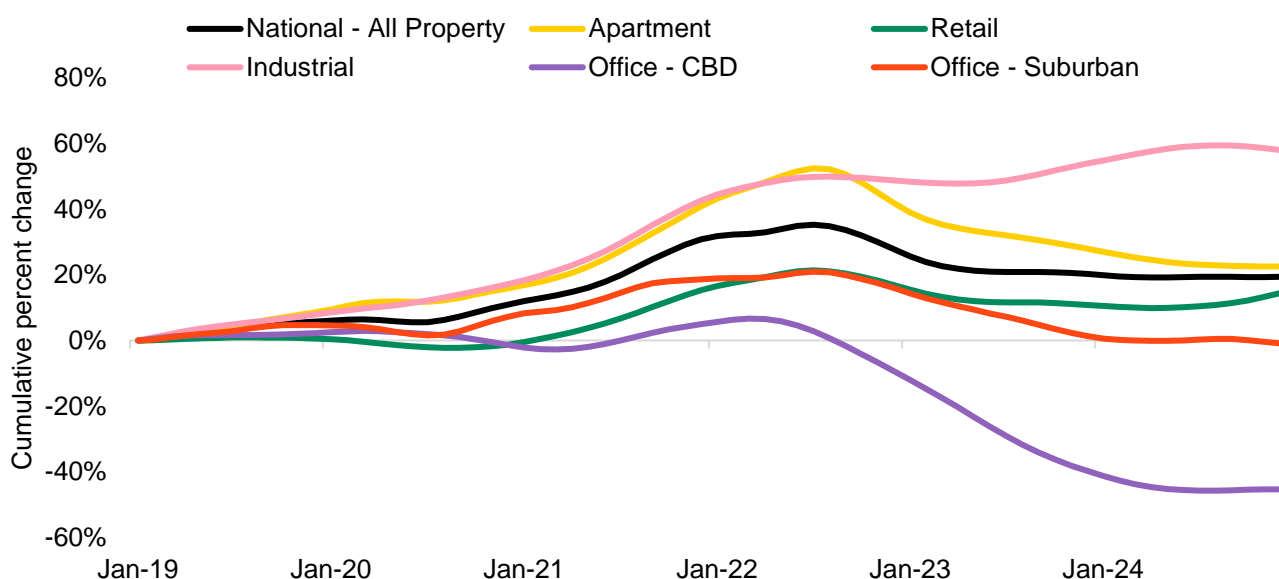
We expect the economic backdrop will support a further recovery in CRE transaction volumes in 2025. Indeed, the recent price stability (Exhibit 2) and the modest uptick in 4Q2024 transaction volumes (Exhibit 3) suggest that, in aggregate, expectations between buyers and sellers are becoming more aligned. We believe this is a function of (1) incremental clarity on the macroeconomic landscape (i.e., confidence of avoiding a U.S. recession), (2) increased acceptance of structurally higher interest rates, and (3) further normalization of post-pandemic disruptions (such as return-to-office mandates).

That said, there continues to be notable dispersion across property types. For example, central business district (CBD) office properties have somewhat lagged other property types in price stabilization and transaction activity recovery (relative to pre-pandemic levels), suggesting that further price discovery may be required to establish buyer and seller alignment within the sector.

Additionally, dispersion *within* CBD office properties also persists. The strong fundamentals of Class A office properties have provided some insulation from the broader office stress, with anecdotes of property owners receiving attractive prices and refinancing terms for these newer, high-quality office locations. Meanwhile, our analysis of recent U.S. bank sector earning calls suggests that additional “lumpy” losses in office (especially Class B and C properties) are expected due to “weak” fundamentals (such as high vacancy rates) and excess supply, albeit with significant regional dispersion. This underscores the importance of nuance when evaluating CRE performance, in our view.

Exhibit 2: Pricing changes have stabilized for most U.S. CRE sectors

Cumulative percent change in the level of the Real Capital Analytics Commercial Property Price Indices (RCA CPPI), since January 2019



Source: Real Capital Analytics Commercial Property Price Indices National All-Property Index, BlackRock. Captures data through December 31, 2024. The figures shown relate to past performance. **Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs, or expenses.** Indices are unmanaged and one cannot invest directly in an index.

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A regime shift in CRE investing: Investor focus shifts to income

Increased acceptance of a structurally higher interest rate backdrop has encouraged investors to focus on fundamental asset-level performance, such as income generation and potential for income (i.e., rent) *growth* when underwriting an investment, per a recent MSCI Real Capital Analytics (RCA) analysis.

For context, in much of the post-financial crisis era, capital market tailwinds often supported underwriting focused on property *price appreciation* (i.e., yield compression). This assumed that property values would increase over the investment timeline and an investor could exit at a higher valuation.

As higher interest rates have acted as a headwind to asset values, however, investors are increasingly focused on a property's underlying income generation trends during the investment process. (That said, some market participants have highlighted challenges to *sustaining* the recent pace of rent *growth*, underscoring the importance of credit selection and property characteristics).

