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REAL ASSET INVESTMENT LEADERSHIP

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Real Estate Debt: The Time is Now

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Optimism may seem counterintuitive amidst a backdrop of prevailing market volatility, tightening monetary policy, and a looming recession. However, as real estate debt providers, we are perhaps the most enthusiastic we have ever been about the lending opportunities available today. In our 25 years of experience, we have learned that loans made during times of macroeconomic distress have a greater potential to outperform more stable periods. Additionally, we are experiencing a meaningful shift in debt costs where benchmark interest rates are more likely to average 3% than they are to approach the near-zero rates we have become accustomed to since the Global Financial Crisis.

This new reality of borrowing costs is a critical consideration for real estate debt investors. When we first began lending against real estate in the late 1990s, LIBOR was 6%, making it significantly easier to hit target returns of 12% or 600 bps over the benchmark. Over the last economic cycle, with LIBOR closer to 0%, earning that same 12% target has been twice as difficult, requiring a 1200 bps premium over the benchmark rate. In today's environment, we again have the potential to achieve equity-like returns (mid-teens) with debt-like risk for the first time in over a decade.

Additionally, the dramatic shifts in debt costs and capital markets have forced many historically active capital providers to take a step back. In this paper, we examine how these macro dynamics, coupled with increased demand for real estate financing, are translating into an enhanced opportunity set of higher quality loans for alternative providers of debt – particularly mezzanine debt.

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A Supply and Demand Imbalance

Given the pace and magnitude of recent interest rate hikes imposed by the U.S. Federal Reserve Bank, financing markets are experiencing a prolonged cycle of turmoil. Senior lending costs have nearly doubled over the course of 2022, driving cap rates higher, valuations lower, and compromising the supply of available financing. Leveraged lenders, such as debt funds that rely on repo financing, are no longer competitive given their own cost of financing. CMBS lenders are less active because of their reliance on the smooth functioning of the bond markets, which have been, and continue to be, volatile. Commercial banks are only selectively lending as they see little incentive to take further risk due to the potential impact of volatility around asset valuations.

This stall in the supply of debt from traditional lenders comes at a time when a growing number of borrowers are in need of repayment solutions. Higher debt costs are particularly problematic for borrowers who purchased commercial real estate with low cost, floating rate debt, with the expectation that the value of their property would increase meaningfully before their loan came due. In other words, a borrower who purchased an asset at a 4% cap rate utilizing debt that cost 3.5% will struggle to replace that same amount of debt at its current cost of 6.0%-6.5%. Further, for borrowers struggling to meet debt service on existing floating rate loans, there are far fewer refinancing options available to them than in the recent past.

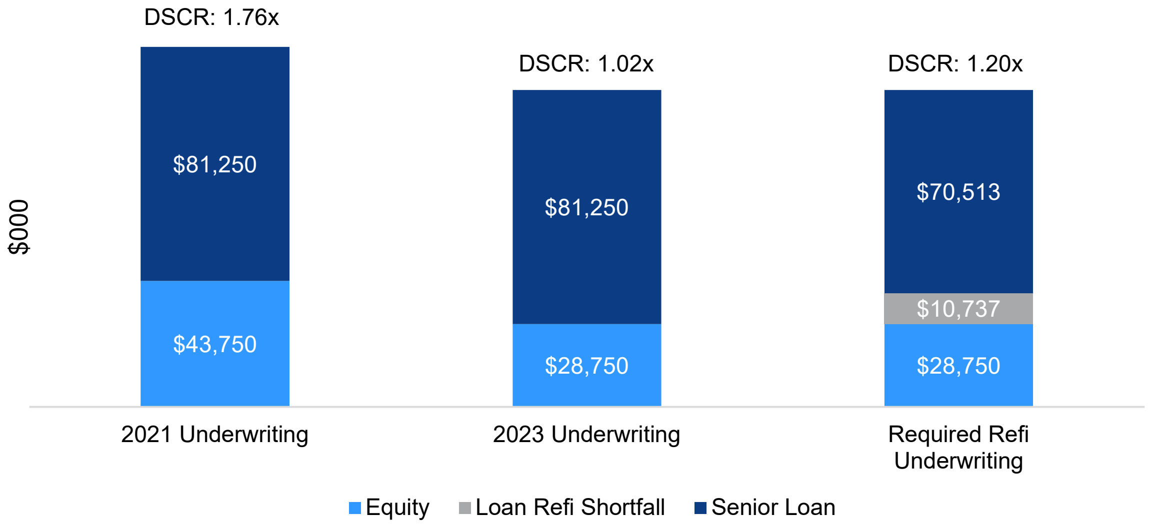
In both of these instances, while the asset itself may not be in distress, the Sponsor simply may not be able to support the higher debt load at the existing income yield. Borrowers in these situations are most commonly faced with the "no-win" decision to either pay down their existing loan meaningfully to accommodate a loan extension or hand the keys back to their lender. In these circumstances, credit providers with discipline and a deep understanding of real estate and asset values will have an abundance of opportunities to play a role in the healthy reconstitution of the borrower's capital stack.

