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COMMERCIAL REAL ESTATE PRIVATE DEBT OPPORTUNITY

Introduction

Commercial real estate private debt / capital is an emerging, viable and scalable investment strategy that may deliver superior risk adjusted returns to investors in the midterm. This paper introduces the concept of private debt and summarizes current market conditions in the US shaping this strategy with a focus on commercial real estate investment opportunities. It delivers a viewpoint from a **direct or "closer to asset"** real estate investing perspective rather than a sector-based analysis of real estate public equities whose valuations tend to fluctuate quarterly in direct (and rapid) correlation with overall market moves.

Private Debt Definition

Private debt or credit is financing provided to companies from funds or alternative capital sources as opposed to financing provided by banks, bank-led syndicates, or public markets.[1] Strategies pursued by private funds can be direct lending, venture debt or special situations like bridge-, gap- and rescue financing for listed or unlisted companies, moreover it can be used to finance real assets like infrastructure and real estate. If it is structured as debt, depending on the seniority in the capital stack, private debt may be senior, junior, mezzanine or unsecured debt. If it is structured as equity instead of mezzanine, it may be called preferred equity. This paper will focus on private debt that is used to directly finance commercial real estate in the US.

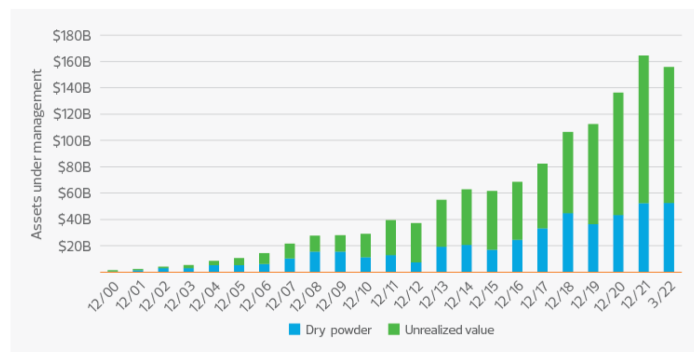
Private Debt History

One can argue that private debt has existed since the turn of the 20th Century, when private lenders led by J. Pierpont Morgan rescued banks, prevented a stock market crash, and saved New York City from financial ruin. The events of 1907 & 08 led to the adoption of the Federal Reserve Act in 1913 which put the government in charge of managing future financial crises.[2]

In the modern world, the role of private debt has been steadily becoming more important, especially after the Global Financial Crisis ("GFC") in 2008 that was essentially caused by subprime bank mortgages and Wall Street's exposure to them through complex financial structures. It was no surprise that the events, failures, bail outs and bankruptcies (at big, financial institution level) of 2008 led to sweeping bank regulations in 2010 under the name of Dodd-Frank Wall Street Reform and Consumer Protection Act. Dodd-Frank introduced more stringent lending and compliance requirements which were further restricted by the international regulatory committee rules (Basel-III) amended in 2011. Basel-III established new capital guidelines and liquidity requirements for banks that were focused on credit risk.[3] Subsequently, commercial loans (especially construction loans) were classified as high-risk / volatility loans and over the years led to banks reducing their commercial loan activity and exposure.

Naturally, the gap has been increasingly filled by private lenders. Below chart from Preqin indicates AUM for private debt funds have consistently grown since 2000, more notably quadrupling from 2011 to 2021.

Private Debt Fund AUM – Real Estate



Source: Preqin

Current Market Conditions

The above-mentioned trend for private debt is likely to continue due to a confluence of current market conditions and further tightening of available credit:

- *Rising interest rates:* The incredible US commercial real estate recovery and expansion after the GFC were possible due to Fed rates held at nearly 0% for years. Rates gradually increased to around 2.4% in 2019 but were reduced to 0.25% again to stimulate the economy during the pandemic. This fueled record high valuations for commercial real estate until the Fed adopted its aggressive anti-inflation policies in 2022 which led to 8