We've seen a similar shift in focus among investors in corporate credit, who are attracted to an elevated all-in yield opportunity – even though credit spreads likely leave only minimal scope for absolute tightening from existing levels. In other words, we currently recommend allocating to corporate credit for the income generation and carry opportunity, and not because we expect a total return “boost” from materially tighter spreads or a notable decline in interest rates.

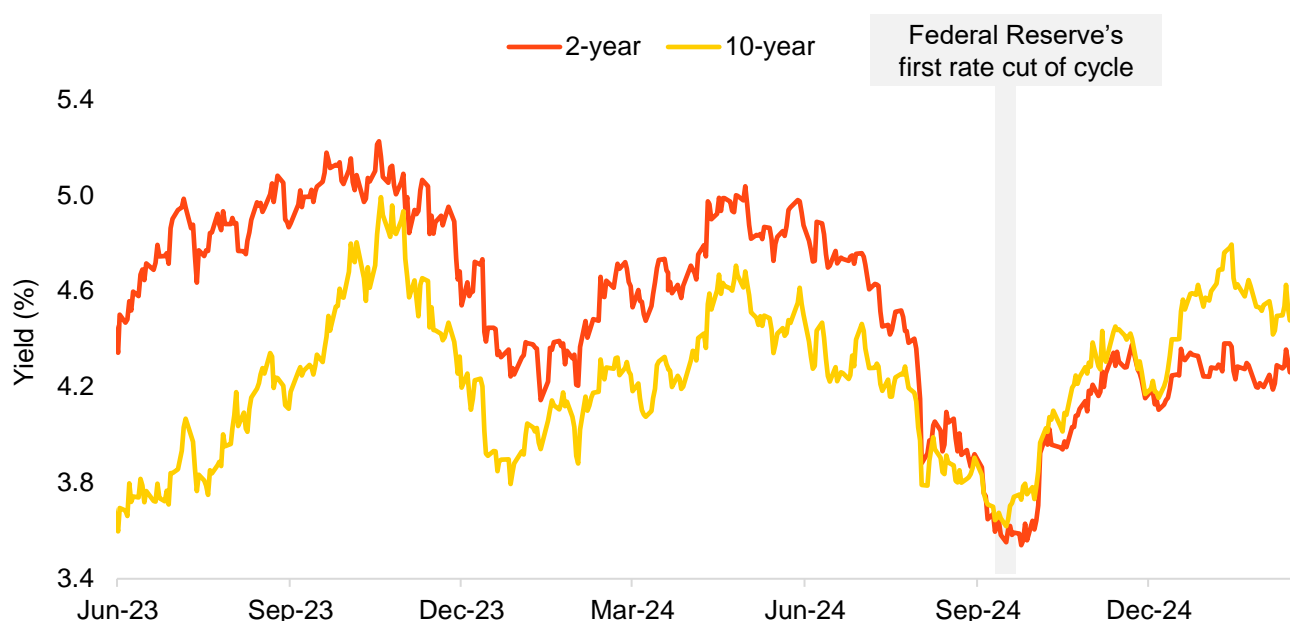
Interest rate exposure for CRE borrowers is also nuanced, which can result in diverging fundamental impacts across the asset class. For example, floating-rate CRE borrowers (absent any hedges) will have debt servicing exposure to the Secured Overnight Financing Rate (SOFR), which generally moves in line with the Federal Funds rate. As such, many floating rate borrowers have benefited from the Federal Reserve's (Fed) 100 basis points of rate cuts since September 2024 (even though rates are still elevated).

By contrast, fixed-rate CRE debt is often tied to the 10-year U.S. Treasury. Exhibit 3 demonstrates how U.S. Treasury yields have *increased* since the Fed began its rate cutting cycle – especially at the longer-end – owing in part to an increase in term premia and heightened focus on the U.S. deficit.

We expect investors will continue focusing on fundamental asset-level performance – especially for categories such as office, where market attention is centered on a bottom in pricing and identification of a “clearing level” – rather than scope for significant price appreciation. And as we have highlighted, dispersion *across and within* property types underscores the importance of active asset selection and management.

Exhibit 3: Long-end U.S. Treasury yields have *increased* since the Fed started cutting rates

Yield-to-worst of the 2-year and 10-year U.S. Treasuries (on-the-run securities, mid levels)



Source: Bloomberg, BlackRock. As of February 19, 2025.

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The road ahead for distressed CRE

The aggregate amount of distressed CRE outstanding continued to grow in 4Q2024 (per RCA), albeit at a more moderate pace – extending the trend in place since late 2023. While somewhat encouraging, it nonetheless suggests that the *full* extent of the CRE distress cycle has yet to be seen.