Expanded and Improved Opportunity Set

These dynamics have created significant opportunities for mezzanine debt providers to lend against high quality assets with better characteristics than we have seen in prior years. Senior lenders (where they are willing to transact) have cut their loan proceeds due to debt service coverage ratio (DSCR) constraints that have been exacerbated by rapidly increasing interest rates, creating a gap to be filled by mezzanine lenders.

Take for example a multifamily asset that was priced at a 4% cap rate in 2021 and financed with a 3.5% loan at a 65% LTV (Figure 1). These metrics resulted in a 1.76x DSCR, well above the lender's required 1.2x DSCR. As the loan for the asset comes due in 2023, adjusted underwriting for refinancing carries a new set of assumptions. Despite NOI being 10% higher as a function of strong rent growth, the asset would be valued closer to a 5% cap rate to reflect today's transaction market. If the existing loan were to be refinanced at today's prevailing all-in rate of 6.5%, the DSCR would fall to 1.04x, breaching the typical lender's required 1.2x. For the borrower to meet these covenant requirements, the senior loan would have to be resized lower, resulting in a shortfall within the capital stack. As a result, mezzanine debt providers can step in and lend against a stabilized asset that has already been revalued, at a higher interest rate, and a lower attachment point, all behind a senior loan that has been right-sized with extended terms and restored DSCR levels. This scenario effectuates a higher return with a lower risk profile.

Figure 1: Multifamily Underwriting Scenarios (2021 vs. 2023)



	2021 Underwriting	2023 Underwriting	Required Refi Underwriting
Cap Rate	4.00%	5.00%	5.00%
NOI ($000)	$5,000	$5,500	$5,500
Asset Value ($000)	$125,000	$110,000	$110,000
LTV	65%	74%	64%
Senior Loan Value ($000)	$81,250	$81,250	$70,513
Loan Refi Shortfall ($000)	$0	$0	$10,737
Senior Loan Rate	3.50%	6.50%	6.50%
Debt Service ($000)	$2,844	$5,281	$4,583
DSCR (min 1.2x required)	1.76x	1.04x	1.20x

