

Privcap/ Conversations

How Will Real Estate Debt Perform in the Next Downturn?

Featuring commentary by:
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About the Experts



Jackie Brady

Executive Director, Business Development
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Jackie Brady is an executive director at PGIM Real Estate and a member of the U.S. Business Development group. Based in New York, she is responsible for marketing PGIM Real Estate's global products and providing client service to institutional investors and consultants, and with helping PGIM Real Estate to broaden its client coverage of insurance companies and high net worth investors.

Jackie joined PGIM Real Estate with more than two decades of experience in the real estate debt capital markets, having served as a principal and portfolio manager at Canopy Investment Advisors and Capmark Investments, LP.

Most recently, Jackie was a senior leader at CenterSquare Investment Management where she was responsible for enhancing and developing CenterSquare's relationships with institutional clients and consultants. Jackie currently Chairs the PREA Publications Committee.

Jackie has a bachelor's degree in political science from Haverford College and serves on the Investment Committee of the Board of Managers of the College. She also has a master's degree in international relations and international economics from the Johns Hopkins University.



Andrew Radkiewicz

Global Head of Private Debt Strategy and Investor Solutions
PGIM Real Estate

Andrew Radkiewicz is a managing director at PGIM Real Estate and global head of Private Debt Strategy and Investor Solutions. Based in London, Andrew is responsible for developing and implementing real estate debt fund product architecture and strategic solutions for global investors. He also has oversight for PGIM Real Estate's global banking relationships. Andrew is a member of the Global Management Council, Global Investment Committee and Global Operating Risk Committee.

Previously, Andrew was co-head of Europe where he was responsible for PGIM Real Estate's European businesses. In 2007, Andrew co-founded the boutique fund manager Paramount Private Equity, which was subsequently absorbed by PGIM Real Estate in 2009 to form the Pramerica Real Estate Capital (PRECap) platform.

Prior to founding Paramount Private Equity, Andrew spent 13 years at N M Rothschild in London, most recently as managing director of Real Estate Finance and Debt Capital Markets. Earlier, he worked for Credit Lyonnais and Lloyds.

Andrew has a bachelor's degree in economics from Warwick University.

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PORTFOLIO & PERFORMANCE

How Will Real Estate Debt Perform in the Next Downturn?

Institutional investor interest in real estate debt of all forms has been surging in recent years, thanks in part to a view that it has attractive risk/return characteristics. In a recent interview, Privcap asked two real estate debt experts to better explain the investor appetite and risk characteristics of real estate debt and, critically, to offer thoughts on how this asset class may perform in the next economic downturn.

Privcap: What is behind the rising interest among institutional investors in allocating to real estate debt?

Jackie Brady, PGIM Real Estate: There are a number of reasons. What we have found is that institutional investors look at debt very much as a non-monolithic asset class. It has appeal across a wide swath of a portfolio. As we get longer into the cycle, investors are interested in a more defensive position. That has caused them to think more about allocating into real estate debt strategies, which don't promise the upside of equity, but definitely have structural characteristics that limit downside risk.

We're also seeing investors coming into real estate debt as a defensive position from fixed income, because we are having an era of very low

returns across much of fixed income, and real estate debt is providing an interesting alternative to fixed-income assets. On both sides of the spectrum, from traditional real estate investors as well as from far larger fixed-income institutional investors, we are seeing increased interest in debt.

Andrew Radkiewicz, PGIM Real Estate: I'd add that real estate debt has been around for a very long time, but most recently is moving from a niche asset class very much into a mainstream asset class, alongside private corporate debt and private infrastructure debt. It is a combination of both real estate allocations and fixed-income allocations coming in. People recognize that this is a large market, it offers a breadth of risk-adjusted return opportunities, and it has been ignored for too long.

Private credit investors that are happy to invest in corporate direct lending, or infrastructure debt, are now increasingly comfortable, for similar returns, to look at real estate debt. They're already in the private markets.

Brady: There is an increasing recognition that all public bonds aren't necessarily liquid. Investors are more and more comfortable to look not necessarily to increase their spreads by going private and illiquid, but actually recognizing that they already have illiquidity in their public portfolio, and are actually switching that into private real estate debt in order to get recompense for that.

Privcap: Andrew, please give us a tour through the various forms of risk in real estate debt.

Radkiewicz: Real estate debt offers a broad church of risk-adjusted returns. On one end, there is what we'd describe as investment-grade style of senior loans secured by real estate. Then, you can go all the way across to higher-risk real estate with more asset management-related risk and higher leverage positions.

There are three fundamental risks defining these different investment opportunities. First and foremost,

there is a real estate risk. At the one end, real estate can be new, really well located, fully leased and producing a very long-term, contracted cash flow. At the other end, you can either have a completely vacant property that needs refurbishment or a brand-new development and everything in between. Obviously, where you are in that real estate risk, no matter how you lend upon it, is going to determine clearly what your risk and expected return is.