[1] https://www.preqin.com/academy/lesson-4-asset-class-101s/private-debt

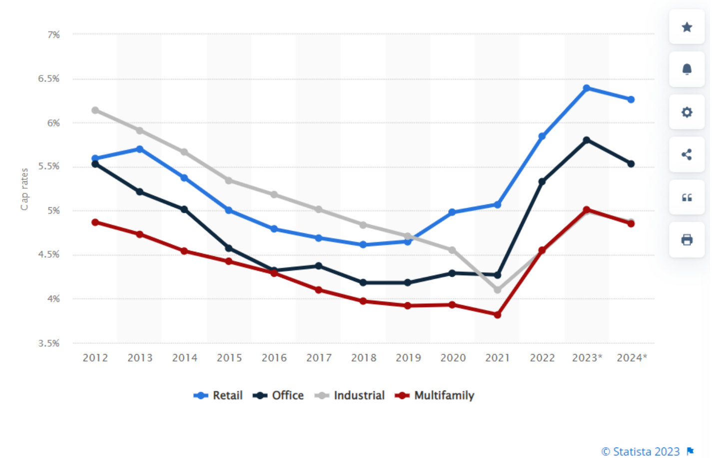
[2] https://www.crf-usa.org/images/pdf/jpmorgan.pdf

[3] https://www.lexisnexis.com/community/insights/legal/practical-guidance-journal/b/pa/posts/the-impact-of-dodd-frank-and-capital-requirements-on-commercial-lending

rapid rate hikes taking benchmark rates from nearly 0% to a range of 4.75% to 5% in a short 12 months.

Fed Funds Rates

Commercial Real Estate Cap Rates



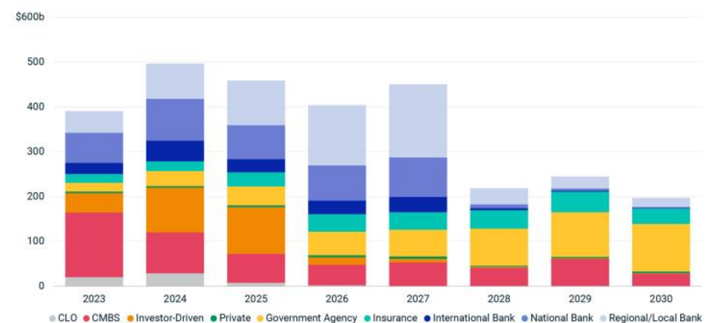
The immediate effects of the rapid rate increase were seen in renegotiation of property valuations between sellers and buyers for existing deals, lenders either canceling their commitments or lowering their loan proceeds, lenders increasing their debt yield-, debt coverage ratio-, net worth- and liquidity requirements. As a result, a lot of transactions in the process of closing were terminated leading to a dramatic decline in investment sales activity. **Transactions that did close had to navigate through the complexity of capital stack gaps created by the pullback of senior lenders. Private debt providers have been crucial in servicing these gaps.**

- Regional bank failures: Recent failure of SVB, Signature Bank and Credit Suisse had a chilling effect on the economy and shed light on systemic risks in the banking system of the digital age. In order to suppress further panic and other potential bank runs, the US government stepped in to backstop all deposits in these banks and the Fed adjusted its rate increase in their last meeting accordingly. Swift restructuring of SVB and Signature Bank and the fulfillment of most of their obligations seem to have minimized the contagion risk for now. However, it is likely that most banks will have to increase their reserves and reduce their risk exposure (this may be governed by new regulation). **As a result, further tightening of credit markets which were already served by a narrower pool of lenders may be expected in 2023.**

Shrinking Lender Pool across real estate sectors[4]

- Loan maturities: Nearly $900 billion of commercial real estate loans are scheduled to mature in 2023 and 24. Most of these loans were 2013/14 vintage CMBS loans that will be maturing to a substantially different market with higher borrowing costs, declining property values and tightening credit conditions. Borrowers who have to refinance their maturing loans are likely to encounter major challenges given the anemic CMBS activity and lower loan proceeds even if they find a willing bank.

Maturing CRE Loans by Lender Type[5]



Because of the origination pattern it is not until 2026/27 that maturities are dominated by bank loans. However, borrowers have already been dealing with massive interest payment increases due to floating rates or