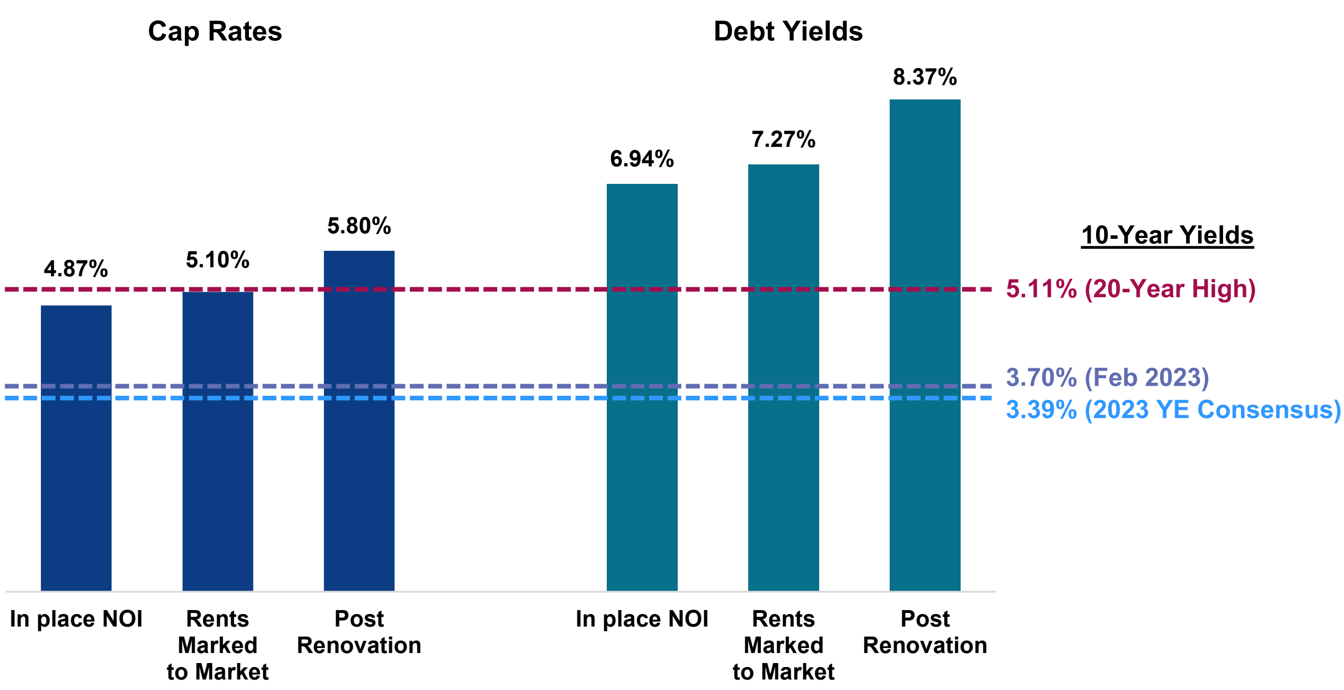
Source: CenterSquare, February 2023. The above illustration is hypothetical and presented for informational purposes only. Actual metrics and outcomes will vary and may not represent the above scenario.

Private Equity vs. Private Debt Prospects

Mezzanine lending also offers a very attractive valuation at its position in the capital stack relative to private equity. While there is much debate among professional investors around appropriate cap rate levels, we rely on the transparency of the public REIT market to help forecast valuations in the private markets. Historically, the public markets are the first to reprice, with the private markets playing catchup months later. Given our insight into the public REIT market, we believe we are on the precipice of such a catchup today with private equity real estate positions expected to decline as assets get repriced lower by 5-10% from peak valuations. Certain asset classes, such as office, will likely experience much wider swings. While this correction will translate into diminished equity returns, it should not impact the quality of the underlying assets or the loans made against them.

To wit, the scenario below represents a multifamily mezzanine lending opportunity. The in-place NOI at the current asset valuation is generating a 4.87% yield for the equity owner, which can grow to 5.10% as leases for unrenovated units are brought to market, and may reasonably be increased further to 5.80% once renovations are complete. Meanwhile, the in-place NOI yield for a lender begins at 6.94% and through the same mark-to-market and value-add renovation, grows to 8.37%. Even if 10-year treasury yields approach a 20-year high and the yield premium diminishes significantly for the equity investor, the debt investor can still enjoy a 300 bps premium to the risk-free rate, greatly enhancing the likelihood that its loan will deliver the expected returns.