Related to the topic of distressed CRE, in [November](#), we discussed banks' willingness to work with CRE borrowers, including by extending loans. This was happening, in our view, because distressed sales can create sub-optimal outcomes for both the borrower and the lender. As a result, both parties are often incentivized to conduct loan modifications in an attempt to maximize principal recovery.

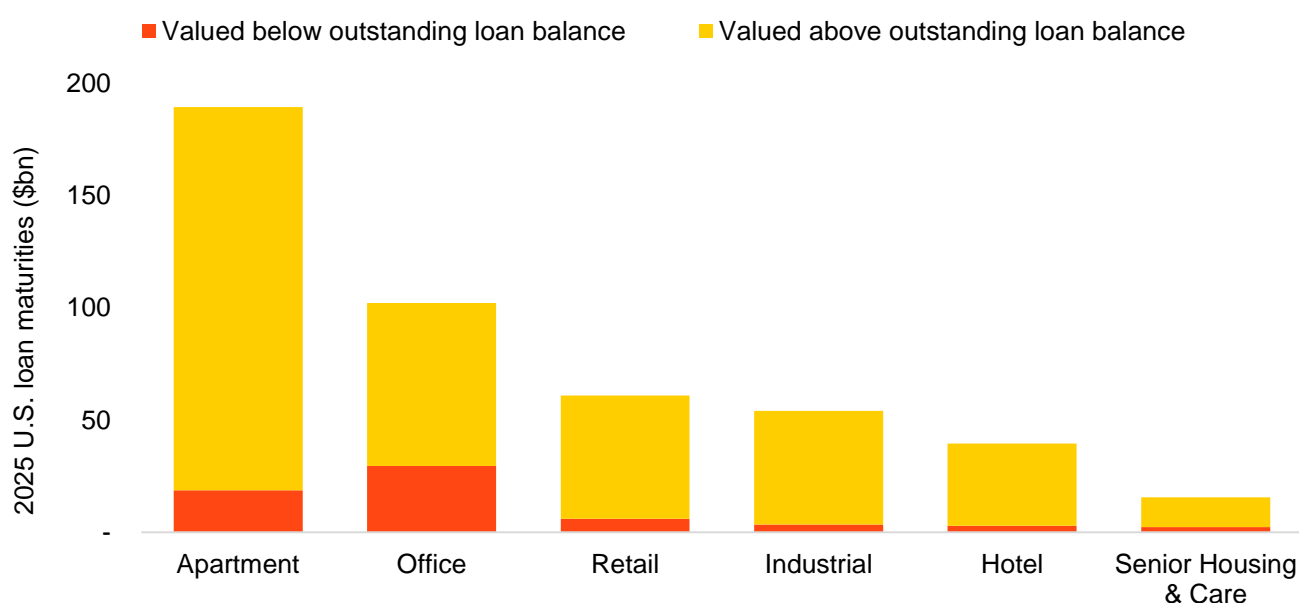
RCA estimated that, as of September 2024, \$397 billion of U.S. CRE loans that were set to mature in 2023 and 1H2024 had been extended, with banks representing the largest holders of these loans. Further, \$360 billion and \$480 billion of loans were expected to mature in 2H2024 and 2025, respectively. A January 2025 Green Street analysis, using CMBS data, found that loan modifications are near decade highs (driven by office, retail and lodging). And Goldman Sachs Research recently noted that rising CMBS delinquencies have not necessarily translated into rising foreclosures. These two trends suggest ongoing collaboration between lenders and asset owners, further reinforcing the extensions trend.

That said, [expectations](#) of the forward path for rates evolved meaningfully during 2024 (when many of these loan modifications were presumably completed), which may temper optimism around the effectiveness of such actions (as a “bridge” to a more favorable macro / interest rate backdrop). Indeed, Fed Chair Jerome Powell’s comments during his [February 2025 Congressional testimony](#) indicated that “there are a lot of embedded losses...that need to be realized” by U.S. banks in CRE but “it doesn’t seem to be betting worse”. Chair Powell said the Fed is working with financial institutions to make sure they understand their potential losses and “have a plan” to manage them.

RCA estimates that nearly 14%, or \$63 billion, of U.S. CRE loan value set to mature in 2025 is “underwater,” meaning the outstanding loan balance is higher than the current asset value (Exhibit 4). Office properties represent the most troubled segment, with 30% of maturing loans below outstanding loan values, again underscoring the importance of active asset selection and management. Looking ahead, absent a material change in the macroeconomic backdrop (such as a steep non-recessionary decline in interest rates), we see scope for these extensions to continue.

Exhibit 4: An estimated 14% of CRE loan value maturing in 2025 is “underwater”

U.S. 2025 CRE loan maturities across property types; split by the value of maturing loans for assets above or below their outstanding loan balance



Source: MSCI Mortgage Debt Intelligence, Real Capital Analytics, BlackRock. Loans outstanding as of 3Q2024. Includes loans maturing in 2025 that were originated prior to 3Q2024. Data as of December 6, 2024.

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