Rise of the Real Estate Debt Asset Class

Finding value in real estate debt deals and funds

WITH EXPERTS FROM:
Ackman-Ziff Real Estate Group
Cambridge Associates
PGIM Real Estate Debt Strategies
Reconsidering Risk and Return

Property and leverage go together quite well, depending on what part of the cycle you’re in. Most investors have, historically, been focused on owning the real estate equity, but the debt side of the equation is rapidly evolving as an asset class unto itself. This report seeks to provide a brief status report on that debt market.

You’ll learn from PGIM’s Steve Bailey how, in the wake of the Great Recession, some savvy investors used real estate debt as a sort of stand-in for core equity, and how that bet paid off. Bailey argues that real estate debt characteristics are so unique that institutional investors should consider a permanent allocation. The good news is, there are many types of debt investments up and down the risk-return spectrum. The bad news? Many investors can’t figure out exactly which allocation “bucket” these investments should come from.

Jason Krane of Ackman-Ziff argues that a cautious sobriety now characterizes the underwriting process of real estate debt, and that this will mean that any overly bullish projections will be met with skepticism by debt providers.

And Marc Cardillo of Cambridge Associates voices his concern that the pace of debt fund creation may not be commensurate with the opportunity to deploy debt at attractive rates of return.

Given the relative immaturity of this real estate debt asset class, there are many developments that are worth closely following as you evaluate your own participation. We hope this content is useful in that endeavor.

Enjoy the report,

David Snow
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Does the ‘Plethora’ Match the Opportunity?

Privcap: What are you going to be watching most closely in the real estate debt market in 2017?

Marc Cardillo, Cambridge Associates: I’m curious about the degree to which traditional lenders—which have been less active over the past few years—start to get more active. Does the regulatory environment, with the new administration, become a little bit more favorable to them so that they potentially are a bigger player on the real estate lending side?

What do you look for when you are vetting a real estate debt manager?

Cardillo: There are fewer barriers to entry in terms of creating a platform to be a real estate lender, and fewer points of distinction. We look for groups that have the capability to get involved with properties if the market becomes more difficult, and [are] able to foreclose on some portion of properties in their lending book. I think that’s where we see a wider degree of difference, where some groups don’t necessarily have the size to take that on.

What role do you think the CMBS market will play in real estate lending in 2017?

Cardillo: It’s unclear to me what the impact of the new rules will be in terms of CMBS structures—some of which are pretty onerous in terms of the risk-retention piece. That to me suggests that CMBS will be a smaller component of the overall lending market this year, which is probably good for a lot of the real estate debt managers that are out there.

What kinds of deals do you think will be more readily financed in the current market?

Cardillo: Given that we’re later in the real estate cycle, I would think most lenders and most funds will be even more cautious and conservative than they would have been a few years ago. Borrowers seeking lower LTVs [loan-to-value ratios] will find a pretty large universe of lenders that they could work with. But those groups looking for higher LTVs will probably struggle to get deals financed. The heavy value-add transactions may be harder to get financed than the core-plus transactions.

Are you seeing a changing appetite among your clients for real estate debt?

Cardillo: It’s a little bit bifurcated in terms of where we’re seeing demand for real estate debt strategies. For endowment clients that have always been biased towards real estate equity investments, we haven’t necessarily seen them be active on the real estate debt side. Their bias is towards looking for higher risk-return opportunities within their illiquid allocation. They also like the inflation protection that an equity strategy can provide.

Whereas, I can see with our family clients and with certain clients outside of the U.S., they seem much more comfortable with the lower return targets and obviously lower risk that comes with the real estate debt funds. That allocation may come from some broader sources—perhaps not just coming out of their real estate allocation—but maybe it’s part of a fixed-income allocation or a broader credit allocation that they have.

Does anything concern you about what you’re seeing in the real estate debt market?

Cardillo: We’ve definitely seen a plethora of real estate debt funds being formed and being raised. That gets me a little bit concerned that there is a lot of capital being formed, and maybe that’s dwarfed by the level of opportunity out there. But again, that does depend on a lot of the banks remaining on the sidelines and the CMBS market being less active.
Playing Lower in the RE Capital Stack

A real estate advisor explains why dealmakers are more interested in holding real estate debt

Privcap: What are your top-level predictions for the real estate debt market in 2017?

Jason Krane, Ackman-Ziff: People are optimistic going into 2017. Investors appear to have a handle on debt pricing, and once there’s a sense of stability, investors feel more comfortable transacting; whether that’s bidding on acquisitions, refinancing and recapitalizing transactions. There are a lot of quality real estate deals that are probably overleveraged from 2006 and 2007, and they just need to be right-sized and/or restructured.

What do you expect from the CMBS market now that issuers have new risk-retention rules?

Krane: Last year, the larger banks—Morgan Stanley, Wells Fargo, Bank of America, Goldman—launched a couple of test deals. The response was favorable, so I think that’s going to continue throughout 2017. I don’t think there’s going to be any further price adjustments or price premiums post risk retention.

What else can you tell us about the way deals are getting underwritten in the current market?

