Real Estate Debt - An Emerging Opportunity for Fresh Capital

Looking Past the Headlines - Why CRE Credit?

While the news cycle is peppered with negative headlines like *"Commercial-Property Distress in the US Rises to a 10-Year High",*[1] it is important to look past the sensationalism. The real story influencing the headlines rests with one primary suspect: the U.S. office sector that is currently seeing historically elevated delinquency rates which continue to trend upwards. Delinquencies for historically safer collateral types, primarily multifamily and industrial, lie far below the levels being seen in the office market.

Delinquency Rates[2]
December 2021 to December 2023

Collateral	Delinq. December 2021 (%)	Delinq. December 2023 (%)
Office	1.82	5.18
Retail	4.79	3.08
Multifamily	0.28	0.40
Industrial	0.22	0.28

Includes 30, 60, 90+ days delinquent and foreclosures

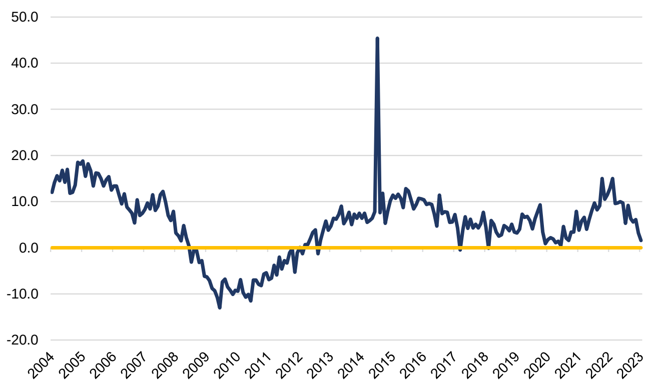
We believe the current issues in the office sector will take many years to play out, with existing lenders being required to spend time and capital to work out various underperforming positions. This has caused a dislocation with many lenders as their focus has shifted away from making new loans to working out their existing portfolios. While many investors are seemingly holding out for the *perfect* opportunity to scoop up distressed assets at the bottom of the market (whenever that may be), they are perhaps missing out on the more *immediate* opportunity to originate new, high-quality loans on performing, high quality assets into a new pool with no legacy credit issues.

With a focused lending strategy supported by (I) less competition from traditional lenders, (II) safer property types with favorable fundamentals, (III) favorable loan bases as a result of recent declines in property values, (IV) high coupons relative to historical levels, and (V) the benefits of income diversification, we believe CRE debt is an attractive allocation choice in private credit portfolios.

(I) Limited Supply of Capital for CRE Lending

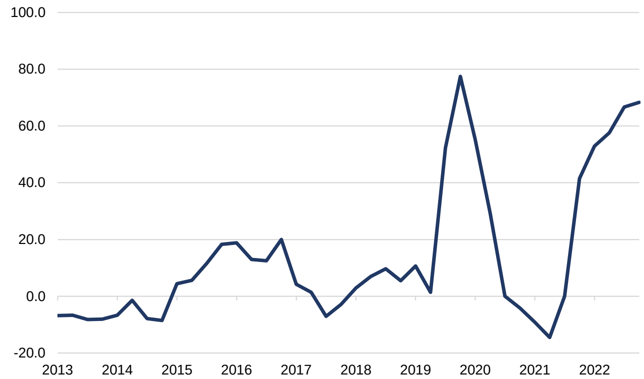
As a result of regional bank failures in early 2023, we expect heightened regulatory scrutiny and increased capital requirements to significantly constrain the availability of capital for CRE lending, creating a less competitive and more advantageous environment for CRE debt vehicles. Commercial banks had reported significant slowdowns in the pace of CRE loan originations starting in 2022 by approaching net zero annual growth in CRE loans (represented by the gold horizontal line on the chart below). With this measure trending towards negative growth in 2023, it appears alternative lenders will benefit from the runoff of banks' more than $1.4T in combined CRE loan assets.[3]

CRE Loans % Change at Annual Rate by all Commercial Banks[4]
2004 to 2023

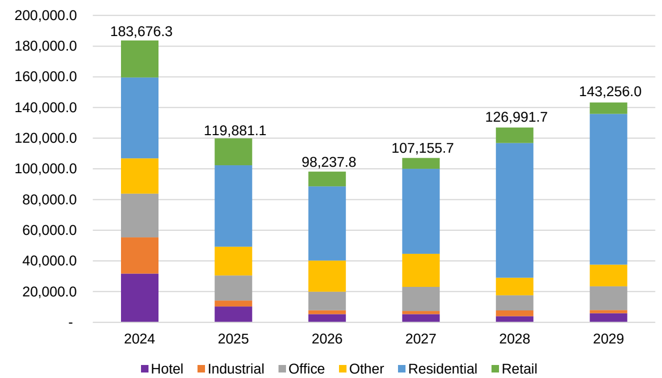


In addition to banks tightening their CRE lending standards, a historic wall of maturities exceeding $750B is coming due over the next five years in the Commercial Mortgage-Backed Securities ("CMBS") market.[5] This is a significant refinancing opportunity that allows CRE debt vehicles to negotiate terms that align with prevailing market conditions by securing higher interest rates and favorable loan structures, enhancing the yield potential for investors.