Secondly, under the banner of credit profile, the key driver is how much you are lending against the property. How much cover does the underlying rent from the property provide to your loan investment? What's your borrower quality? What's their track record? Loan to value and debt service firmly determine risk, again, and return on the credit profile.

The third risk is called "subordination profile." It's a bit more technical, but is best described as comparing a senior loan investment (i.e., the investors investing in the full part of the debt) to junior debt or mezzanine position. The size of that subordination from the third-party debt provider is another key determinant of risk.

Privcap: How are these various forms of real estate debt going to perform in the next economic downturn?

Brady: Without having my crystal ball fully shined up, looking at the last downturn, some of the results that we saw coming out of real estate debt portfolios were related to poor construction of the underlying real estate debt—interest-only lending, lending on speculative development, leverage on leverage in excessive ways.

What we are seeing, as we have been lending into this most recent cycle, are more protections being retained in lending. The asset class will look very different from how it looked in the last global financial crisis, large-

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—Jackie Brady, PGIM Real Estate

ly because we haven't seen underwriting excesses in the same way. Banks have been more constrained. Even the non-bank market, the securitization market, has been more constrained. Overall, that has meant that we've had a healthier loan portfolio book across many lenders in the market.

The underlying assets are real estate, so we don't expect that we will get a pass in another downturn. But we would enter another downturn on a much stronger footing, given what the underlying loans look like today, and how constrained lenders have been.

Radkiewicz: Over the last 20 years, even looking at our own activity, which stretches to over \$100 billion, the actual loss rates on high-grade loans are all negligible, something like one basis point—that even compares well against corporate investment grade losses. In looking through the weeds, good, solid lending strategies to invest into can perform well, and history shows they can perform well in the downturn.

Let's look at it a bit more theoretically. Why do we say real estate is downside protected? Clearly, if you buy a property, you carry the first dollar risk and your rent is all the income you get. So, at one end, you can just buy a property for cash, no leverage. At the other end, you can lend against

that property, at 60% of that value. That gives you two things. One, you have a significant increase in capital protection, because the market could obviously move by 40% before there's a capital loss. Also, there's a significant benefit on the income volatility to the extent that the underlying rent from the real estate would cover your interest payments on your loan investment. If you compared buying it and lending on it—let's say your return expectations are similar—clearly the lending way not only has a big capital buffer, but half the tenants can fall away and the debt will still get its full return.

In most real estate debt investments, a decrease of 10% or 20%, even 30%, would lead to very little change in expected underwritten return. Whereas, obviously, buying and taking equity risk on the real estate, one would assume that entire reduction value as a hit on your return.

Privcap: Can you give an example of an asset on the least risky side of the spectrum?

Brady: On the least risky side is what we would consider to be a core mortgage. This is generally a loan that is, let's say, 50% or so loan to value—sometimes even lower than that—made against a property that is 100% leased to very high-quality tenants.

Think about an office building, or a similar asset that has very long leases, very stable tenants. The loan is half of the value of the asset and it has two times, or in some cases more than two times, interest coverage.

Privcap: What advice would you give to institutional investors who are thinking about integrating real estate debt into their broader portfolios?

Radkiewicz: You used precisely the right word there: integration of real estate debt. We would argue that this is not a case of real estate debt replacing real estate equity. If one looks at the downside protection at a certain return, real estate debt, certainly at this part of the cycle, can look very attractive. From a portfolio construction perspective, we think, adding real estate debt alongside private real estate equity investments is a good thing to do. Across the cycle, one would look at dialing one of those up a bit more, and dialing down. If one is expecting a downturn, one would naturally see some benefits in dialing up real estate debt and, in other times, dialing it down versus an equity return.

Real estate debt does give up future upside. The way you like to think about that is, what is that expected upside, and is that small or big enough to give you the downside protection at different parts of the cycle? We would argue there is always a space for it, and one should look at expectations of future potential changes in real estate value as the determinant to where one should position one's self.

On the other side of the fence, we can't forget the key driver for all of this is target return. An investor with a Treasury-plus 100 basis-points target return is going to behave differently than someone seeking a double-digit return.

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Privcap: How should investors think about gaining access to real estate debt?

Radkiewicz: Essentially, there are two ways. One can access secondary markets through an intermediary, the banking market, and actually buy debt. We believe that the best access to the biggest breadth of investments is through what we call “primary origination,” where the people managing the debt on behalf of investors are the same people and the same firms that actually have the relationships with the underlying borrowers, an understanding of the market, and a primary access to investment opportunities.

Privcap: Real estate debt has a servicing dimension to it. What do investors need to understand about that?

Brady: Having a direct servicing relationship with the borrower is critical. It's a downturn mitigation strategy to be constantly monitoring the portfolio and to be able to implement resolution strategies, if needed, with the borrower well in advance of an actual default.

Radkiewicz: If things do go wrong, you need to totally understand the real estate and actually manage that real estate if you get it back. It's critically important that this is not just a debt strategy. Credit and real estate expertise is required.