IACPM 2024 Annual Spring Conference

May 16th, 2024

Smart CPM Techniques to Navigate Commercial Real Estate Shifts

www.iacpm.org

Speakers for today's session

Ryan Luby
Associate Partner, New York

Ryan leads McKinsey's work at the intersection of macro and real estate

Filippo Mazzetto
Associate Partner, Milan

Filippo supported banks and investors in innovation in the Credit Portfolio Management and Real Estate strategy

Key Messages

1. A new world for CRE lending
2. Implications and first reactions by Banks and investors in the world
3. Sizing the opportunities: smart CPM techniques now and looking forward

IACPM

Appendix includes client studies and macro scenarios with effects on growth and interest rates

Globally, asset and loan fundamentals frame a difficult decade ahead for CRE

3.7x Increase in Office delinquencies YoY in 2023

40% Share of loans maturing in 2024-25 originally underwritten at rock-bottom rates (2021-22)

14% Of all bank-held CRE is "underwater"

"Commercial real estate investors risk painful losses in post-COVID world"

"Germany's Slow-Motion Property Crash Is a Looming Risk for Banks"

"US regional banks tumble for second straight day on NYCB woes"

The Financial Stability Oversight Board listed CRE first in their list of top risks for 2024

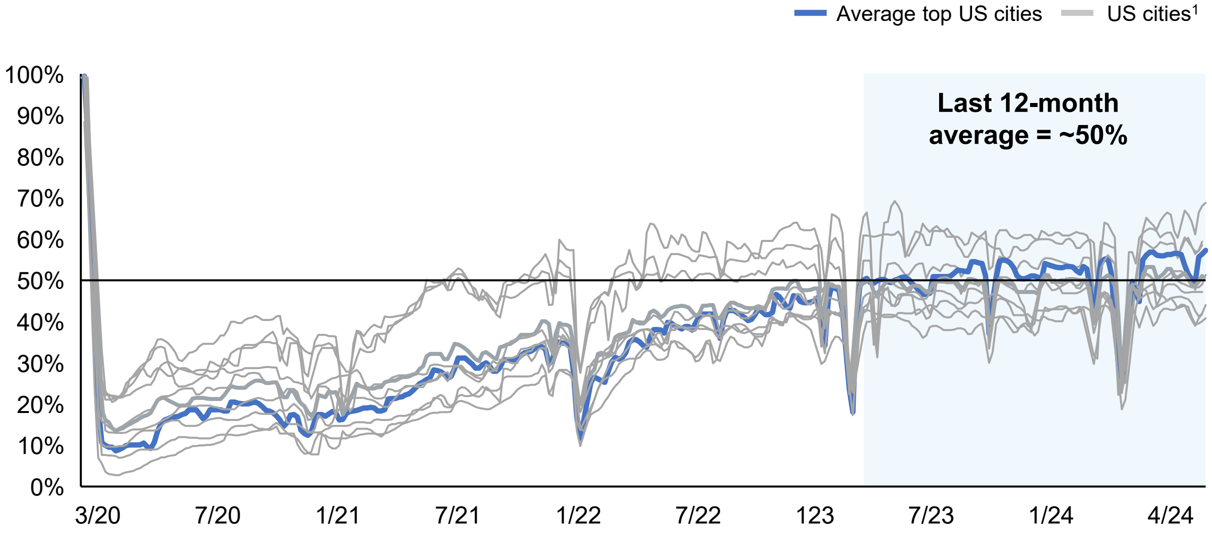
IACPM

Sources: Bloomberg, Reuters, FSOC annual report

Office attendance in the post-pandemic world of flexible work has stabilized…

Office attendance over time

(March 4, 2020 to April 17, 2024), indexed to 100



…and is here to stay

Flexible work is here to stay

87% of workers given the option to work remotely take their employers up on that offer[2]

38% of workers say that flexibility is why they stay in their job or take a new job[3]

53% of leaders say that they expect remote work to increase in the future[4]

