PRINCIPAL REAL ESTATE

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Private real estate debt:

Out with the old and in with the new

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The significant property valuation declines which have occurred in commercial real estate (CRE), the accompanying market stress, and the pullback in direct lending by the banks are creating attractive opportunities in real estate debt. As investors consider allocating capital to the space, it is important to understand the drawbacks of legacy strategies/portfolios in today's marketplace and the potential benefits of new strategies which are not burdened by the risks related to legacy loans.

Collateral valuation drift

The underlying collateral for CRE loans underwritten before (and during) the Fed's series of interest rate hikes have experienced material valuation declines. This downward pressure occurred across property sectors including multifamily and industrial. Even assets in desirable locations with higher quality improvements were not spared from the rising capitalization rates that have resulted from the increase in interest rates.

Exhibit 1 highlights the potential loan-to-value (LTV) ratio of a loan after cap rate increases. There is no escaping the realities of the math. If this change in LTV metrics is not appearing in existing portfolios, we recommend the investor should dig deeper. Rent growth on some assets helped mute the magnitude of the change but the sum of this expected market-to-market of rents was factored into the pricing (even lower cap rates at origination than used in Exhibit 1).

EXHIBIT 1: Potential loan-to-value ratio of a loan after cap rate increases

Legacy Loan LTVs using post inflation cap rates

NOI Growth Scenarios	Cap Rate	5.00%	5.25%	5.50%	5.75%	6.00%
	0.0%	88%	92%	96%	101%	105%
	2.5%	82%	86%	90%	95%	99%
	5.0%	77%	81%	85%	89%	93%
	7.5%	73%	77%	80%	84%	88%
	10.0%	69%	72%	76%	79%	83%

Original LTV=70%

Assumptions:

- Original cap rate = 4%
- Minimum of 100 bps expansion in cap rates
- Original NOI = $2M
- Loan = $35M
- Multifamily asset in a good location
- Purchased/financed in 2H 2021
- 2.5 years of rent/NOI growth assumed

Source: Principal Real Estate, March 2024. For Illustrative, informational purposes only and are based on current market conditions and is not intended to forecast or predict future events. Does not represent any investment strategy.

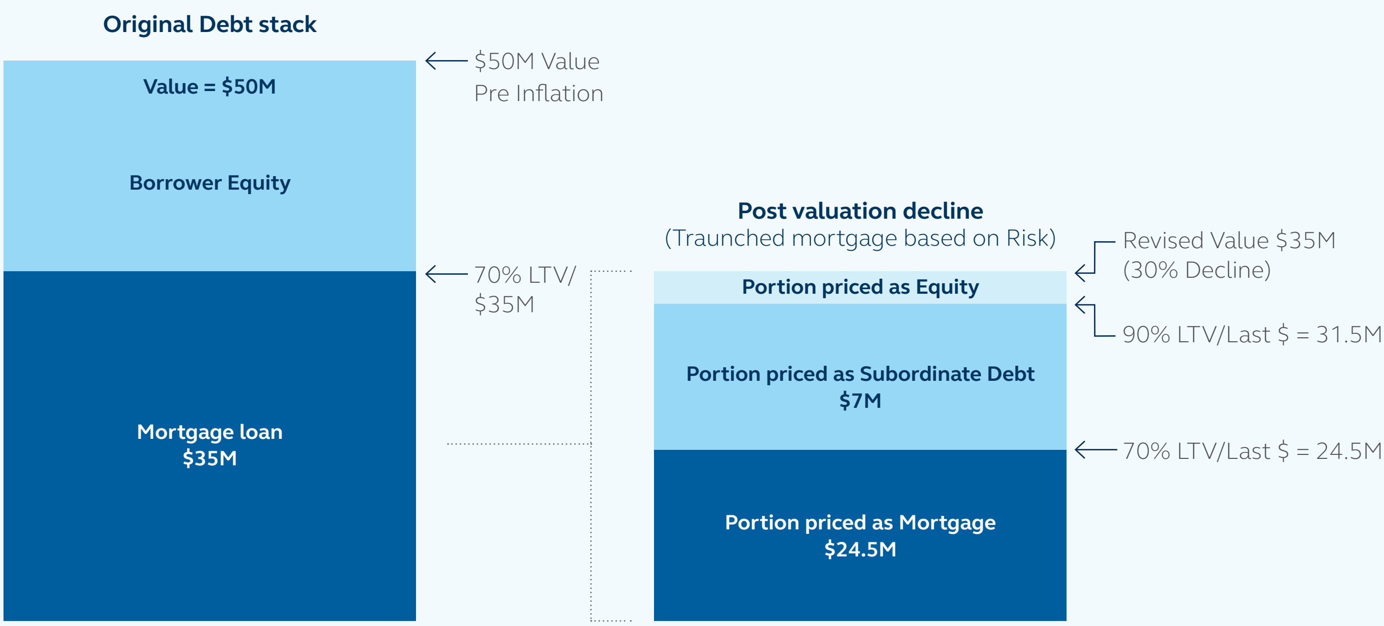
Marking legacy loans is a challenge

A recent topic in private credit is the valuation of loans and whether managers fully incorporate market changes into the marks on a timely basis.[1] Private real estate debt managers face the same challenges, and this topic notably began emerging not long after the Federal Reserve (Fed) started to hike rates.