Net % of Domestic Banks Tightening CRE Lending Standards[6]
2013 to 2023



Upcoming CMBS Loan Maturities[7]
2024 to 2029



(II) Strong Operating Performance Metrics in Select Asset Classes

Despite inflation and recession concerns, certain sectors of CRE continue to have strong fundamental tailwinds. We expect multi-family and industrial assets to emerge as top choices for CRE debt vehicles due to their resilient operating metrics. These asset classes offer consistent and predictable income streams, aligning with the risk-adjusted return profile of CRE debt vehicles.

Multi-Family Sector Fundamentals

A lack of investment appetite for housing in the wake of the GFC led to underbuilding relative to population growth and has caused a persistent undersupply of multi-family housing. Fewer new homes were built in the 10 years ending in 2018 than in any decade since the 1960s,[8] and the pandemic-induced materials and labor shortage exacerbated this trend causing rents and home prices to surge. Furthermore, multi-family housing remains attractive based on younger generations exhibiting a higher propensity to rent due to escalating student debt, rising starter home prices, and increasing interest rates. According to the 2021 U.S. Census, one-in-three adults ages 18-34 lives with their parents. This rate has steadily risen from just one-in-five in the 1960s, implying significant pent-up demand for housing.[9] Lastly, we believe that Freddie Mac and Fannie Mae will continue to provide cheaper financing for stabilized properties, creating a sturdy and well-proven exit option for transitional loans originated by CRE lenders.

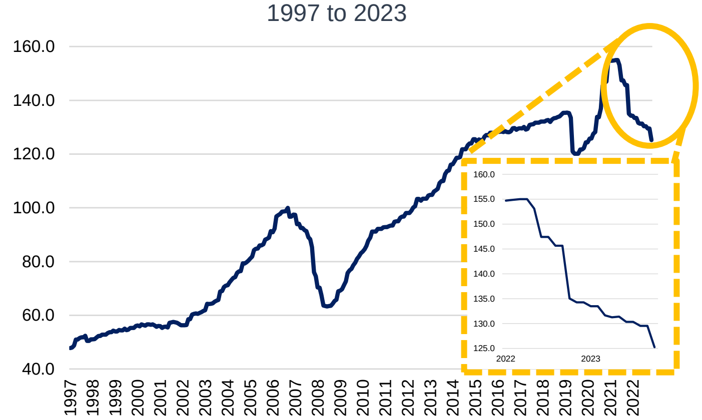
Industrial Sector Fundamentals

Accelerated by COVID-19, historically high savings, and government stimulus, consumers' adoption of convenient e-commerce has further spurred a transition from brick-and-mortar retail to direct shipments to customers, which relies upon well-built and efficient industrial infrastructure. According to McKinsey, e-commerce sales penetration in the U.S. more than doubled in 2020 from the previous year, roughly the equivalent to ten years of growth. This exponential e-commerce demand led to supply chain shortcomings, resulting in the need for additional storage space and a shift in inventory management from 'just-in-time' to 'just-in-case'. This shift is critical when considering 20% of total global sales were made from online purchases in 2021, with McKinsey expecting this level increasing to 25% by 2025.[10] We believe that these durable macro dynamics support continued high occupancy and well-capitalized tenants who underpin the industrial real estate debt market.

(III) Favorable Loan Basis Resulting from Reset Property Values and Lower Leverage

The current higher interest rate environment has led to a corresponding increase in property cap rates, which has generally caused property prices to decrease in cases where there hasn't been a corresponding increase in property income. As a result, CRE prices have fallen on average by 16% from their high in 2022.[11] Additionally, with less competition in the market, CRE lenders have been able to pull back on the amount of leverage provided to property owners as they take a more conservative approach in the current economic environment. Whereas typically first mortgage loans could get as high as 75% to 80% loan to value in early 2022, 65% to 70% loan to value metrics are more common in the current environment.[12] The combination of lower property values with the decreased leverage being offered means CRE lenders are currently able to achieve an advantageous basis as much as 26% lower than their recent highs.[13]

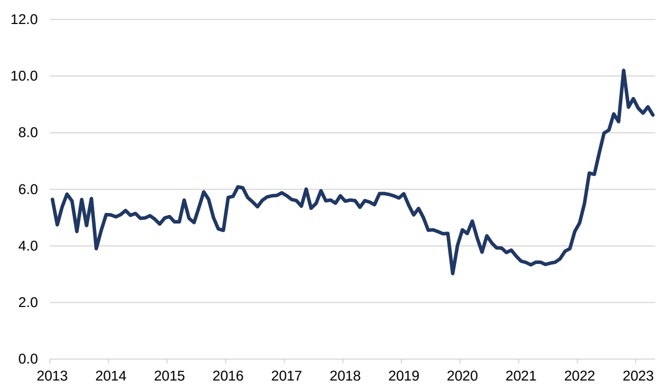
Green Street Commercial Property Price Index[14]
1997 to 2023



(IV) High Coupons Relative to Historical Levels

The average CRE loan coupon in 2023 was 8.5%, which is nearly twice as high as the previous decade's average of 4.9%.[15] The current One Month Term SOFR forward curve indicates that SOFR will stay above 3.0% for at least the next 10 years, enabling investors to continue to achieve elevated returns on floating rate first mortgages.

