Townsend Views

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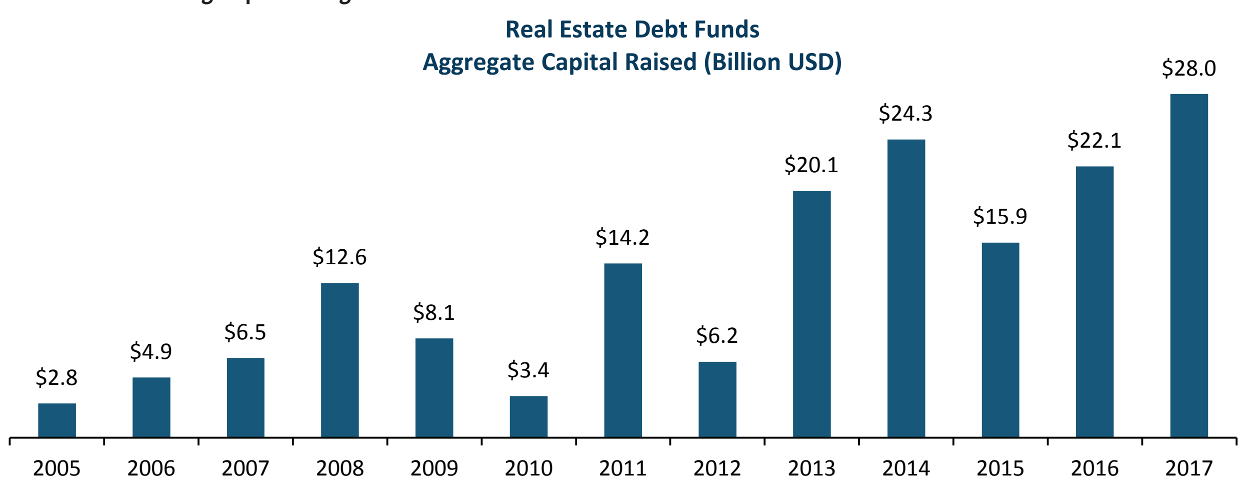
Commercial Real Estate Debt Overview

With the maturation of the current U.S. real estate cycle, a large number of institutional investors have shifted incremental capital towards debt strategies. Since the GFC, real estate valuations have increased by 27% relative to the prior peak, cap rates have fallen 360 bps to historic lows, and interest rates have begun to rise. Given this combination of rising interest rates and record low property yields, commercial real estate investors are taking on more debt investment positions, the latter viewed as a less risky option in the current environment. This incremental preference is typically and primarily driven by two considerations:

1. Debt provides downside protection relative to an equity position within a given capital stack. In the event that property values fall, debt investors are better protected than equity investors. For institutional investors, CRE debt provides one way to curb risk in a diversified multi-asset portfolio.
2. Floating rate debt limits/reduces portfolio duration risk in a rising rate interest rate environment.

While this line of thought is not without merit, not all commercial real estate debt comes with the same risk/return trade-off. For example, floating rates debt, common within the real estate sector, offers a hedge against declining valuations as the result of a rising interest rate environment. The perceived versus actual risk within these strategies is nuanced and must be evaluated methodically. Historically, performance has been widely varied amongst higher risk debt funds, indicating a reality that is less straightforward than is being advertised.

Exhibit A: Increasing Capital Being Raised for Debt Funds



Source: Preqin

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Similar to equity strategies/funds in private equity real estate, underwriting of real estate debt strategies/funds is nuanced, especially given the asymmetrical information present in the real estate market. Debt funds have historically produced results that trend with vintage year risk, albeit core mortgage funds appear more insulated given their sheltered position in the capital stack, more conservative exposure to property collateral risks, lower LTVs and/or more stabilized properties, and traditionally less use of fund level financing. The risks within debt funds must be evaluated at both the asset and fund level. Properly structuring funds to mitigate risk and ensure disciplined underwriting standards is critical to protecting investors. These debt strategies require loans on tangible assets, and, as such, demand operating expertise in the event of a takeover. Furthermore, debt strategies encompass a wide array of risk profiles and investors should evaluate the incremental risk return trade-offs present with each opportunity.

