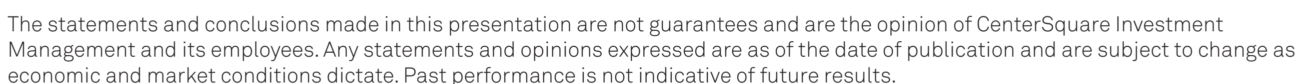
CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

NAVIGATING A LENDER'S MARKET

2024 Real Estate Debt Outlook



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Navigating a Lender's Market

At the beginning of last year, as we were assessing the commercial real estate investment landscape, we published a paper titled "Real Estate Debt: The Time is Now." Amidst the backdrop of an anticipated, meaningful reset in the real estate asset class, we had never been more enthusiastic about the opportunities available to generate equity-like returns through debt investments. As we look forward into 2024, we remain steadfast in our optimism for real estate debt, which we believe screens as a compelling investment opportunity in a "lender's market" driven by the following dynamics.

- Demand for credit will remain elevated as real estate debt maturities keep mounting.
- Supply of credit from traditional lenders is likely to remain limited, creating a meaningful opportunity for alternative debt providers to participate in the reconstitution of the capital stack.
- The reconstitution of the capital stack will be occurring in the context of real estate assets with a reset basis appropriate for the prevailing reality of debt costs.

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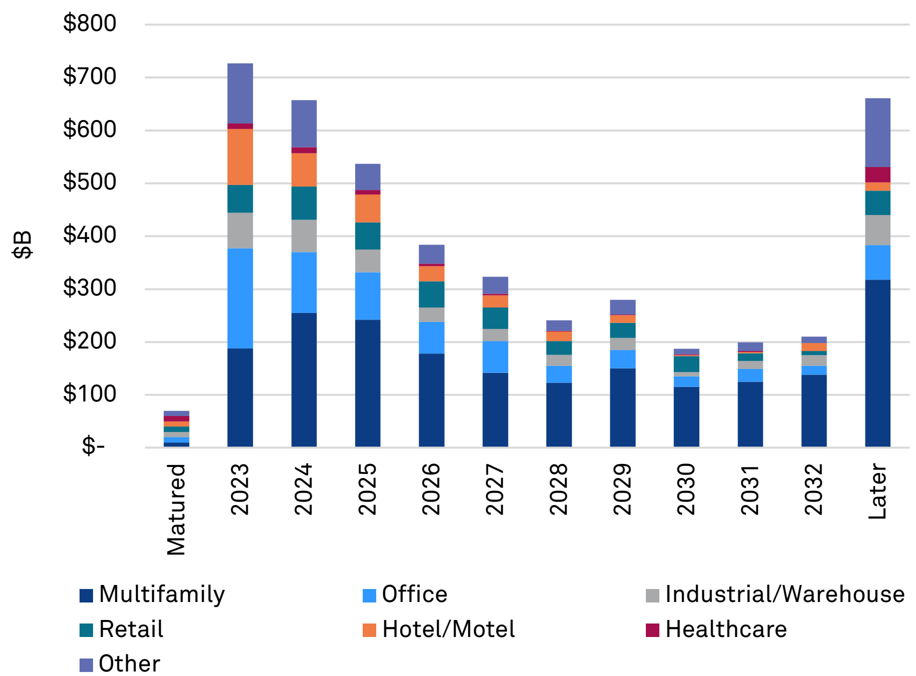
Econ 101

The Supply/Demand Backdrop

The demand side of the equation for real estate debt is simple today – an elevated number of loans are maturing through 2025 (Figure 1). Additionally, while over $700 billion in loans were set to mature in 2023, many of those loans have been modified through a "blend and extend" strategy, whereby lenders asked for additional collateral from the sponsor, adjusted the interest rate, and provided short-term modifications to the loan. This has pushed more of these maturities into 2024 and 2025 with the hopes of a friendlier refinancing environment.

