CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

Accessing Private Real Estate Debt to Smooth the Recovery Ride

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For better or worse, the COVID-19 pandemic has changed the way we live, work and play, upending the global real estate market and redefining winners and losers within property sectors. These changes are happening within the backdrop of prevailing macroeconomic uncertainty, ongoing secular shifts, and varied reactions from providers of debt and equity solutions. Such dynamics have created numerous investment opportunities, presenting a robust spectrum of risk/reward scenarios for those seeking to ride the recovery trend.

With a plethora of strategies available, investors are confronted with the challenge of choice in terms of sectors to target and platforms to leverage. In a volatile market, private real estate debt – and specifically mezzanine lending -- offers a distinctive value proposition that allows investors to diversify their risk while capturing the upside of the expected post-COVID rebound. This paper examines the elements of the current market environment that make real estate mezzanine lending in specific sectors and conditions a compelling complement to a diversified investment strategy.

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Increasing Demand for the Mezzanine Lender

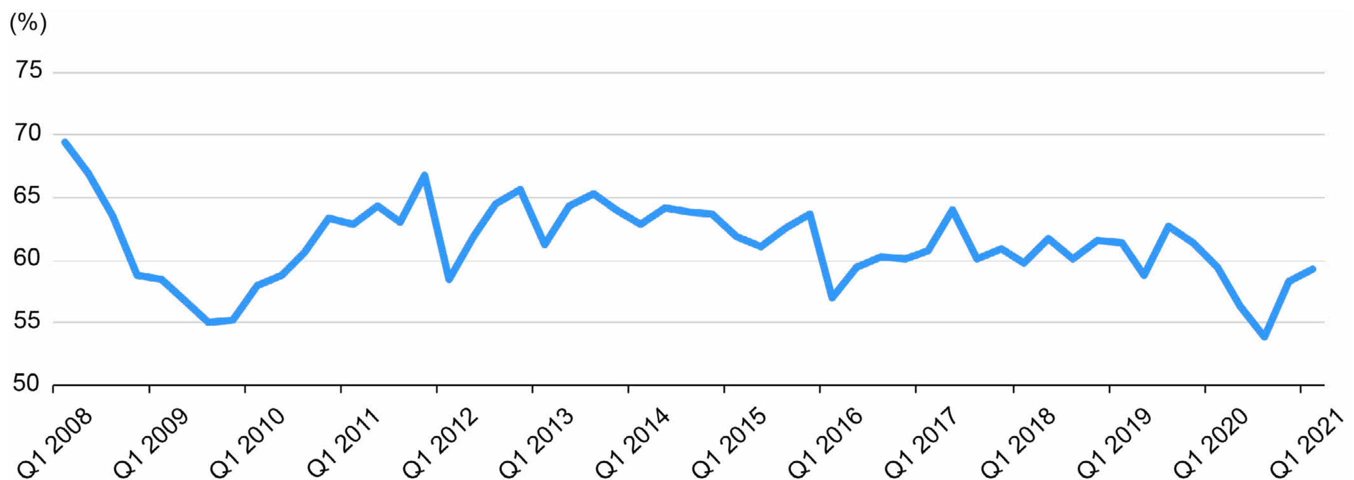
Mezzanine lenders have and continue to play an increasingly meaningful role in the real estate capital stack. Access to subordinated financing has historically allowed borrowers to optimize their leverage beyond a traditional mortgage for the purpose of acquisition or implementation of valued-added improvement plans with little or no equity dilution. Within the last two years, several externalities, most brought on by the pandemic, have fostered increased demand for mezzanine lending, creating opportunity for private lenders to step in to meet the need.

First, we have seen a retrenchment of senior commercial lenders and the continued migration into a lower risk/lower return position within the capital stack in response to regulatory pressure and the more recent macroeconomic uncertainty. As they try to make sense of the marketplace noise and take advantage of the protracted low interest rate environment, banks are more willing to provide very inexpensive financing at lower leverage points, thereby creating an opportunity which private debt providers are poised to fill. To wit, while senior lender loan-to-value (LTV) attachment points rebounded in late 2020, these levels remain sub-60% which fall below historical norms. (Figure 1)

In addition to the retrenchment by senior lenders, we believe that the size and scope of the COVID-related Federal stimulus measures may eventually give rise to inflationary pressures and rising interest rates, further increasing opportunity for mezzanine lenders. Should benchmark interest rates begin to rise, traditional banks constrained by debt service coverage thresholds will likely find themselves further hamstrung in advancing higher loan amounts, fueling the gap.