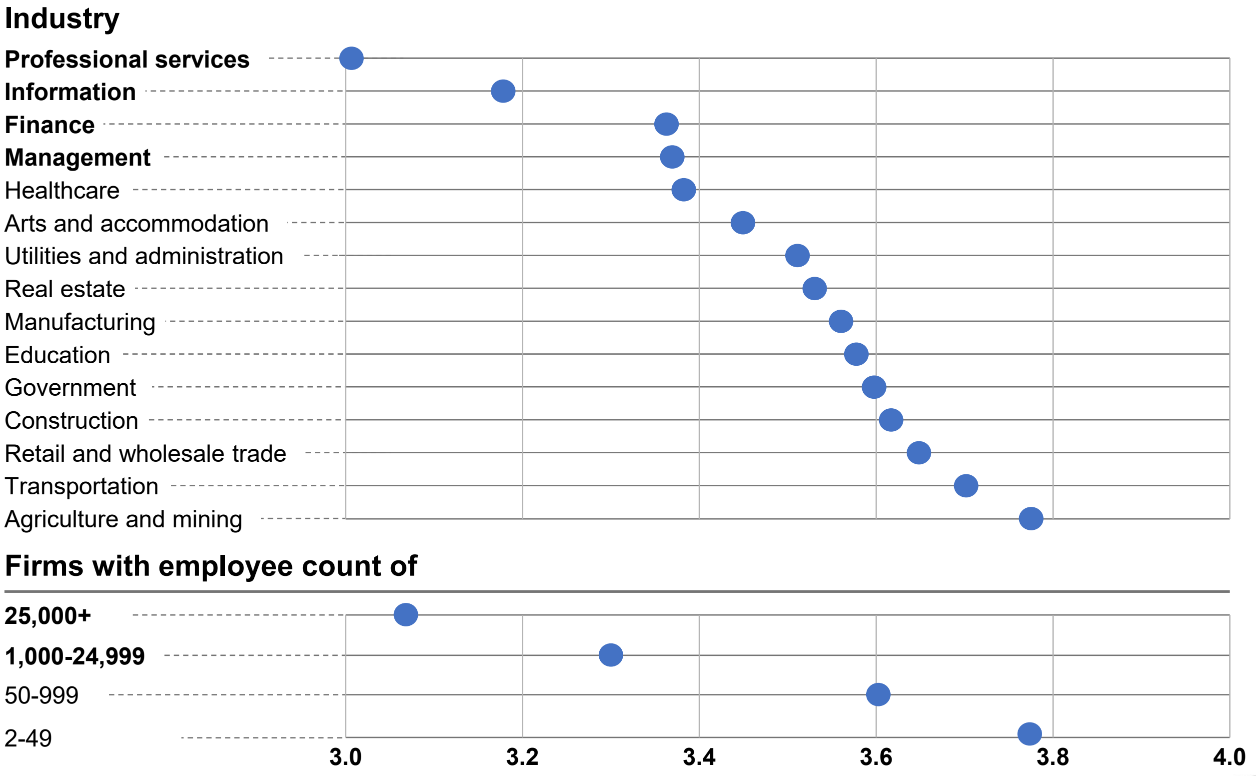
3.2 ideal number of days per week worked in the office on average across superstar cities[5]

1. Chicago, Los Angeles, DC, NYC, SF, Dallas, San Jose, Austin | 2. McKinsey American Opportunity Survey, March-April 2022 (n=25,062 US adults) | 3. McKinsey Talent Trends internal analysis, Jan 2023, n=15,366 (working adults, across 7 countries) | 4. McKinsey State of Organizations Survey, May-June 2022 (subsection, n=566) | 5. McKinsey Global Institute Real Estate Survey, Oct-Nov 2022 (n=~13,000 full-time office workers across 6 countries)

Source: Kastle, McKinsey Global Institute

Office attendance is lower in large firms and the knowledge economy

Reported number of days per week worked in the office[1]