Floating Rate CRE Loan Coupons (%)[16]
2013 to 2023



Additionally, CRE first mortgages are typically structured with benchmark SOFR floors to reduce downside risk of an unexpected decrease in benchmark rates. If SOFR falls below a specified rate, usually around 3.5% in the current lending environment, mortgage borrowers will continue to pay a coupon based on that greater specified benchmark value instead of the actual benchmark.[17]

(V) Income Diversification Benefit

CRE debt returns also have had a low correlation with stocks, bonds, and equity REITs. Averaged over two and a half decades, the CRE first mortgage benchmark return profile has been higher or equivalent to corporate debt with less volatility. The benchmarks assessed in this analysis include the LifeComps Commercial Mortgage Loan Index, Barclays Investment Grade U.S. Corporate Unhedged Index, S&P LSTA Leveraged Loan Index, and Credit Suisse U.S. Corporate High Yield Index. We believe these preeminent benchmark indices provide a reliable reference for corporate debt performance and highlight the risk-adjusted benefit of investing in CRE first mortgages long-term.

Risk and Return Profile[18]
1996 to 2022

Asset Class	Returns (%)	Volatility (%)
CRE First Mortgages	6.23	4.06
IG Corporate Bonds	5.44	5.81
Leveraged Loans	5.01	6.09
High Yield Bonds	6.88	9.01

As a result of current market dynamics, CRE debt investments appear to be benefiting from less competition, exhibiting strong sector fundamentals amongst multi-family and industrial collateral, and are producing historically high returns.[19] By taking initiative and originating a fresh portfolio of loans in this higher-rate and more lender-friendly landscape, it is our view that investors will have an immediate advantage over others with legacy portfolios exhibiting higher loan bases and lower rates of return. While the current market is supporting more favorable dynamics, we believe long-term investors are often better off with a strategic position in CRE debt to generate uncorrelated, consistent, income-driven returns with protection against downside risks at all points in the cycle.

Coming Soon:

Optimizing Risk-Adjusted Returns Through 2:1 CRE Lending

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Disclosures

1. Source: "Commercial-Property Distress in the US Rises to a 10-Year High", Bloomberg News, October 18, 2023
2. Source: Bloomberg, Commercial Real Estate Delinquencies
3. Source: Federal Reserve Economic Data, Series: BOGZ1FL213065503Q, BOGZ1FL763065503Q, BOGZ1FL753065503Q, BOGZ1FL743065505Q, BOGZ1FL513065505Q, BOGZ1FL543065505Q, BOGZ1FL573065505Q, BOGZ1FL223065545Q, BOGZ1FL413065505Q, BOGZ1FL673065505Q, BOGZ1FL613065503Q, BOGZ1FL643065505Q, BOGZ1FL153065505Q, BOGZ1FL103065503Q, BOGZ1FL113065503Q, BOGZ1FL313065505Q, BOGZ1FL423065405Q
4. Source: Federal Reserve Economic Data, Series: H8B3219NCBCMG
5. Source: Bloomberg, CMBS Balloon Risk Analysis
6. Source: Federal Reserve Economic Data, Series: SUBLPDRCSN
7. Source: Bloomberg, CMBS Balloon Risk Analysis
8. Source: Fannie Mae Perspectives Blog: U.S. Housing Shortage: Everything, Everywhere, All at Once. Jeffery Hayward, EVP, and CAO of Fannie Mae
9. Source: U.S. Census Bureau, Current Population Survey, March and Annual Social and Economic Supplements, 1981 to 2023. Source of 1980, 1970, and 1960 data: U.S. Census Bureau, 1980 Census of Population, PC80-2-4B, "Persons by Family Characteristics," Table 4. 1970 Census of Population, PC(2)-4B, Table 2. 1960 Census of Population, PC(2)-4B, Table 2
10. Source: "What is e-commerce?", McKinsey & Company, June 29, 2023
11. Source: Green Street Commercial Property Price Index (CPPI), November 1, 2023
12. Source: Sound Point CRE CLO Database and Bloomberg
13. Source: "Commercial Property Prices Down Another 0.8%", Green Street Research, July 7, 2023
14. Source: Green Street Commercial Property Price Index (CPPI), November 1, 2023
15. Source: Sound Point CRE CLO Database and Bloomberg
16. Source: Sound Point CRE CLO Database and Bloomberg
17. Source: Sound Point CRE CLO Database and Bloomberg
18. Source: LifeComps Commercial Mortgage Loan Index and Bloomberg
19. Source: Sound Point CRE CLO Database and Bloomberg

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