The volatility of certain lending channels also supports a need for private mezzanine lenders. For example, the window for Commercial Mortgage-Backed Securities (CMBS) lenders can open and close quickly based on market conditions, impacting loan levels at any given time. These fluctuations create opportunity for private, balance sheet lenders not subject to short-term sentiment swings to play a stabilizing role.

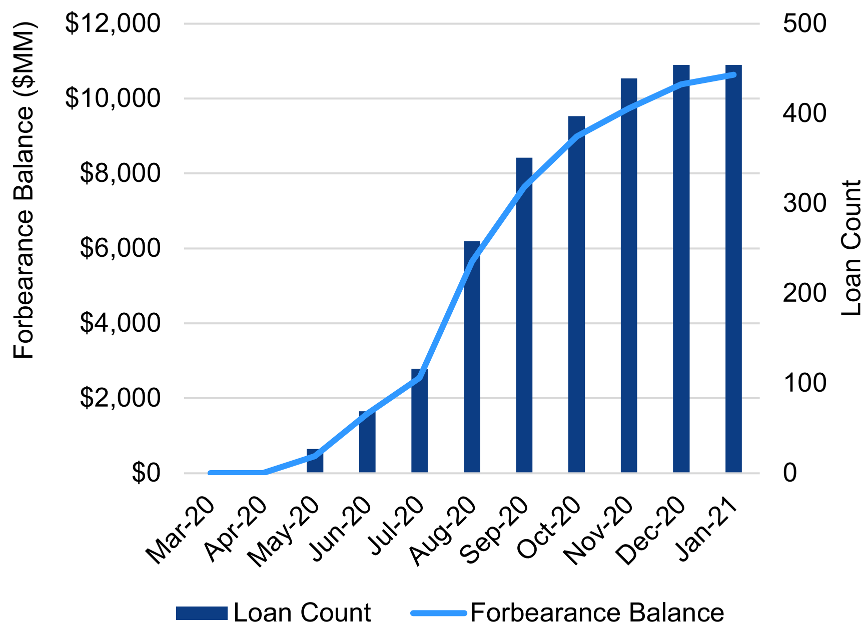
Figure 1: Q1 Commercial Loan-To-Value Percentages
(2008 - 2021)



Source: CBRE Research, Q1 2021.

These dynamics do not only impact loan originations but also transitional assets where interim cash flow has been suppressed. These scenarios have become more abundant in the last year due to the payment deferrals, short-term extensions and forbearances offered by many senior lenders to assist borrowers with COVID-19 cash flow issues. CMBS loans in forbearance steadily increased throughout the pandemic, leveling off in early 2021 but remain outstanding. (Figure 2). Some of these plans allow borrowers to tap reserves to cover their monthly principal and interest payments. These reserves need to be replenished and have resulted in a backlog of deals that are now being resolved, creating financing opportunities for which mezzanine lenders are highly suitable.

Figure 2: CMBS Loans in Forbearance
(March 2020 - January 2021)



Source: Morgan Stanley Research, February 2021.

While a good number of these deals involve properties that are truly distressed such as retail and hospitality, there are ample assets seeking additional capital that have viable uses in their current form, generate durable cash flow, and merely require additional debt capital to implement sound, value-added business plans to realize their full value. Given the prospective volatility around underlying property values and/or more restrictive lending criteria, these properties present an optimal area of focus for mezzanine lenders who seek to trade outsized returns for downside protection.

Given the shifting landscape, we are also seeing a flight to quality. Borrowers are finding themselves with fewer financing options, allowing lenders today to be more selective with their terms. For those lenders with good reputations and proven origination channels, loans can be made with better characteristics than those available pre-COVID. Some of these enhanced characteristics may include more experienced sponsors, lower loan-to value ratios (LTVs), lower attachment points, larger reserves, and more robust covenants, especially with transitional assets where there are lower senior loan proceeds available. When the markets do eventually recover, today's active mezzanine lenders are likely to be in the position of holding very high-quality loan portfolios at attractive pricing levels.