Marking legacy loans in a regular environment where underlying collateral values are steady to increasing is a fairly straightforward process. In this situation, there are plenty of recent loan originations of similar LTV and interest coverage metrics to support the market spread assumptions. Conversely, in today's market, where legacy loans have increased from 65% - 70% LTV at origination to potentially the 80% - 100% LTV range (or higher if occupancy has declined), there aren't any new originations at these LTV levels to use as comparison.

To handle this dilemma, one common approach is to theoretically bifurcate the higher leverage legacy loan into a market leverage mortgage loan (for example 70% LTV) with the remaining loan amount being treated as a subordinate piece which is priced at a much higher spread/ rate (see Exhibit 2). If the loan is above 90% LTV, in theory the remaining loan proceeds are priced as if they are equity.

EXHIBIT 2: Post inflation/normalization of rates risk tranching of a legacy loan



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As the number of inputs and assumptions increase, combined with limited financing activity in general, it brings into question the precision of the marks. This is important for new investors allocating capital to an existing open-end debt strategy or a REIT with legacy debt assets.

[1] Bloomberg, 28 February 2024

Underlying collateral valuation lag has not fully played out

The appraisal valuations are still in the process of catching up with market declines—so be aware portfolio valuation metrics on legacy collateral may appear to be better now than where they may ultimately land in another two to three quarters. A full re-underwriting of each asset is the only way to ascribe a best estimate of market LTVs, and even then, there could still be a fair amount of uncertainty involved.

The risk embedded in legacy portfolios climbs along with higher LTVs

The risk profile of loans in legacy portfolios has changed since the loans were underwritten. Again, even the loans originated by the "top" managers with the best underwriting practices are subject to the normalization of rates and its impact on the underlying collateral valuations. Investing in legacy assets on an informed basis, requires an investor who can re-underwrite each loan and assess the outcomes with respect to modifications, refinance risk, and the ultimate recovery of the outstanding loan balances. Some investors have the platform, which includes equity expertise, to make these judgements.

In addition to the expertise, the underlying collateral detail is needed to perform the analysis. In summary, absent a fresh re-underwrite, the only known is the risk profile of a legacy portfolio of loans is different than a freshly underwritten portfolio where LTVs are in the 60% to 75% range.

Other risks to legacy portfolios (not present in new portfolios underwritten to current values)

In today's market, there are legacy strategies that may experience liquidity pressures. Credit facility providers are concerned about legacy loans, and the potential for margin calls and forced paydowns to gain extensions exists. Strategies that used collateralized loan obligations (CLOs) are not subject to margin calls but may experience declines in cash flows as the CLO credit-related mechanisms are triggered. New strategies have no liquidity pressures, and, in fact, the banks are eager to extend credit against freshly originated loans to lenders with established real estate platforms.

New strategies/portfolios should benefit from restart of credit cycle and growth of private lending (bank dislocation)

Looking back, the best risk-adjusted debt investments have been made coming out of periods of market turmoil. The next few years are setting up to be the start of a new credit cycle. In addition to this dynamic, the role of private lenders is expected to continue expanding. Banks have retrenched and are not expected to expand direct lending back to prior levels for the foreseeable future. Also, many banks have demonstrated a preference to finance newly originated mortgages allowing them to achieve a "super core" risk profile and attain better capital treatment and favorable reviews from risk management, regulators, and investors. We expect this financing will facilitate growth for the private lenders in the real estate debt space.

Conclusion: Allocations to real estate credit strategies should be made in vehicles targeting new investments

As investors begin capital allocation in this upcoming period to take advantage of the opportunities in real estate debt, we suggest using caution with portfolios that have legacy loans. The valuations of legacy positions at both the underlying asset level and loan level are difficult, even with the best of intentions by the parties involved. The amount of risk present in the legacy portfolios is hard to analyze with limited information and the resource-intensive nature of the analysis. By allocating capital to new strategies, the investor may remove variables that can lead to unexpected outcomes – with strategies starting their investment period you know what you are getting.

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