Core Real Estate Debt

Exhibit B: Various Core Enhanced Mortgage Products

Fund			Collateral Risk		Financing Risk		Rate Risk
Name	Type	Net Target Return	Collateral Type	Fund LTV Max (Loan Max)	Primary Financing Type	Percent of Loan[1] Percent of Collateral[1]	Coupon Type (majority of loans)
Core Fund 1	open-end	6.5%	Large and mid-sized assets; Top 30 markets; Traditional and specialty property types; Stable and light transitional.	75% (80%)	Warehouse Line and A-note	60% / 45%	Floating
Core Fund 2	open-end	6.5%	Large and mid-sized assets; Top 50 markets; Traditional property types; Stable and light transitional.	75% (80%) *Targets 65%*	Warehouse Line and Subscription Line	50% / 32.5%-37.5%	Floating
Core Fund 3	open-end	7.0%	Large-sized; Major markets; Traditional property types; Stable.	75% (75%)	A-note and Subscription Line	60% / 45%	Floating
Core Fund 4	open-end	7.0%	Large and mid-sized; Major markets; Traditional property types; Transitional.	70% (70%) *Targets 60-65%*	Warehouse Line	50% / 35%	Floating

[1]Some cap both metrics and some only cap one. Within their caps, some include and some exclude outstanding balances on subscription lines and/or value of A-notes sold.
Source: The Townsend Group

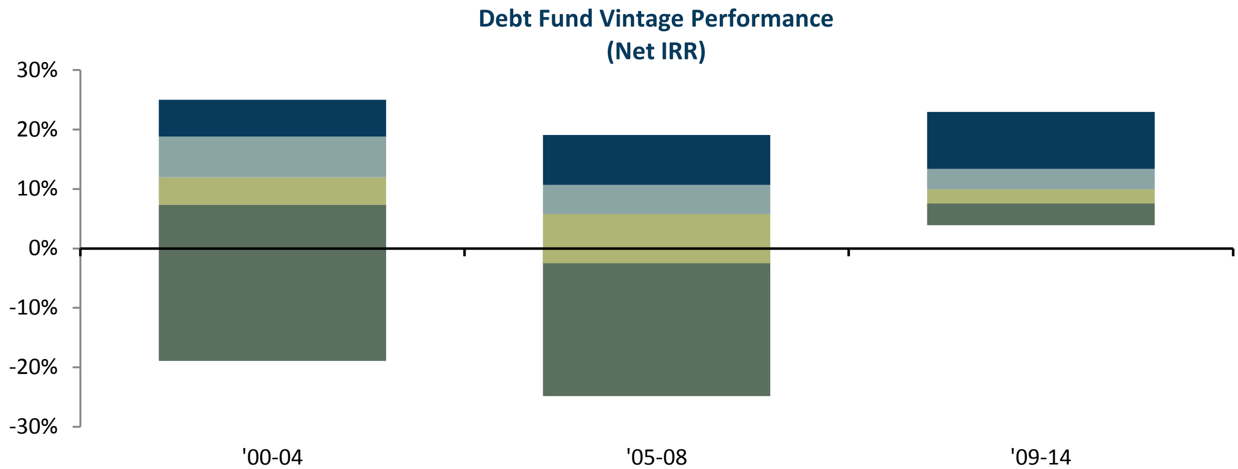
Core debt strategies typically share similar characteristics, involving enhanced mortgage or senior mezzanine positions. Enhanced mortgage strategies are executed by creating leverage (whether it is through A-note origination, subscription, or warehouse lines) on a first mortgage to bolster returns; strategies may also take on selective exposure to transitional assets. Senior mezzanine positions involve thicker slices within the capital stack and lower last-dollar exposure. Target net return expectations for these products are typically within a range of 6-7%. Returns increase in higher interest rate environments and decrease in lower interest rate environments, although the coupon is typically protected by a LIBOR floor.