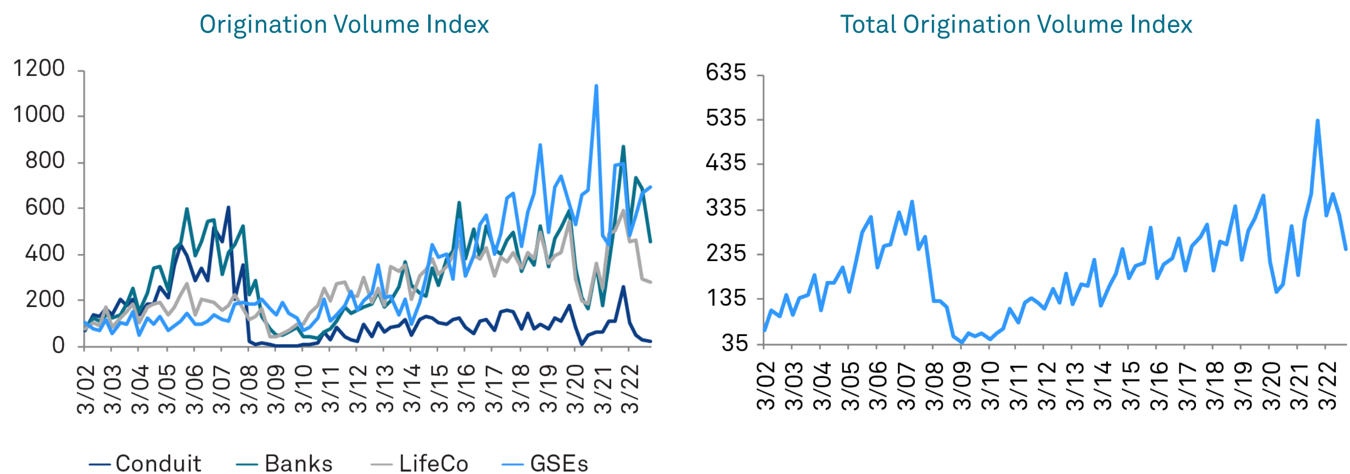
Figure 1: Estimated total commercial mortgage maturities



Source: Mortgage Bankers Association, as of March 10, 2023.

While the "blend and extend" strategy is providing some level of breathing room for sponsors and keeping lenders from having to take back keys (which they have no desire to do), it means these existing lenders have fewer loan repayments – let alone prepayments – and therefore, they have less capital to deploy into new loans. Furthermore, many of these traditional lenders are grappling with legacy issues in their portfolios associated with "core" property types like office or regional malls, that are facing structural issues of their own, occupying a significant amount of time and resources. Thereby, the new supply of credit from traditional lenders in the real estate market has decreased meaningfully (Figure 2).

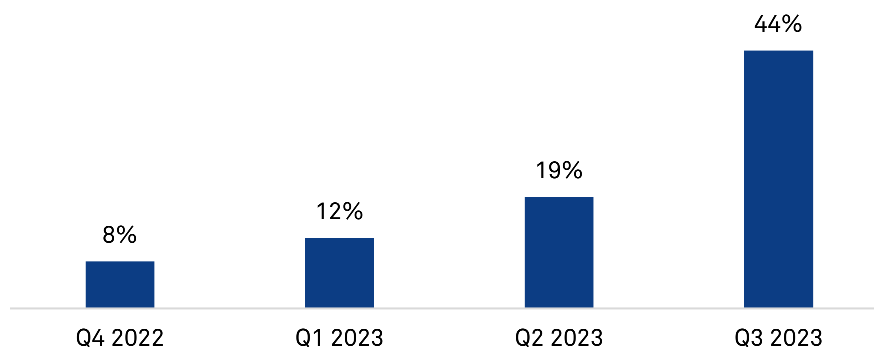
Figure 2: Real estate loan originations



Source: J.P. Morgan, Mortgage Bankers Association, as of November 29, 2023.
Note: 2001 Quarterly Average = 100

In this backdrop of above-average demand and limited supply, alternative real estate debt providers are experiencing a plethora of opportunities to fill the void left by traditional lenders in a "lender's market," with strong pricing power and access to high-quality assets with favorable risk profiles. Consequently, private funds and other specialty lenders are taking an increasing market share of CRE debt capital commitments. Capital is responding to this opportunity set; pensions committed $5.98b to CRE debt vehicles through the first nine months of 2023 (Figure 3).

Figure 3: Percentage of commercial real estate commitment volume to debt vehicles



Source: Ferguson Partners Consulting, as of Q3 2023.

