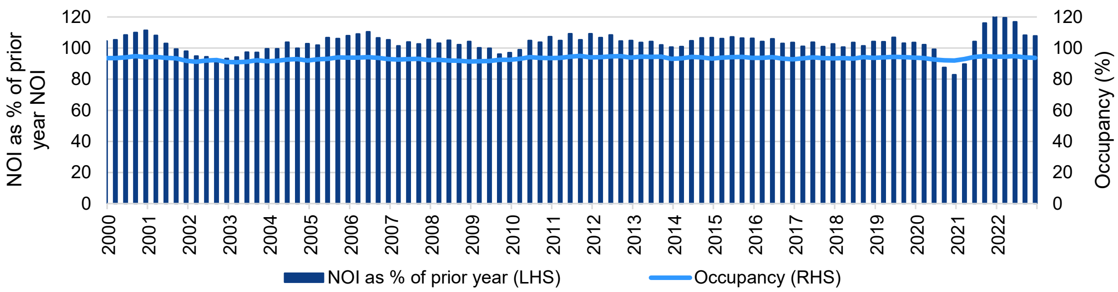
Private Real Estate Lending: There's No Place Like Home

As veteran real estate debt providers, we are more enthusiastic than ever about the commercial lending opportunities available today. Traditional lenders have been sidelined due to elevated market volatility and lack of real estate price discovery, creating a gap in the marketplace to be filled by alternative lenders, including private mezzanine providers like CenterSquare. While this opportunity set is significant today, it is important to note not all asset classes are created equal. Certain property types are far better positioned to lend against, especially as we head into a recession. To wit, we believe rental residential to be a shining sector for private real estate debt due to the structural undersupply of housing and strong demand tailwinds for affordable options.

Fundamental Resiliency

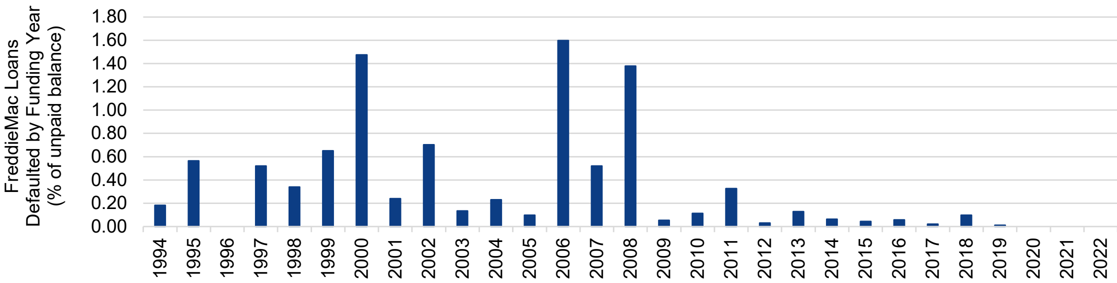
The needs-based demand for multifamily has resulted in the asset class experiencing resilient occupancy levels throughout historical downturns. Going as far back as the late 1980s (Figure 1), occupancy levels of institutional multifamily investments have remained above 90.6%. This data suggests that even through economic downturns, while rent levels of multifamily assets may flatten or even decrease, these assets are unlikely to become vacant, unlike other types of commercial real estate property types. As a result of the sticky tenant base, NOI levels have remained robust, and recovered quickly following economic recessions. As a function of the steady cash flows, delinquency rates for these assets have remained muted. For example, Freddie Mac's Multifamily Loan Performance Database shows that of the 52,500 loans purchased by Freddie Mac (total unpaid balance > $700 BN), only 0.14% have defaulted (Figure 2).

Figure 1: Historical Multifamily Occupancy and NOI Levels Steady



Source: NCREIF as of December 31, 2022.