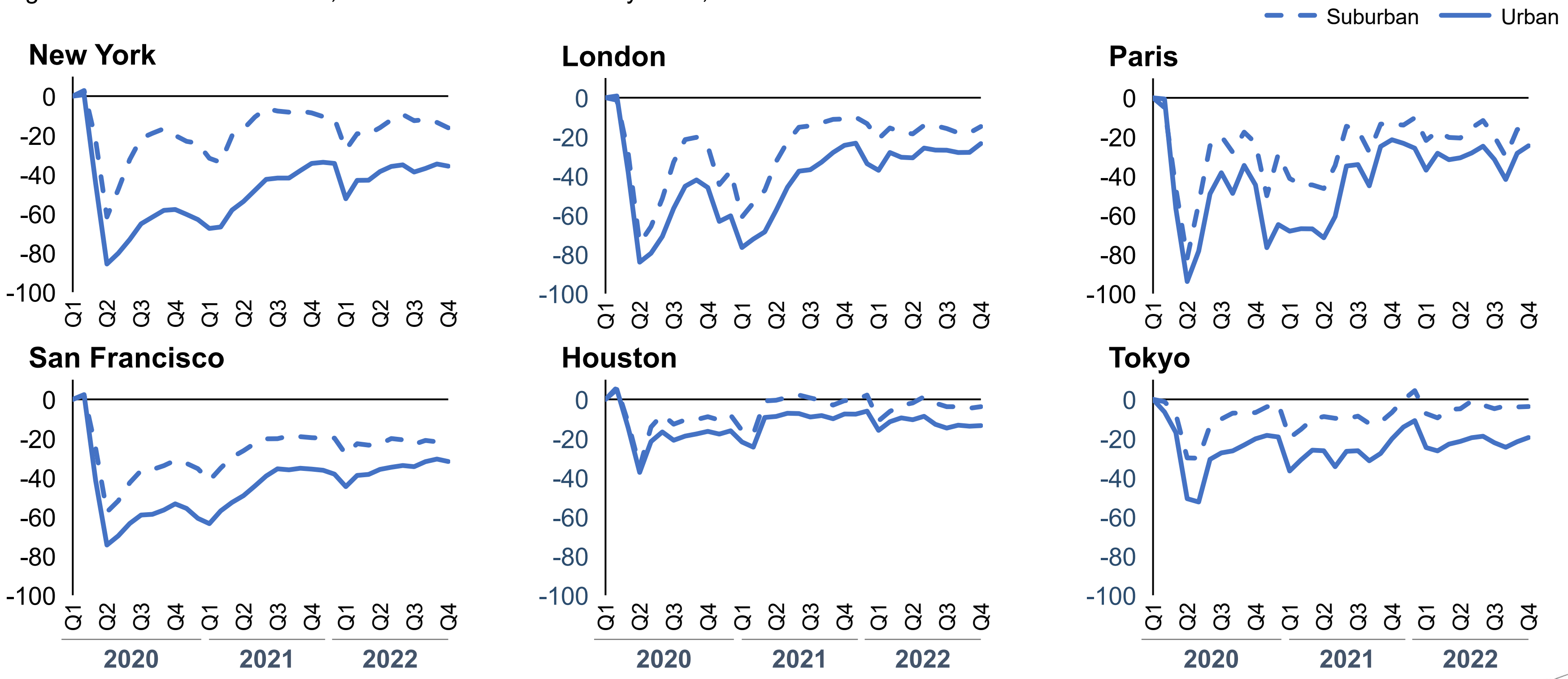


1. Survey conducted between July-October 2022. N = 12,989 respondents

Sources: MGI's Future of real estate employee survey

Foot traffic near stores is recovering more quickly in the suburbs than in urban cores

Change in foot traffic near stores, indexed to zero in January 2020, %[1]