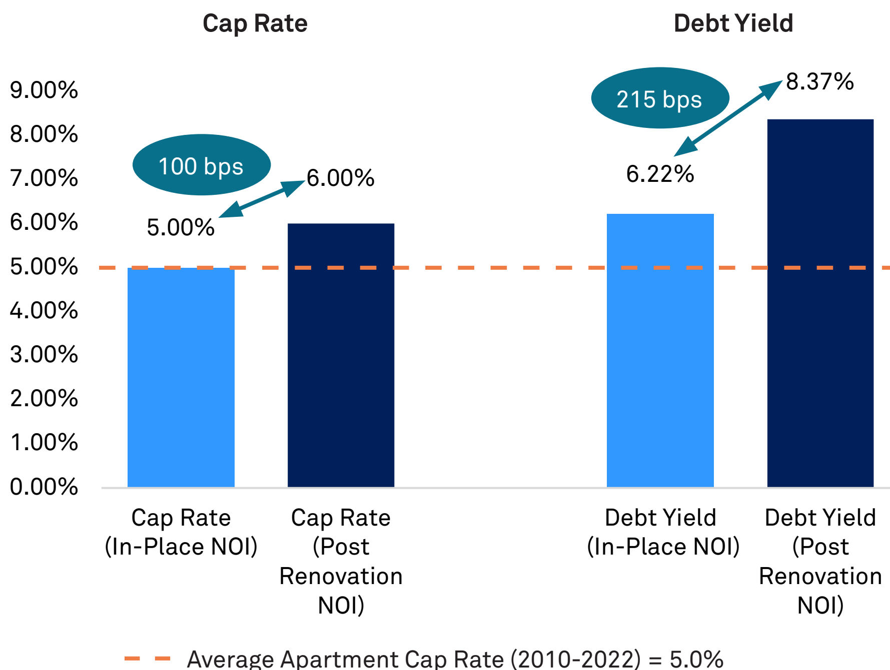
The Opportunity

Viable Growth Story

The viable growth story presents an opportunity in the form of a value-add business plan for class B multifamily product in supply-constrained markets that creates a path for net operating income (NOI) growth, not by simply counting on market rent growth, but by capturing a mark-to-market upon renovation (i.e., not dependent on top-line rental growth, which we believe will be muted).

The scenario below (Figure 4) represents a multifamily mezzanine lending opportunity on a value-add business plan. The in-place NOI at the current asset valuation generates a 5.0% yield for the equity owner, which can grow to 6.0% once renovations are complete (and likely higher if top-line market rents experience any meaningful growth). Meanwhile, the in-place NOI yield for a lender begins at 6.2% and through the same value-add renovation plan, grows to 8.4%. Even if cap rates reset for this asset and increase by 100bps, significantly diluting the return expected by the equity owner, the debt yield upon completion of the business plan remains insulated – it is highly likely the loan will deliver its expected returns.

Figure 4: Viable growth story

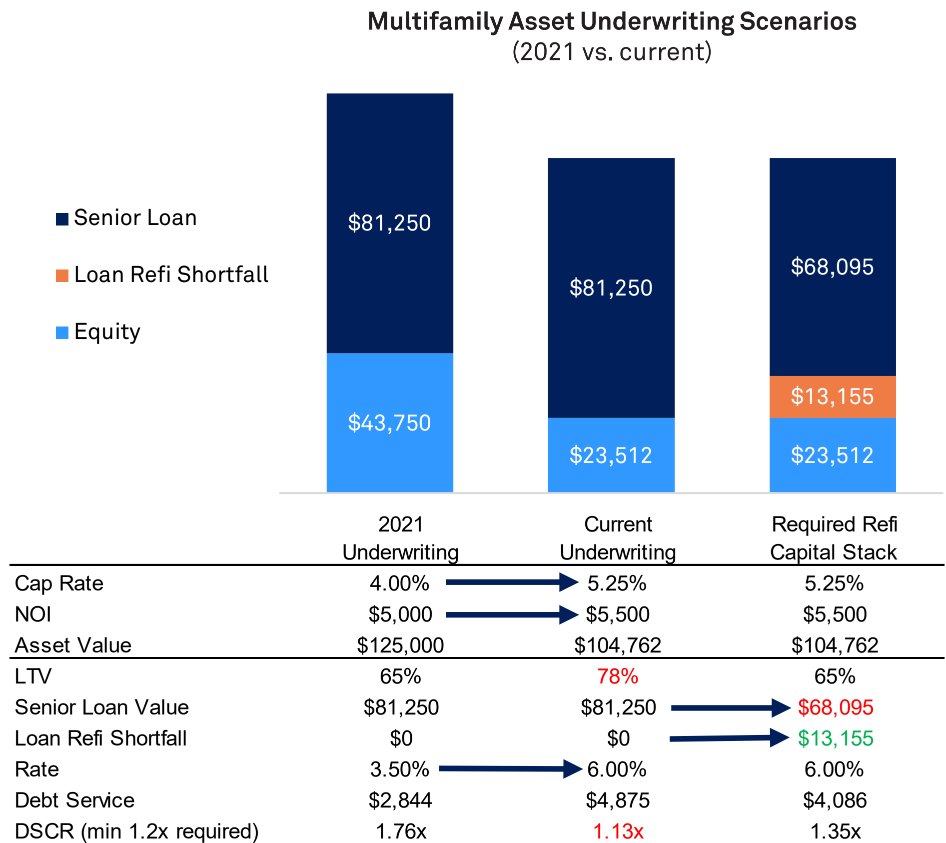


Source: CenterSquare, as of December 31, 2023.

Gap Capital

We had provided the below hypothetical example (Figure 5) of this in our paper at the beginning of 2023 where the change in the underlying valuation of this hypothetical stabilized asset combined with higher interest rates would require senior loans to re-size lower to meet requirements from lenders for debt service coverage ratios and loan-to-value (LTV), providing an opportunity for mezzanine debt providers like CenterSquare to fill the "gap" and balance out the capital stack.