[4] https://www.msci.com/www/quick-take/fewer-lenders-active-in-us/03721038128

[5] https://www.msci.com/www/quick-take/cmbs-dominates-first-wave-of/03740236548

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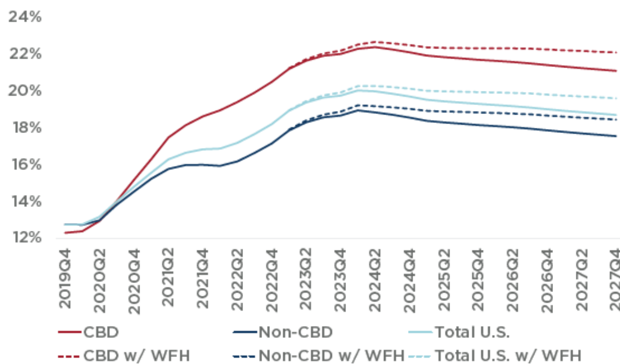
amortization period commencement. Borrowers who were more risk averse at origination and have purchased interest rate caps are dealing with cap expirations ahead of loan maturities in a market where recent pricing of caps compared to a year ago is dramatically more expensive.[6] **Adding lower loan proceeds or having to pay down a portion of the loan at refinancing (cash-in refinance instead of the conventional cash-out refinance that the real estate industry is used to) to the equation, serious gaps in capital stack are arising.**

- Asset Class Specific Considerations: All commercial real estate is subject to the current / near future debt market dislocation; however, some asset classes have inherently stronger fundamentals than others. As the largest investment category, US multifamily has the strongest fundamentals, due to demographic & socioeconomic trends and home ownership having become expensive for most Americans. The logistics / industrial sector has been benefiting from consumer behavior changes and incorporation of technology into every aspect of our post pandemic lives in a more pronounced way. At the other end of the spectrum, commercial office has remarkable headwinds due to a confluence of factors including changing industries, digitalization, economic activity & participation therein, productivity, inflation, technology, AI, outsourcing, employment trends, human psychology, politics, global / local power dynamics and remote work.

Impact of "Work from Home" on Vacancy



Source: Cushman & Wakefield Research

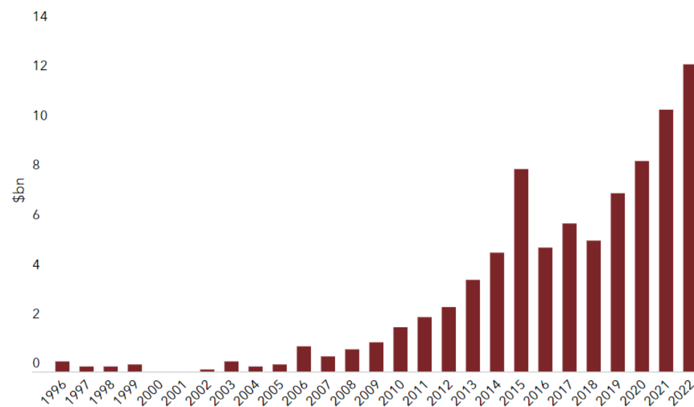
Interestingly, even best performing assets and borrowers are not immune to the effects, especially in the office sector.

Potential Refinance Scenarios

The sheer volume of loan maturities under the current market conditions is daunting, however there is no doubt that a big portion of these maturing loans will be worked out or extended. Some will be paid off by owners liquidating assets at lower valuations, some will be subject to short sales (at prices lower than the mortgage amount to avoid foreclosure) and some borrowers will be foreclosed on. As it relates to foreclosure, it is important to note that if an asset has been held by the owner for a long period with a low tax basis, "giving back the keys to the lender" will bring significant tax implications. Therefore, it is not an easy solution for certain types of owners such as family offices and generational wealth investors. At the institutional end of the spectrum, refinancing reality is likely to spur equity recapitalization activity in the secondaries market. [7]

REAL ESTATE SECONDARY TRADING VOLUME

The $12.4bn in secondaries transactions in 2022 marked a record high for the third year in a row ($bn)



Source: Ares Secondaries Group

As an alternative to the above-mentioned scenarios, there is a strong case for a private debt / gap finance strategy.