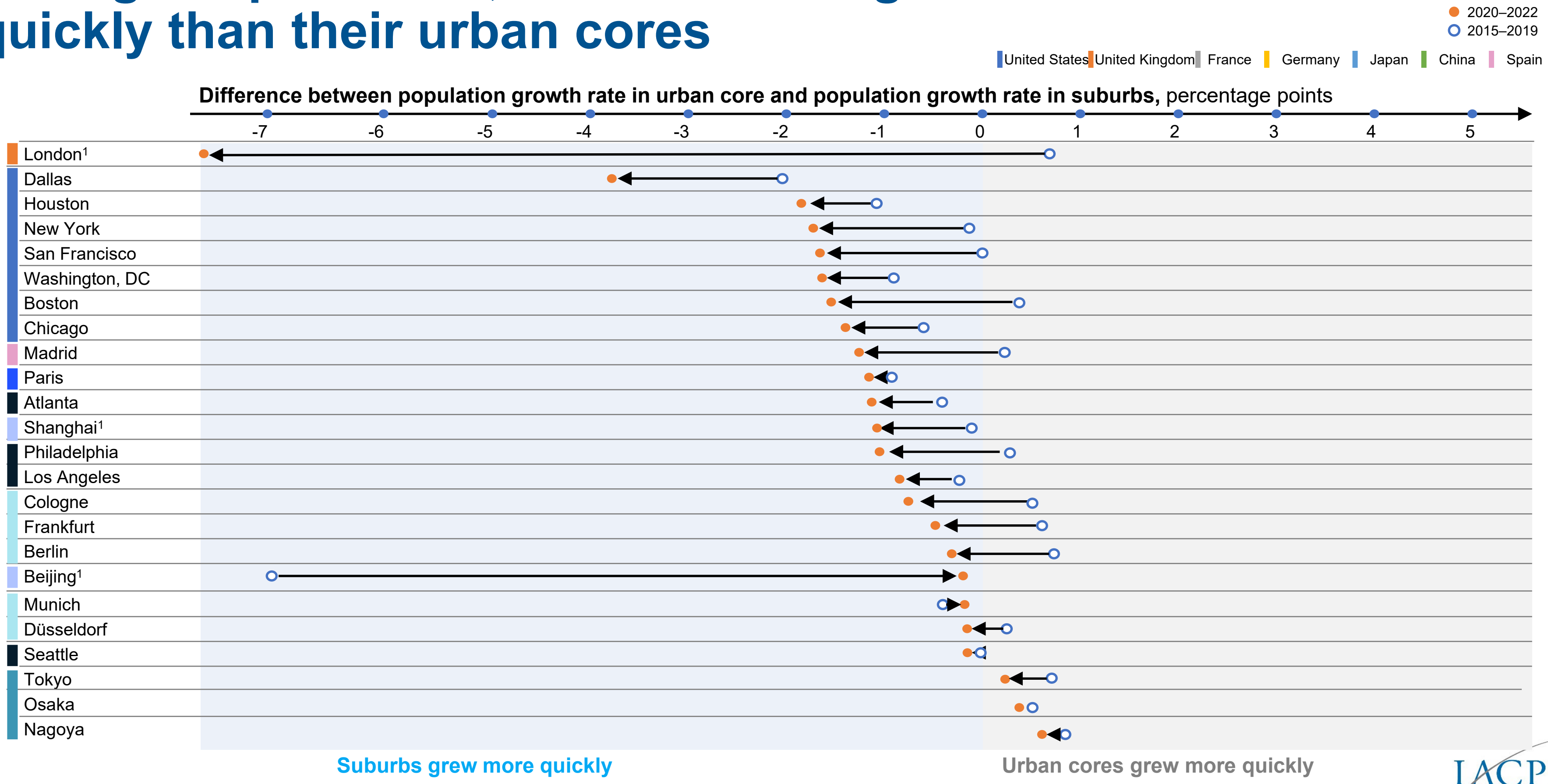


Note: In this exhibit, the cities are defined as follows: the New York–Newark–Jersey City metropolitan statistical area (MSA); the Greater London area; Île de France; the San Francisco–Oakland–Hayward MSA; the Houston–The Woodlands–Sugar Land MSA; and the Kanto Region (Tokyo).

1. Stores include retail and recreation locations but not grocery stores or pharmacies.

Source: Google's Community Mobility Reports; McKinsey Global Institute analysis

During the pandemic, most suburbs grew more quickly than their urban cores



1. Data for 2022 were not available yet, so the change labeled "2020–2022" actually shows the change from 2020 to 2021.

Sources: Beijing Municipal Bureau of Statistics; Eurostat; National Institute of Statistics and Economic Studies (France); National Statistics Institute (Spain); E-Stat (Japan); Office for National Statistics (United Kingdom); Shanghai Municipal Bureau of Statistics; US Census Bureau; McKinsey Global Institute analysis

Behavior changes impact all CRE asset classes

Modeled change in floorspace demand 2019-30 (projected); %; Moderate scenario; ceteris paribus assumptions with no price elasticity effects

XX Net impact % | Baseline ex-pandemic | Pandemic impact

City	Where we work[1]: Baseline ex-pandemic	Where we work[1]: Pandemic impact	Where we work[1]: Net impact %	Where we live (impact on urban core)[2]: Baseline ex-pandemic	Where we live (impact on urban core)[2]: Pandemic impact	Where we live (impact on urban core)[2]: Net impact %	Where we shop (impact on urban core): Baseline ex-pandemic	Where we shop (impact on urban core): Pandemic impact	Where we shop (impact on urban core): Net impact %
London	5	-16	-11	15	-9	6	-14	-8	-22
Paris	-5	-8	-13	-3	0	-4	-9	0	-9
Munich	-6	-10	-16	9	0	8	-1	-2	-4
NYC	2	-18	-16	14	-8	6	-3	-11	-14
SF	2	-23	-20	8	-10	-2	-4	-13	-17
Shanghai	-9	-5	-14	4	-1	3	10	-9	1
Tokyo	-2	-7	-9	13	-1	12	0	-2	-2
Beijing	10	-9	2	5	0	5	-2	-8	-9