Krane: Investors want to purchase deals where a meaningful portion of the equity return is derived through cash flow, and not just reversion relying on exit cap rates. We don’t see investors underwriting overly-aggressive assumptions for example, hotel ADRs [average daily rates] and/or residential rents are going to grow 10 percent. That’s not happening. Investors will underwrite deals and markets based on supportable information.

What kinds of deals will be easiest to finance in 2017, and what will be the attributes of deals that will be tough to finance?

Krane: The challenges will be ground-up luxury condos and ground-up hotels where there is a supply-demand imbalance. Secondary and tertiary malls—those will all be somewhat challenged. By contrast, deals that have solid cash flow, a strong tenant base with really good fundamentals—those deals will attract favorable financing, whether it’s from commercial banks, life insurance companies, Wall Street, debt funds, etc.

There is a tremendous amount of capital in the market, but lenders are really prudent today on how they underwrite deals, making sure that assumptions are supportable.
The head of PGIM’s real estate debt investment platform describes the advantages of being tapped into the Prudential network, the risk-return spectrum for real estate debt, the challenges the asset class faces as it grows, its appeal to institutional investors, and what is likely to happen in a rising interest rate environment.

Steve Bailey
Managing Director, Portfolio Manager, PGIM Real Estate Debt Strategies

Privcap: What is your approach to real estate debt, and how have you structured this platform to succeed?

Steve Bailey, PGIM: Inside Prudential we have a very large investment-management firm called PGIM. Inside that broad umbrella of investment-management businesses, we have capabilities of both debt and equity. And my business, PGIM Real Estate Debt Strategies, is really built to take advantage of those debt and equity capabilities and to bring the best of the two.

Real estate debt is a burgeoning asset class, and yet it’s one that not every institutional investor fully understands. How do you define the asset class?

Bailey: Our business operates in what we call the high-yield debt space. And our definition then starts with, essentially, core-plus debt, which sits risk- and return-wise just above CMBS or life company lending or bank lending—more commodity-like debt.

Can you give examples of types of real estate debt investment on different ends of the risk-return spectrum?

Bailey: In our core-plus strategic approach to the market, we are looking at primarily bridge lending on stabilized assets as an alternative to a long-term fixed-rate mortgage. We’re also looking at some lending on transitional assets. So when you look at stable assets and light transitional kinds of assets, the cash flow from

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those is very predictable and therefore low-risk.

At the other end of the risk-return spectrum, you see heavy transitional kinds of assets—so a historic industrial building in an urban core being converted to a multifamily building. Or you might see a development project [for] ground-up development, and we could lend to those sorts of assets either through mezzanine or preferred equity kinds of investment—subordinated investments. Or whole-loan lending where we’re, in essence, taking the senior position and the mezzanine position in one investment.

Can you talk about how, tactically, real estate debt was used in the downturn and what the results were?

Bailey: The results were pretty good. We participated in that marketplace. Coming out of the financial crisis, the risk-return comparison of real estate debt to equity was very favorable. So in our view, we were getting equity-like returns for taking very conservative debt risk. And so as a tactical move for our investors, it made perfect sense. Now, the opportunity was short-lived, and it got arbitraged away fairly quickly.

As you speak to investors, do they sometimes wonder which bucket their allocation to real estate debt should come out of? And what do you think the right approach to that allocation is?

Bailey: That is absolutely a challenge for the growth of our industry. The investors we speak to are often set up in a way where their different groups, their staffs, are set up to be real estate or fixed income or alternatives. They have very defined strategies for what they do. Real estate debt often falls somewhere between those various strategies.

I think we need to be better about defining strategies and reaching above the staff to the CIO level inside, in our investor clients, and making sure that at the top of these institutional investors they understand the array of opportunities that we can bring with real estate debt.

How transparent is the real estate debt asset class currently, and what challenges remain?

Bailey: What I defined as the high-yield part of the business lacks transparency. And it is a challenge, because many investors need to have solid benchmarks—very transparent ways of looking at the market comparison of different managers across strategies. And that’s hard to do right now. So one thing that we are involved with, with some of our colleagues in the industry, is creating a benchmark—or, actually, a series of benchmarks—that address that transparency issue.

What is the optimal fund structure for your type of real estate debt investing?

Bailey: It really depends on the investment that we’re looking at, and the strategy that we’re executing. If we’re looking at a core-plus, strategic kind of strategy that is meant to be a diversifier and an income-producing investment for an investor client, then open-end seems to make sense to us.

If we’re investing in a very tactical and market-driven opportunity, then closed-end makes sense. And we tend to think about a fundraise that’s relatively smaller in size and one that we feel very confident about being able to execute in the defined time period in which that opportunity is available in the marketplace.

How do you think your kind of investing will be affected in a rising interest rate environment?

Bailey: That’s the trillion-dollar question. The hunt for yield across the globe has been so intense that we’ve seen, at least at some level, what we think is a warping of proper risk-adjusted returns. And some investors [are] perhaps being too aggressive price-wise or structure-wise in trying to invest dollars that they’ve raised that need to get put into the market. So from our perspective, a rising interest rate environment relieves some of that pressure, hopefully normalizes the market—and [brings us back] to a better risk-adjusted return with less competition—that is behaving in a way that ... might not be fully rational.