Figure 2: Historical Multifamily Loan Default Rates Low

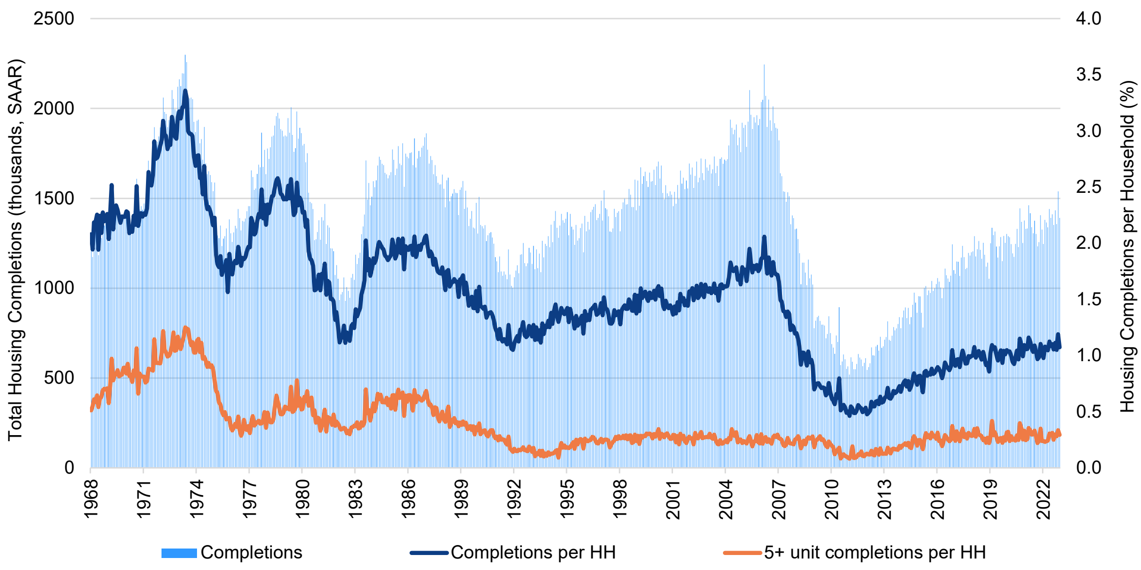


Note: The Multifamily Loan Performance Database (MLPD) provides historical information on a subset of the Freddie Mac multifamily loan portfolio. It excludes loans that are credit revolvers, sold book (pre-1994) loans, and negotiated transactions/structured deals and K001 and K002.
Source: Freddie Mac multifamily loan performance database as of December 31, 2022.

Structural Tailwinds

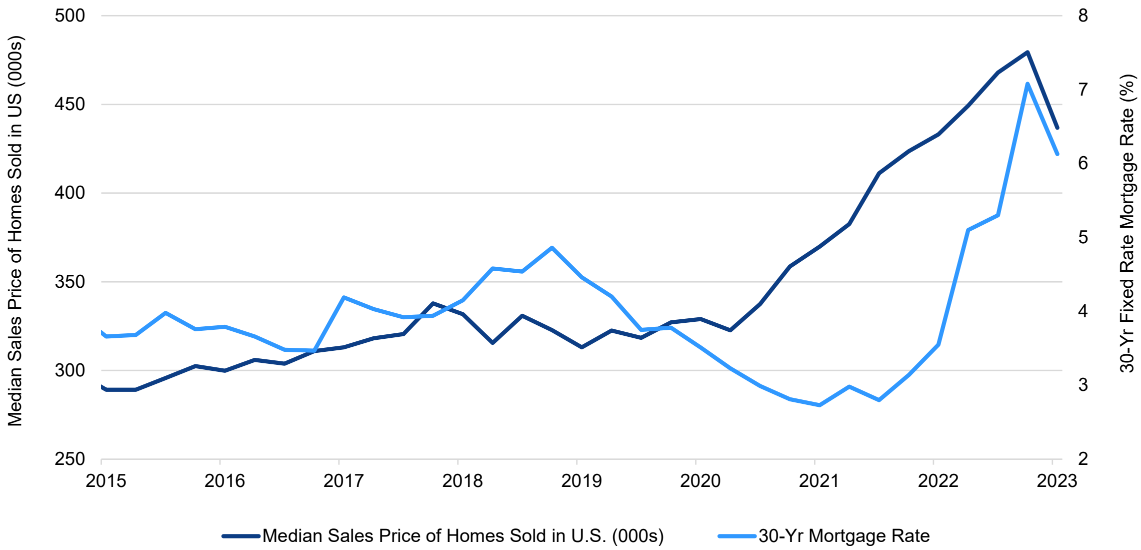
In addition to the resiliency of the asset class, current supply and demand dynamics are creating the foundation for future strength for the rental residential sector. Housing completions have not kept pace with household formations over the last economic cycle, creating a structural undersupply of housing (Figure 3), resulting in rising home prices. This dynamic coupled with higher mortgage rates has exacerbated the unaffordability of home ownership for consumers (Figure 4), keeping them renters for longer. These factors should continue to provide structural demand, and therefore, pricing power for rental residential landlords, especially for product at lower price points that provide affordable housing solutions.

Figure 3: Multifamily Demand Benefitting Today From Structural Undersupply of Housing



Source: U.S. Census Bureau as of December 31, 2022.