What we are seeing to date[4]

19.2%

U.S. office vacancy rate (highest ever other than 2008 Crisis)

2x

Year-over-year increase in projected 2024 Multifamily CMBS delinquency rate (1.3% vs.62% in 2023)

8.5%

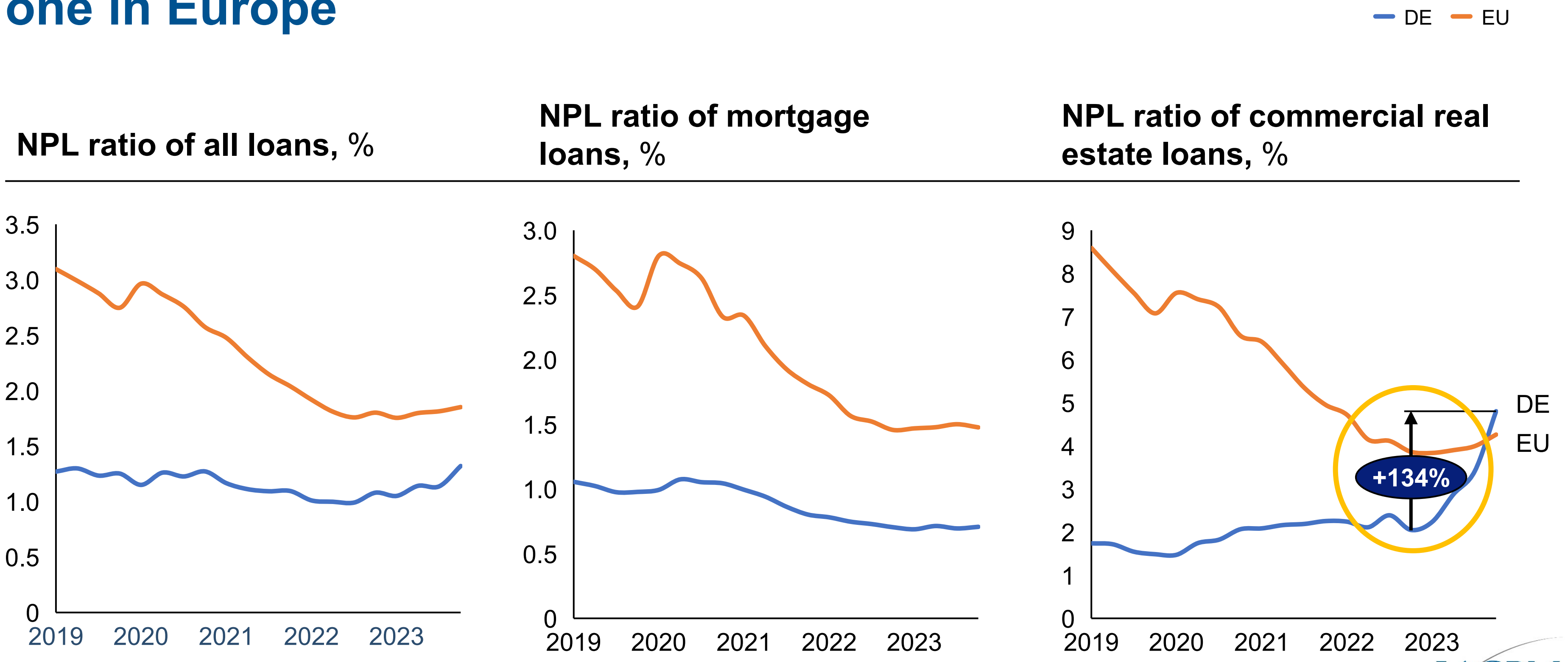
Mall vacancy rate at end of 2023[3] (compared to non-shopping mall centers at 4.9%)