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Opportunity and Uncertainty within Sectors

While the demand for mezzanine lending is poised to create greater opportunities for private real estate debt providers and their investors, risk remains a significant part of the equation. The real estate industry has been permanently altered by the pandemic. The winning formula for a property investment is now driven by different factors including but not limited to demographic shifts, accelerated use of technology, and new behavior patterns.

In response to these and other accelerating macroeconomic trends, investor sentiment has fluctuated considerably with many property sectors painted with a broad brush. Such generalizations can result in both oversaturating and overpaying for favorable sectors while missing quality opportunities in areas that appear distressed. Prospects for value creation are not binary by sector; rather, they exist throughout asset classes. Successful sponsors will be able to identify those supply and demand patterns ripe for longer term value creation that align with their areas of expertise and expectations set forth by their investors. It is our experience that the most compelling market opportunities have arisen in the wake of large market disruptions. We anticipate this current cycle to follow suit.

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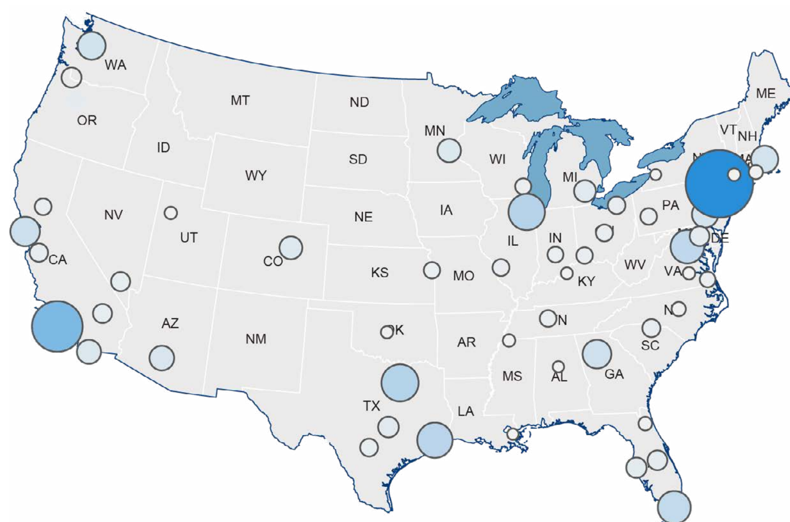
Two areas where we see these dynamics taking place are in the multifamily and modern office sectors, where each come with risk and opportunity – and the need for considerable expertise to tell the difference.

Affordability and Migration Impact the Multifamily Sectors

At first blush, the multifamily residential sector has benefited in recent years from shorter supply and a growing demand. Prior to the pandemic, increased construction costs and infrastructure constraints led to a housing shortage felt most acutely in the affordable housing sub-sector. This cycle, which has been exacerbated by the pandemic has likely seen an overbuild of product skewed towards the higher end, especially in primary coastal cities, and a shortage of quality, middle-income multifamily housing in secondary markets. (Figure 3)

Figure 3: Total Apartment Stock in the 50 Largest Metropolitan Areas



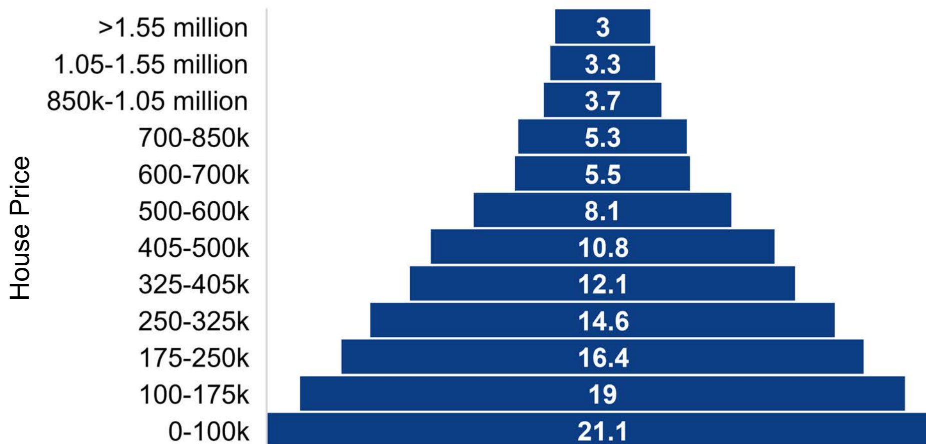
Total Apartment Stock

65,278 — 2,424,811

Source: NMHC tabulations of 2019 American Community Survey microdata, U.S. Census Bureau as of November 2020.