Opportunity in Real Estate Private Debt

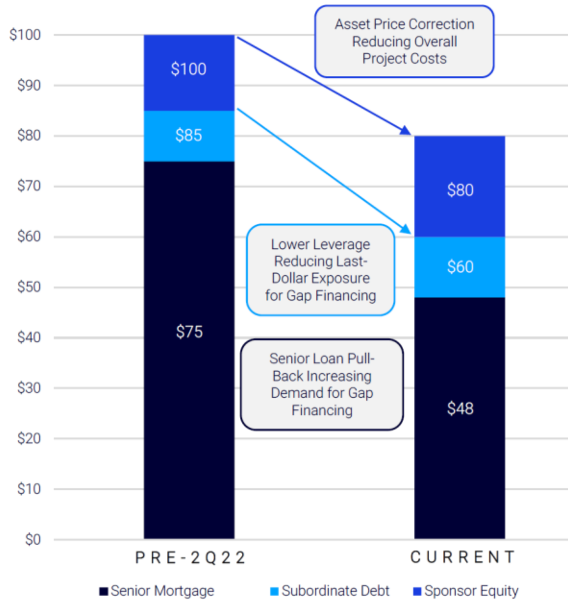
The interrelation of current market conditions is creating a challenging environment for the commercial real estate refinancing activity by causing unexpected gaps in capital stacks. **These gaps, significant in size, potentially adding up to hundreds of billions of dollars, are likely to be financed by non-traditional, private lenders until the banking system stabilizes.**

[6] https://commercialobserver.com/2023/03/rising-interest-rate-cap-costs-pressure-cre-borrowers/

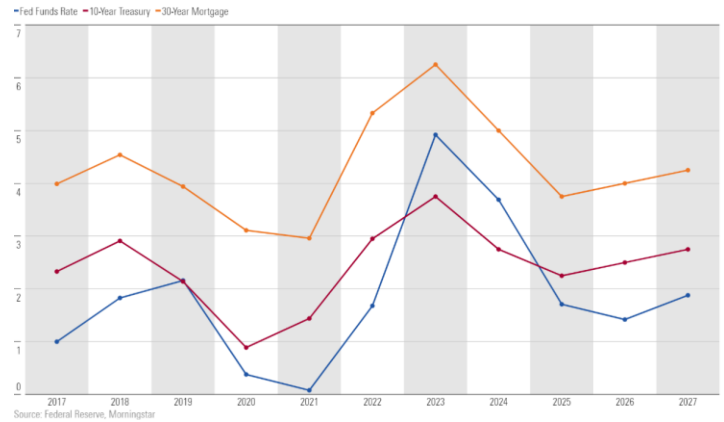
[7] https://www.perenews.com/recapitalizations-headed-for-turbocharged-year

CATALYST	EFFECT
High interest rates / borrowing costs are causing lower valuations as cap rates are expanding in response to negative leverage. Higher rates also mean higher debt yield requirements for lenders.	**Lower valuations mean lower refinance loan proceeds. Proceeds are further decreased by higher debt yield requirements creating a 15%-20% gap in the capital stack for the same asset.**
Due to volatility and tightening credit in the market, refinancing borrowers are served by a narrower pool of lenders.	**Supply of credit by traditional lenders is scarce while demand for credit is likely to grow exponentially.**
Massive amounts of commercial debt are maturing over the next few years to dramatically more expensive borrowing conditions combined with lower leverage points.	**Demand for refinancing activity will be very high while the supply of conventional credit will be scarce.**

Adjusted Capital Stack Example [8]



The effects are likely to linger even if the Fed stops rate hikes or starts rate cuts by the end of 2023. A relatively higher interest rate market [9] until 2025 with a potential recession in sight would only exacerbate the need for alternative gap financing, **creating a viable midterm strategy for private debt.**