1.Defined by real estate market, depending on reporting geography | 2. Residential floorspace demand is highly price elastic, so this shift in demand will likely lead to a rebalancing of prices rather than an actual reduction in demand in the longer-run | 3. The same rate in 2008 was 7.5%, which itself was a high point compared to the prior 15 years | 4. Data was pulled week of Feb 12th, 2024

IACPM

Source: US Census, American Community, CoStar, MGI Future of Real Estate survey, BLS, Kastle

Defaults are already visible in CRE, especially in some countries – Germany being the most impacted one in Europe



Market trends are reshaping the landscape for CRE lending

From …	… to
Strong asset fundamentals, with steady NOI growth of 4.5% annually across asset classes over the last ~10 years[1], despite spots of weakness (e.g., malls)	**Generational shift in how residents and tenants use space,** driven by hybrid work (e.g., 5-40% decrease in office demand)
15-year "experiment" in near-zero interest rates resulting in nearly 10 consecutive years of cap rate compression[2] buoying real estate valuations	**Higher-for-longer interest rate environment,** resulting in ~15% of all CRE loans on bank balance sheets "under water" and decreased capacity for new lending activity
Widespread chase for yield and high share of deposits in illiquid hold-to-maturity securities (e.g., loans, government bonds)	**Regulatory and depositor scrutiny on bank balance sheets** following the failure of SVB (particularly among regional banks)
Regulatory framework (Basel II) that introduced risk-weighted assets and differentiated capital requirements based on risk profiles, incentivizing more sophisticated risk assessment strategies	**Impending regulatory changes (Basel III)** that increase required capital on hand by ~15-20% due to introduction of additional capital buffers, liquidity standards, and leverage ratios

1. Period from 2014-2023, barring 1-year dip in 2021
2. 2010-2021, barring 1-year jump from 5.6% to 5.7% in 2017

IACPM

In the coming years, succeeding in CRE will require an evolved set of capabilities

Context

Evolving tenant demands across residential and commercial real estate

Sticky inflation driven by shift in rate expectations and structurally tight labor markets

Hyperlocal variation in **performance** linked to historically unobserved data

Implications

Imperative of **operating excellence**

Flexibility of operating model, deal structure, and capital partnerships (e.g., space allocation, lease terms, risk transfers)

Capability to capitalize on **"hyperlocal" nuances** across geography and asset classes

IACPM

Key Messages

1. A new world for CRE lending
2. Implications and first reactions by Banks and investors in the world
3. Sizing the opportunities: smart CPM techniques now and looking forward

IACPM

In this context, Banks are deploying a wide set of strategies

Defense

No-regret moves to protect the bank's credit book from NPL losses, preserve capital and safeguard organization's financial stability

A. **Holistic Capital Optimization, Allocation & derisking strategy:** structurally assess value creation of its exposures and trigger specific derisking actions and re-addressing origination strategies

B. **Evolution of underwriting and Early-Warning models with CRE "forward-looking" perspectives:** evolution of models leveraging AA and external data

C. **Asset-driven restructuring**

D. **Distressed credit funds:** pooling of credit exposures from different banks into credit funds, promoting "industrial" solutions

Offense

Proactive measures to seize opportunities from Bank's and Client's assets assets, maximizing value and gain competitive advantage