It is here in affordable rental options where we expect demand to continue to increase. Prospective homebuyers will likely be more reluctant or unable to make the necessary down payment required for home ownership in the face of economic uncertainty. In 2021, 56.5 million U.S. households out of a total of 122.9 million are unable to afford a $250,000 home. (Figure 4)

Figure 4: U.S. Households (Millions) by Highest Priced Home They Can Afford Based on Income: 2021



Source: CenterSquare, National Association of Homebuilders, 2019 American Community Survey Public Use Microdata Sample File, U.S. Census Bureau, as of February 2021.

As the economy continues to rebound, the jobs outlook improves, and younger renters emerge from their COVID retreat to their parents' homes, we are likely to see a drive towards the renovation of older housing product as well as the development of new assets to meet the needs of a population not yet able to buy. These dynamics represent an enhanced opportunity set for mezzanine lenders.

While there is enthusiasm for the multifamily opportunity, there is an equal level of uncertainty surrounding where the tailwinds are blowing and whether urban living will have the same appeal post-pandemic. A desire for space and less density may drive residents even faster and further to the suburbs and Sunbelt where affordability and the flexibility to work from anywhere will accelerate the migration away from more expensive coastal cities. For these reasons, we believe that well-conceived multifamily housing (and in certain locales, a single -family rental product), with features such as room for workspace, will be even better positioned in the long term.

Yet, despite these shifts, we also believe the allure of city life will return in earnest. We have already begun seeing indications of stabilization in the multifamily market across global cities as prices have fallen enough to attract tenants looking to capitalize on the discounts. In fact, Manhattan apartment leasing volume was 94% higher in December 2020 than the same month the prior year.[1] We believe that green shoots will continue to sprout throughout 2021, and by the second half of the year, we expect rebuilding will truly commence, likening the deterioration in fundamentals for multifamily assets to a temporary, cyclical event as opposed to a massive paradigm shift. For lenders with conviction around these ideas, primary city residential product presents an interesting opportunity to generate higher returns by capitalizing on short term conditions, in an asset class with durable cash flow characteristics.

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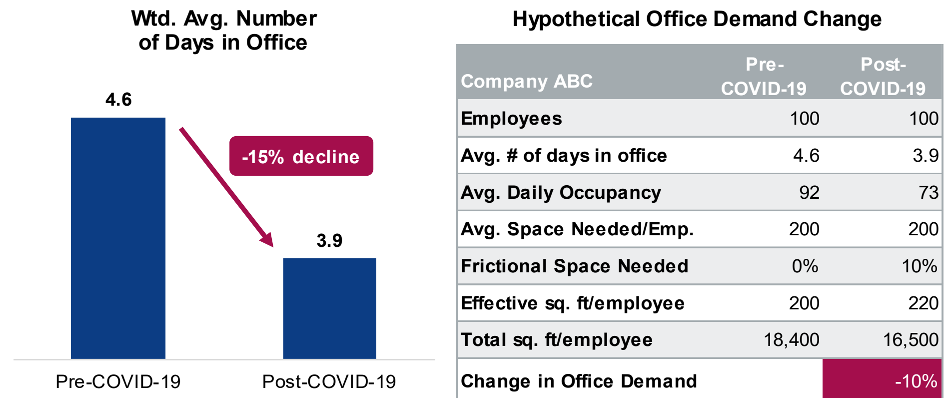
This rationalization of corporate space will foster a clear distinction between winners and losers in the office sector.

The Disruption of the Modern Office

While many companies were already moving towards more remote work options, the COVID-19-induced work-from-home experiment of 2020 created a step-change in the way companies view their office space. The pandemic forced us to acknowledge the efficiencies of working remotely, but it also provided a new appreciation for the importance of in-person collaboration as it relates to idea generation and organizational culture. With these two competing realizations, we believe that remote work will likely become a larger part of the corporate culture globally, but not completely replace the function of an office space to bring people together.