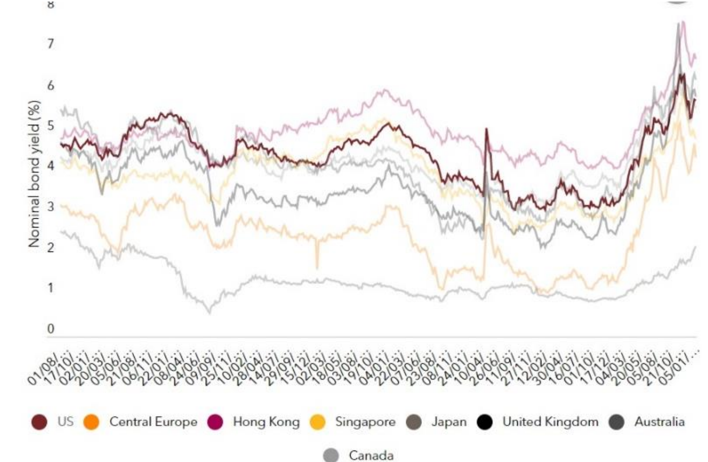


Private Debt Structuring

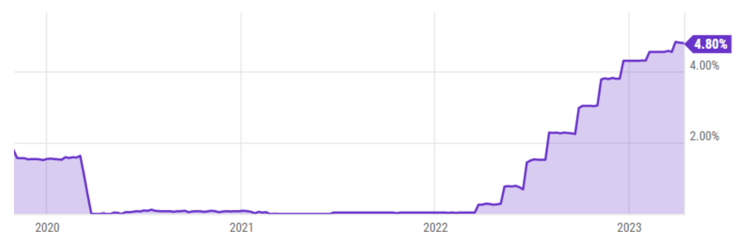
Transactions financing a capitalization gap are likely to be structured as **subordinate debt or preferred equity** that will stand behind a lower loan-to-value ("LTV") senior debt. Return expectations on these subordinate positions are directly correlated with increased cost of capital and recent changes in the base index they are quoted on, SOFR.

Increase in Global Cost of Capital per Bloomberg

(US highlighted in dark red)[10]



Recent Changes in SOFR [11]



[8] Source: Courtesy of Vero Capital, for illustrative purpose only

[9] https://www.morningstar.com/articles/1106505/when-will-the-fed-start-cutting-interest-rates

[10] https://www.perenews.com/deep-dive-real-estate-borrowers-feel-the-pain/

[11] https://ycharts.com/indicators/sofr

Although it is difficult to quantify deal terms in the private market, recent transaction activity Caldera has proprietary access to through private fund managers indicates that investors may be able to generate **12%-14% unlevered coupons in addition to fees** associated with origination of subordinate debt. These positions are senior to common equity and backed by borrower entity shares. **Coupons may be expected to be accrual only or a combination of accrual and current pay. Asset classes include multifamily, logistics / industrial, office, mixed-use, and hospitality. Underlying assets are cash flowing and operated by experienced sponsors. Investment horizon is 3-5 years.** These types of deals were likely to generate 8%-9% coupons in a low interest rate environment and they were higher up in the capital stack (i.e higher loan basis on top of a higher LTV senior loan).

For quality cash flowing assets suffering from the market dislocation, the new subordinate capital could replace the equity injection expected from the borrower, facilitate new interest cap purchases, replenish the interest reserve for the senior loan and fund crucial capital expenditures to combat vacancy or increase operating income.

Private debt is also likely to breathe life into new acquisitions as the same market headwinds apply to new transaction capital stacks. In this case, alternative lenders may come to rescue by filling in the gap after a lower LTV senior loan (similar coupons of 12%-14%) or they may have an opportunity to originate the whole loan that would be collateralized by the asset itself. Whole loans with a senior and subordinate piece may blend to a 9%-11% weighted average rate.

In addition to originating gap capital financing, investors are likely to find opportunities purchasing performing or non-performing loans at meaningful discounts. Depending on the complexity of the underlying special situation, these investments may generate superior returns. However, they certainly may require a more hands-on restructuring strategy, thorough risk mitigation, active asset management and operational know-how.

In conclusion, Caldera Real Estate Ventures ("Caldera") believes that there is a strong case for a commercial real estate private debt strategy in the next few years. The investment thesis is supported by current macro trends, dislocation in debt markets and overall tighter lending conditions. However, the future success of a private debt investment truly depends on a profound understanding of the underlying asset and investment horizon, conducting thorough due diligence for ultimate risk assessment and management, independent vetting of the borrower as well as the sponsor / manager of the debt investment. **Family offices and investors, especially the ones who do not have the right in-house team to diligently assess risks, are advised to work with external advisors like Caldera that have a direct, asset level real estate investment track record.**

Author Information

Can Tavsanoglu is the Founder of Caldera Real Estate Ventures, a Chief Investment Officer on Demand ("**CIO on Demand**")**, strategic, independent advisory** business for commercial real estate. Caldera caters to US & Non-US based family offices, institutional investors and (U)HNW individuals who want to invest / or have already invested in US Commercial Real Estate but have not hired a full time CIO and/or an asset management team.

Caldera is founded on Mr. Tavsanoglu's track record of 14 years of successful principal side investment experience totaling $2billion in transactions, developments, and financings. Caldera has an advisory board that consists of the former head of Ernst & Young's global real estate advisory, Executive Chair of Herrick Feinstein, a legal firm with 140 attorneys and global presence, and the head of northeast construction financing at Santander Bank.

Caldera offers a comprehensive set of services including Strategy & Growth, Acquisitions, Due Diligence, Finance, Structuring, Dispositions, Development and Asset Management including ESG compliance & institutional reporting.

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