The debt space has been challenged more recently by an influx of competing capital, resulting in spread compression and, in tandem, lower return expectations. In this cycle, the industry appears to be maintaining discipline, choosing to compete over spreads, rather than last dollar exposure, covenants, Libor floors, etc.

Non-Core Real Estate Debt

In the current environment, high yield debt strategies typically target returns of 7.0-11.0%, while providing the benefit of protection from an equity cushion. High yield debt strategies typically utilize additional risk levers to augment returns relative to the previously mentioned core strategies. Return (and risk!) may be increased through modifying investment structure (increasing last dollar exposure, layering additional leverage, cross-collateralizing fund positions, etc.,), providing construction lending on speculative development/construction, and/or lending on lower-quality collateral. Altering the investment structure can create attractive return opportunities, but risk can quickly escalate and requires mindful deal structuring.

Exhibit C: Debt Fund Net IRR Variance by Vintage Year



Source: Townsend Group, Preqin. (1st Quartile Represent the 95th Percentile and 4th Quartile Represents the 5th Percentile)

Each return lever has its own unique pitfalls. For example, given the typical theoretical return distribution of debt, increasing last-dollar exposure (assuming the same thickness of the slice), cross-collateralizing loans within a fund pool, and/or layering in additional leverage, increases the probability of default in a non-linear fashion. Construction lending takes on a mix of project-specific and systematic risk. Recognizing there may be unique situations in operating-intensive industries where an investment manager is able to exploit the market's unwillingness to lend, for strategies with greater exposure to operational-intensive assets, selecting managers intimately familiar with the property type and the market is a must. As we voiced in our H1 2018 View of the World, we recommend avoiding binary risks at this point in the cycle, a great example of this would be condo developments, which given the length of a typical development, will likely deliver into an economic environment materially different than at the onset of the project; the additional level of idiosyncratic risk with a project such as this deters us from such an investment, particularly within a highly levered debt fund with potential for a binary outcome.

The last cycle highlighted the risk embedded in higher yield strategies (Exhibit C), and the impact of taking on a higher probability of total loss in the worst case scenario. Given the limited volatility the market experienced from '09-'14, we've seen a relatively tight return range in the newer vintage funds. As this cycle has matured, we've noted an increasing level of divergence of fundamentals at the market and submarket level, as well as increasing uncertainty with market direction. Given the current environment with heightened geopolitical tension, global trade war rhetoric, and normalization of monetary policy, we remain mindful of the potential for an investment environment characterized by much greater volatility going forward.

With this backdrop, it makes evaluating risk within a given deal and understanding how it translates to fund level risk even more crucial. Following disciplined underwriting standards, properly structuring fund terms, and creative financing solutions can mitigate risk to an extent and ultimately create attractive investment opportunities within this space. While some of these debt strategies ended up at the top of the peer group in the stressed vintages prior to the GFC, other debt strategies provided no downside protection at all but rather traded off probability of loss with severity of loss.

Conclusion

As debt strategies emerge as an expanding portion of capital formation, investors need to be mindful of the risk trade-offs and implications within the context of their portfolio. Given the possible nuances we've highlighted for debt strategies, the pre-conceived notion that –*one should rotate into debt because it's a lower risk alternative to equity* – is simply not that straight forward. A debt position and the underlying collateral's performance are fundamentally intertwined and, emphasis needs to be placed on lending to high quality collateral as opposed to reaching for return. Fueled by the substantial liquidity available in the market, we've recently witnessed significant spread compression, impacting the real estate debt world, leading to deterioration of the risk-adjusted return profile of higher yielding loans. With that being said, investors need to select managers who will maintain realistic return expectations and a disciplined underwriting approach, particularly given the binary nature of outcomes. With the length of the bull market, numerous groups have built successful track records in a time of minimal economic stress, thus being able to delineate deals and managers that will succeed through the next downturn, is crucial to successful investment execution within the debt sector.