Still, companies should expect the number of days an employee spends in the office to decrease in a marked way. A Green Street Advisors analysis that demonstrates a 15% decline in employee office days translates into a 10% decline in the demand for office space, even after additional social distancing concessions are considered. (Figure 5) Given the longer-term nature of office leases, this impact is likely to be felt over time in the coming decade.

Figure 5: Hypothetical Remote Work Impact on Office Demand



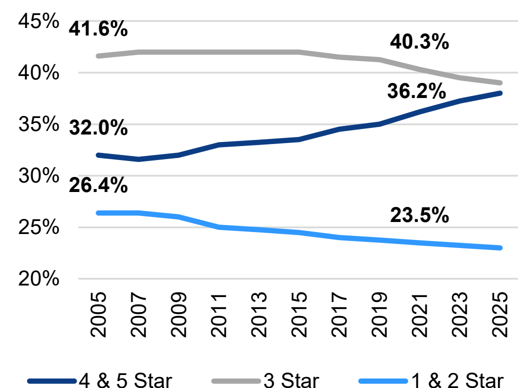
Hypothetical Office Demand Change

Company ABC	Pre-COVID-19	Post-COVID-19
Employees	100	100
Avg. # of days in office	4.6	3.9
Avg. Daily Occupancy	92	73
Avg. Space Needed/Emp.	200	200
Frictional Space Needed	0%	10%
Effective sq. ft/employee	200	220
Total sq. ft/employee	18,400	16,500
Change in Office Demand		-10%

Source: Bureau of Labor Statistics, Green Street Advisors as of June 2020.

This rationalization of corporate space will foster a clear distinction between the winners and losers in the office sector. Over the last decade, a large bias toward higher-quality workspaces has resulted in those properties experiencing the lion's share of occupancy and commanding greater rent premiums; we expect that to continue. (Figure 6) Moving forward, newer offices with favorable health-conscious amenities like outdoor spaces, better daylighting and indoor air quality will continue to attract demand while older, commodity office space lacking amenities will face obsolescence. We have already seen indications of this movement in the REIT market where returns for companies with an inventory of newer buildings significantly outperformed those with older properties in the last year.

Figure 6: Flight to Office Quality



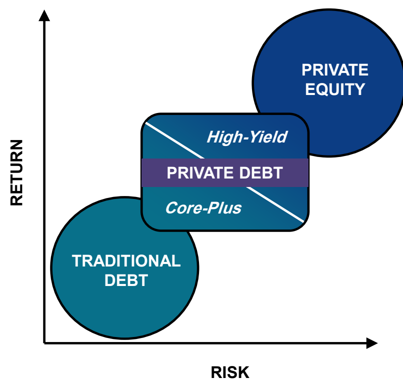
Source: CoStar, CenterSquare Investment Management, Bloomberg, as of March 31, 2021.

We also see flex office solutions, such as those provided by the likes of WeWork, as potentially large winners in the future of office. This model will be the answer to those companies evolving to hybrid work environments and requiring smaller footprints, but also needing options for employees on their remote workdays. Assets with meaningful exposure to flex office companies provide yet another opportunity for astute investors willing to look beyond the headlines, understand the dynamics currently at play, and capitalize financially when others fail to act on their convictions.

Real Estate Debt for Risk Diversification

Market uncertainties, which pervade all asset classes to one degree or another, will create an additional layer of risk for investors seeking to identify high performing opportunities. Investors in private equity real estate must attempt to determine the future value of an asset which comes with potential upside, but also considerable downside. Just as investors diversify their portfolios among sectors, markets, check sizes and managers, so should they consider diversifying their position in the capital stack to mitigate the volatility that comes with the post-pandemic economic recovery. (Figure 7)

Figure 7: Risk Reward Attributes of Real Estate Investment



Source: CenterSquare Investment Management, May 2021.