Figure 4: High Mortgage Rates and Elevated Home Prices Make Home Ownership More Unaffordable

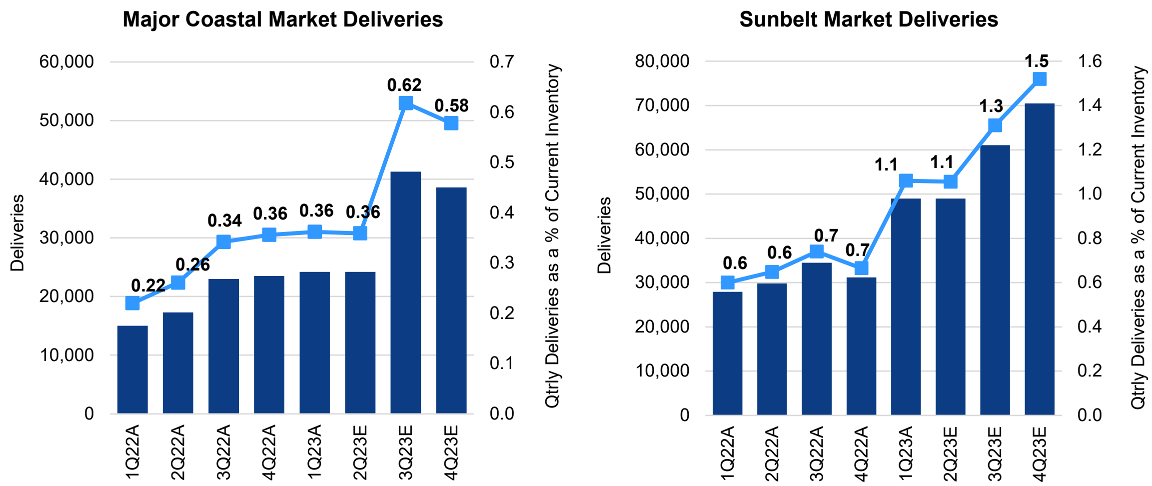


Source: Federal Reserve of St. Louis as of December 31, 2022.

Markets Matter

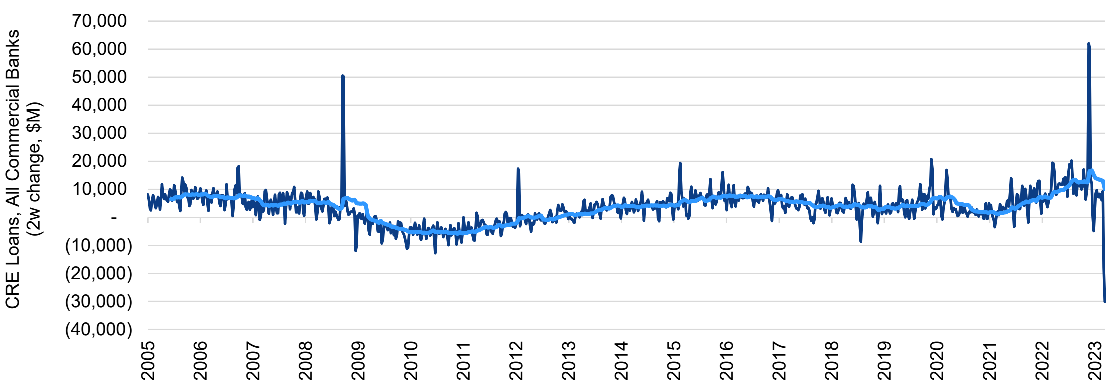
While there is an elevated multifamily development pipeline poised to increase supply, the new product is largely concentrated in sunbelt markets (Figure 5) and at higher price points, as construction costs remain elevated and higher rents are required to justify new development. While the current development pipeline for multifamily nationally remains elevated, real estate lending, especially for construction, has come to a standstill (Figure 6) and should result in a moderating supply pipeline. Meanwhile, moderate-income product, especially in the coastal geographies, is facing limited pressure as new supply remains cost-prohibitive. Lenders like CenterSquare who have chosen to focus upon lending on value-add business plans for Class B multifamily in the coastal markets are less concerned with an oversupply anytime soon.

Figure 5: Coastal and Sunbelt Supply Trends Differ



Source: RealPage, Evercore ISI Research as of April 13, 2023. The above charts contain forward-looking information that can not be guaranteed.

Figure 6: Commercial Bank Lending for CRE Has Come to a Halt



Source: Federal Reserve of St. Louis as of December 31, 2022.

Amidst a cacophony of macroeconomic and market drivers, private real estate debt is having its moment. Yet, this favorable risk/reward scenario won't manifest for every lender. Operating in sectors benefiting from the current supply and demand imbalance while remaining insulated from the pending recession is the line to walk. From our viewpoint, the multifamily rental residential sector is optimally positioned to capture the greatest upside over the next decade as secular tailwinds and long-term foundational fundamentals form the optimal backdrop. For CenterSquare Real Estate Debt, there really is no place like home.

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