Figure 2: Cap Rate and Debt Yield Scenarios for Multifamily Asset



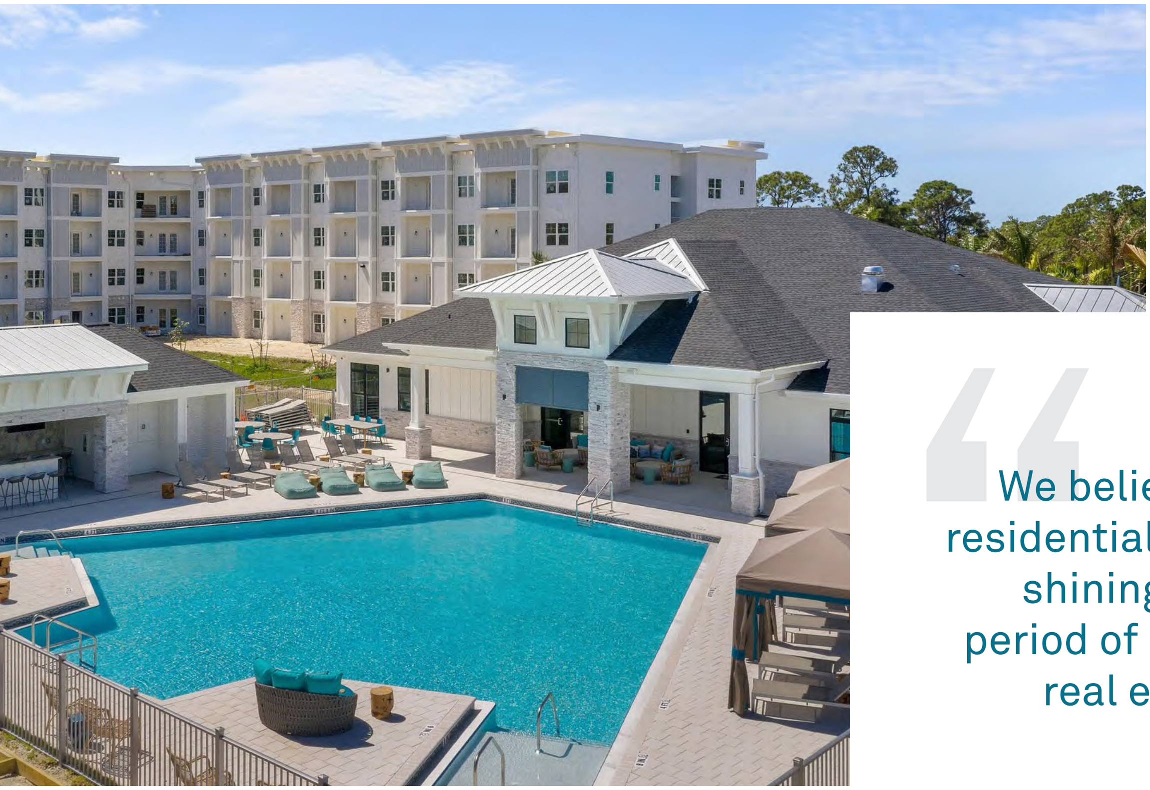
Source: CenterSquare, February 16, 2023. The above illustration is presented for informational purposes using recent multifamily property credit metrics which CenterSquare has underwritten.

A Standout Sector

While the opportunity set for mezzanine investors is large today, it is important to note that some property types will be better positioned than others. Specifically, we believe the rental residential sector will be a shining star in this period of opportunity for real estate debt. The United States is structurally undersupplied from a housing perspective, and particularly so from a moderate-income housing perspective. Supply has not kept pace with the rate of population growth and household formation over the last economic cycle. Given current elevated construction costs, this supply/demand imbalance is likely to persist.

The rental housing shortage is further exacerbated when one considers the cost of home ownership has grown considerably. The benchmark 30-year mortgage rate has grown from 3.5% a year ago, to almost 6.5% today (Jan 2023) and home prices remain well above pre-COVID levels. This inflation will likely continue to drive rental housing demand for years to come. Even as we face an economic downturn, while rent levels at a multifamily asset may flatten or even decrease, these assets are unlikely to become vacant.

For these reasons, we stand firm in our conviction for lending on cash flow-generating, high-quality multifamily assets. While we believe in the fundamental durability of cash flows from well-positioned multifamily assets, not all cash flows are created equal. It is critical to analyze the sources of increasing property level cash flows and attribute a different value to each. For example, year-over-year multifamily cash flow increases may be derived from bringing existing rents up to existing market rents or predicated on future market rent growth. Given that rent growth in many U.S. markets is no longer sustainable, we tend to attribute more value to the reliability of bringing existing rents to market, which we see as a viable outcome for many residential assets currently in need of alternative financing.



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Conclusion

The market is ripe for high-yield real estate debt transactions today due to a combination of circumstances. Increased demand for financing, a decreased supply of debt capital from historically reliable sources, and the ability to lend against quality assets at higher rates puts real estate debt financing in an attractive risk-return category not seen for decades. We believe this favorable environment is especially prevalent in the rental residential sector where the ability to renew leases at market rents will insulate borrowers from repayment woes. Investors are now beginning to recognize the unique benefits of a private real estate debt strategy. Those who can act in 2023 and partner with reputable mezzanine lenders will be poised to reap the rewards.

About the Author

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Michael Boxer is a Managing Director at CenterSquare Investment Management and is responsible for co-leading the RCG Longview real estate debt platform, which was acquired by the Firm in 2019. As a member of CenterSquare's private debt and equity investment committees, Mr. Boxer plays a critical role in the Firm's investment strategy and process. 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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