Investment in private debt at the mezzanine level of the capital stack allows investors to achieve more equity-like target returns relative to senior debt, without the need to be 100% correct about the future value of the underlying asset. In the hypothetical scenario in Figure 8, the senior lender and the mezzanine debt provider both receive full repayment of principal and interest in the event that the asset increases in value, remains stable, and even if the ultimate sale

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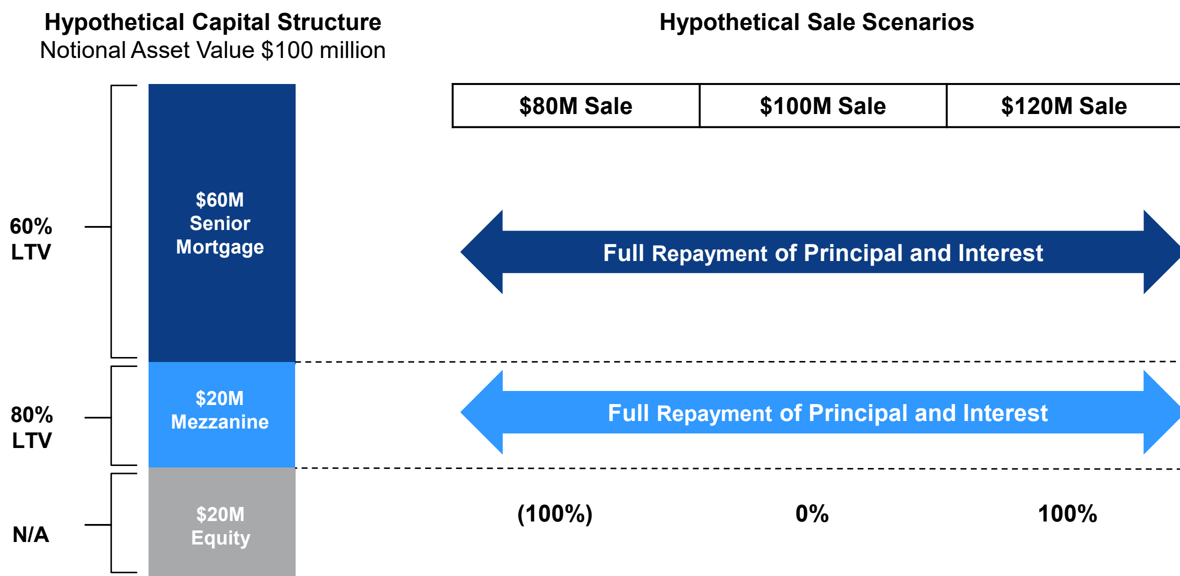
Figure 8: Hypothetical Sale Scenarios and Impact on the Capital Stack



Source: CenterSquare Investment Management, May 2021.

price falls 20% below the notional asset value. The asset value would have to fall below that level for the mezzanine provider's capital to become at risk. Thus, investors benefit from a meaningful cushion, resulting in returns that approximate those of equity in most conditions, with risk that veers closer to that typically assumed by the senior debt provider.

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In addition to diversifying risk, when implemented by an astute investment manager, a private debt strategy can also provide exposure to the strongest sectors and geographic trends in real estate, making it a worthy complement to a private equity allocation.

Conclusion

Commercial real estate has endured remarkably well throughout economic cycles, and the post-pandemic viability of the asset class will be no exception. Still, as the world returns to a new normal, considerable volatility is expected to remain as the market adjusts to the disruption which has taken place. The recovery ride will be rocky, but ripe with opportunity. Investors are well served to consider strategies which take advantage of demand shifts in the capital stack, emerging sectors and sub-sectors most likely to outperform, and opportunities to diversify risk. A private real estate debt strategy with a cycle-tested investment manager focused in areas of strong conviction could be a winning trifecta to address all three elements.

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Endnote:

[1] Bloomberg News, "Manhattan-bargain-hunters-drive-a-94-jump-in-apartment-leases," January 14, 2021.

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Michael Boxer is a Managing Director at CenterSquare Investment Management and is responsible for supervising the RCG Longview investment management platform. As a member of RCG Longview's investment committee, Mr. Boxer has played a primary role in the creation of RCG Longview's debt and equity funds as well as its joint venture investments in multifamily and workforce multifamily housing. Prior to joining RCG Longview, Mr. Boxer negotiated and structured the disposition of real estate and real estate related assets on behalf of institutional lenders at Victor Capital Group. Mr. Boxer began his career as a real estate attorney with Shea & Gould, where he represented owners and lenders in the structuring and consummation of real estate development, leasing and financing transactions. Mr. Boxer holds a Bachelor of Arts degree from Franklin & Marshall College and a JD from New York University School of Law.

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