Figure 5: Gap capital requirement driven by senior debt constraints



	2021 Underwriting	Current Underwriting	Required Refi Capital Stack
Cap Rate	4.00%	5.25%	5.25%
NOI	$5,000	$5,500	$5,500
Asset Value	$125,000	$104,762	$104,762
LTV	65%	78%	65%
Senior Loan Value	$81,250	$81,250	$68,095
Loan Refi Shortfall	$0	$0	$13,155
Rate	3.50%	6.00%	6.00%
Debt Service	$2,844	$4,875	$4,086
DSCR (min 1.2x required)	1.76x	1.13x	1.35x

Source: CenterSquare, as of December 31, 2023.

Fast forward to today, we are seeing this play out in earnest. Alternative debt providers are able to access to more stabilized assets, higher quality sponsors, and tighter loan covenants in light of traditional lenders being sidelined. For mezzanine investors, attachment points that were 65-75% a year ago are closer to 55-65% while detachment points that were 80-85% can now be as low as 70%. We anticipate this will continue into 2024 as traditional lenders remain limited in their capacity to deploy new capital.

It is important to note, however, this opportunity is contingent on the continued availability of senior debt within the capital stack. Here, we believe the multifamily sector screens extremely favorably as liquidity will remain available from the GSEs. CenterSquare's special status with Freddie Mac as an approved provider of subordinate financing (in the form of debt-like preferred equity) to its borrowers, will likely remain a source of transaction activity in 2024 while other senior lenders find their footing. Additionally, we anticipate there will be a tremendous opportunity to also provide the senior portion of the cap structure (up to 60-65% LTV) at historically wide spreads in the face of muted supply of senior loans.

Looking ahead into 2024, our optimism for real estate debt remains steadfast, driven by the characteristics of what we term a "lender's market" and creating an environment ripe for investment opportunities. Alternative debt providers, capitalizing on the vacuum created by an absence of traditional lenders, now wield substantial pricing power. Confidence in resilient, high-demand assets – particularly in the multifamily sector – remains robust, underpinned by a structural undersupply of housing and an increasing demand for affordable options, positioning multifamily assets as a focal point for success. Prevailing market dynamics, defined by heightened demand and limited supply for credit, as well as mounting real estate debt maturities will present a compelling opportunity for real estate debt investors to generate attractive risk-adjusted returns in the coming year.

About the Authors

Michael Boxer

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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, Michael 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, Michael negotiated and structured the disposition of real estate and real estate related assets on behalf of institutional lenders at Victor Capital Group. Michael 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. Michael holds a Bachelor of Arts degree from Franklin & Marshall College and a JD from New York University School of Law.

Richard Gorsky

Managing Director, Private Real Estate Debt

Richard Gorsky is a Managing Director at CenterSquare Investment Management and a member of RCG Longview's investment committee. His responsibilities include overseeing all the investment related activities of RCG Longview, such as deal origination, structuring, underwriting, and asset management. He has previously served on the Economic Development Committee of the Real Estate Board of New York and taught as an adjunct professor at New York University's Schack Institute of Real Estate. Before joining the RCG Longview platform in 2003, Richard was Vice President at Belvedere Capital Management, LLC, working on all aspects of various real estate transactions. Prior to joining Belvedere, he was an analyst and controller at Scott Cove Capital Management, LLC, an investment manager of corporate distressed debt and equity. He also previously worked as a senior auditor for Ernst & Young LLP. Richard has a Master of Business Administration in finance from New York University Stern School of Business and a Bachelor of Science in Accounting from the State University of New York at Albany. He licensed as a Certified Public Accountant.

Uma Moriarity, CFA

Senior Investment Strategist and Global ESG Lead

Uma Moriarity is the Senior Investment Strategist and Global ESG Lead for CenterSquare Investment Management. She focuses on investment strategy and leads thought leadership across the Firm's public and private real estate platforms. She is part of the listed real estate investment team and serves on CenterSquare's Private Real Estate Debt Investment Committee. Uma leads the Firm's Environmental, Social, and Governance (ESG) strategy to incorporate ESG into the decision-making and management of listed and private real estate investments to create long-term value, reduce risk, and generate superior risk-adjusted investment returns. Prior to joining CenterSquare, she spent three years in corporate strategy and planning at ExxonMobil in Houston. Uma graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a B.S. in Finance with a minor in International Business, B.S. in Accounting, and Master of Accountancy. She is a CFA charterholder and member of the CFA Institute, a LEED Green Associate, and a member of the ULI San Francisco Sustainability Committee. She currently serves on the Board of Directors for Green Building United, the Penn State Smeal Sustainability Advisory Board, and the FTSE EPRA Nareit Americas Regional Advisory Committee.

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