E. **Maximize value extraction from Bank's Assets**

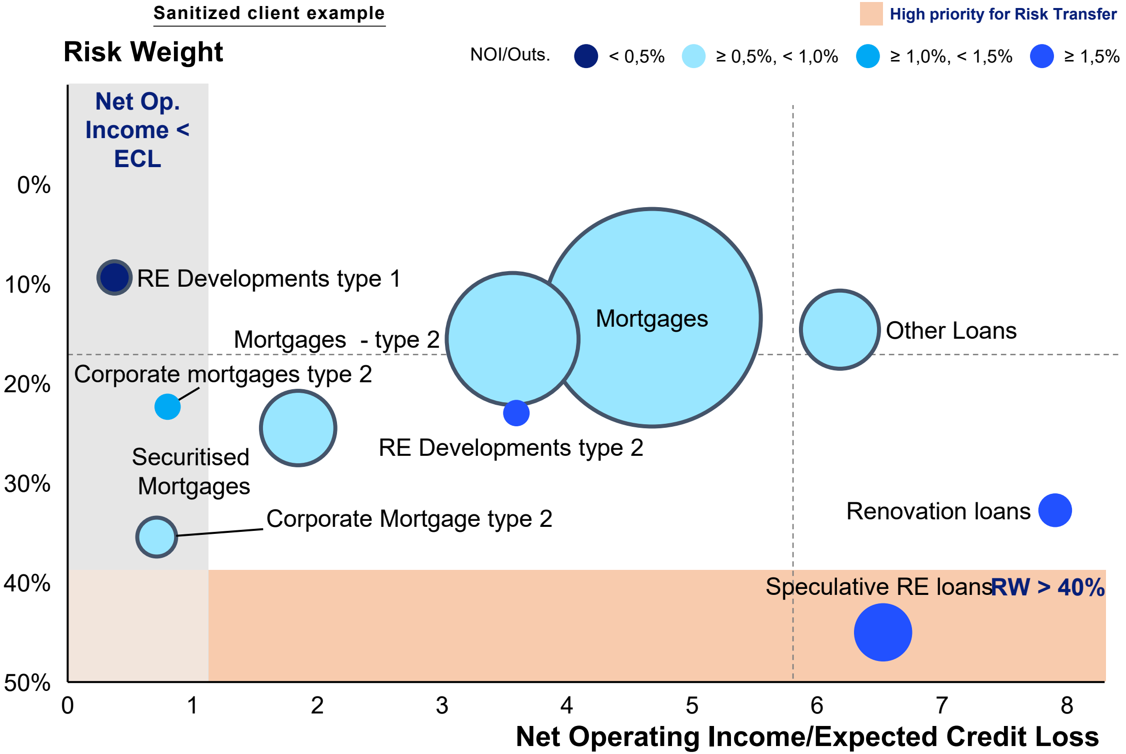
F. **Expand RE offer for clients:**
- **One-stop-shop Real Estate Platform**
- **Tailored RE Investment Products**
- **"Sectorial" RE Funds** to renovate/ "own to rent" Client properties
- **Real Estate management Advisory**

Support *Transversal strategies that enable virtuous initiatives accelerating banks' objectives*

G. **ESG: Acceleration of ESG objectives** through sustainable lending, urban regeneration

H. **Digital & Analytics: Leverage technology** to reduce RE management costs / risks

A | Banks are structurally assessing the value creation of each credit exposure to trigger asset rotation/capital optimization levers and steer new origination



Value Creation assessment and steering

Structured **assessment of the value creation** of each of the Real Estate portfolios including **Risk Weight** (i.e., Cost of Capital) and **profit generation net of Cost of Risk** (NOI/ ECL)

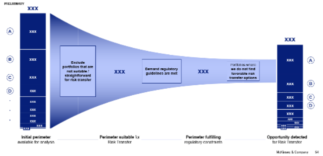
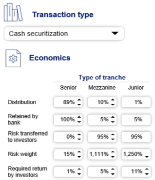
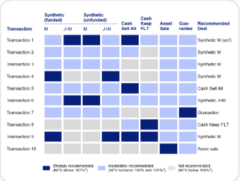
External information (i.e., "market view") can be **included** to assess the trade-offs in profitability ("hold vs sell")

Identification of the **Risk Transfer levers for each cluster**

Definition of the origination strategy by cluster, e.g., "hold to maturity"/Hold to Cross-Sell/ OtD/ Originate-to-Ristk Transfer

A | Banks are accelerating asset rotation through the use of advanced tools – example of solutions

Illustrative

	i Identification of homogeneous portfolios	ii Simulation of deal features	iii Scenario analysis
Description	**Mapping of credit exposures into portfolios with similar characteristics** (e.g., types of Real Estate products) identifying the priority portfolios with opportunity to enhance **holistic value creation**	**Sett**ing of the market assumptions in terms of Risk-Transfer strategy **hypotheses** (e.g., tranches scheme, required return)	**Estimation of impacts** for **different Risk Transfer strategies** for all selected portfolios, prioritizing the most appropriate strategy by cluster
Examples	 **Prioritization of sub-portfolios** to be analyzed	 **~+20 inputs** (incl. portfolio metrics and operation structure)	 **8 metrics evaluated** per each deal (e.g., lifetime NPV, EVA, day-0 loss)

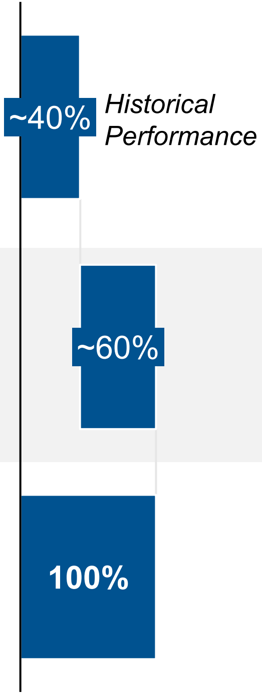
B | Non-traditional variables linked to location vibrancy and asset characteristics help banks in underwriting and monitoring

Relative importance[1]

Traditional features

Non-traditional features

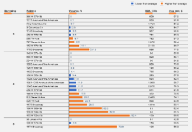
Total



Non-traditional feature Features breakdown and examples

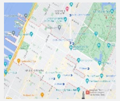
Experience
- Post-pandemic activation[3]
- Count/mix of retail establishments[2]
- In-flow migration

Asset Quality
- Years since last renovation/ development
- Floor size/number of stories
- YoY% rent growth



Economic Activity
- Unemployment rate in adjacent census tracts
- % of people employed in information technology sector

Convenience
- Average MTA turnstile traffic in the area
- # of stations/bus stops/metro lines



Competition
- Total square footage of direct competitors in the area
- Vacancy rate of FTQ4 competitors weighted by size

Use case

In a **large US bank**, the **non-traditional features model** has been applied to **identify "winning" properties vs "riskier" positions for:**

- **Guidance on new origination**
- **Credit monitoring and provisioning**
- **Restructuring and strategy**

1. Relative importance indicates amount of influence a certain data category has on produced predictions. Expressed as a percentage of total predictive power | 2. Retail establishments within a quarter mile radius around the asset | 3. Percentage change in yearly foot traffic | 4. Flight to Quality competitors (e.g., trophy or class A office buildings)

IACPM

"Offense": Banks are exploring wide set of partnership opportunities with real estate investment managers/ investors

Bank + REIM[1]/RE Investors

- Bank's real estate asset optimization and sale
- New real estate-backed investment products for Affluent, Private and Institutional
- Co-creation of Real Estate Credit Fund for Originate-to-Distribute of new origination
- RE Asset retrofitting and building decarbonization platform
- New real estate services for HNWI clients (e.g., PRS)
- Sectoral real estate sell & lease-back funds (e.g., for SB/ SMEs)

1. Real Estate Investment Manager

Key Messages

1 A new world for CRE lending

2 Implications and first reactions by Banks and investors in the world

3 Sizing the opportunities: smart CPM techniques now and looking forward

IACPM

Appendix includes client studies and macro scenarios with effects on growth and interest rates

Smart CPM techniques are emerging in the market in relation to Real Estate

Potential strategies	Description	Case examples	
Private Credit support/ Originate-to-Distribute approach for Commercial Real Estate	**Co-origination/"Originate-to-Distribute"** approach of banks in partnership with a dedicated Private Credit fund	Brookfield, Societe Generale, Intesa Sanpaolo, Tenax Capital	10bn€ Private Debt fund, with focus also on Real Assets +300 mln€ "OtD focused" fund
Scale up Risk Transfer (synthetic securitization)	**Synthetic credit risk** transfer providing a subscription for 'credit protection' on a bank's credit exposures, in order to optimize RWA	Christofferson Robb & Company, PGGM, BV Bayview Italia, Blackstone	Scale up of Risk Transfer activity in Europe Emerging Real-Estate focused transactions
Sub-performing/non-performing credit funds in "pool"	Contribution of banks exposures to Credit funds with an "industrial" perspective pooling exposures of different banks and driving restructuring process	Prelios, intrum, amco, Arrow Global	+10 bn€ in Italy over various funds Emerging interest in other countries (e.g., Germany)
Value extraction from Bank's owned Real Estate	Transfer **bank-owned real estate assets** in **specialized funds**, aiming to optimize income generation		*Leading Italian Bank with REIM*
Real Estate partnership	**Comprehensive partnership** centered around **Real Estate** to create a resilient value proposition for clients/investors		*Leading Italian Bank with REIM*
Sectorial funds	Partnership bank-funds to offer tailored RE solutions for clients in a sector (e.g., sell and lease back of Tourism premises)	Pillarstone	*Hospitality-focused fund*

IACPM

Source: Press releases

Q & A