For Institutional, Professional, Qualified and/or Wholesale Investor Use Only in Permitted Jurisdictions as defined by local laws and regulations.

Principal Real Estate

SPECIAL BULLETIN #1 | PRIVATE REAL ESTATE DEBT

THE IMPACT OF RISING SHORT-TERM RATES ON PRIVATE REAL ESTATE CREDIT

Author: **Troy W. Kort, CFA, Portfolio Manager, Principal Real Estate Investors**

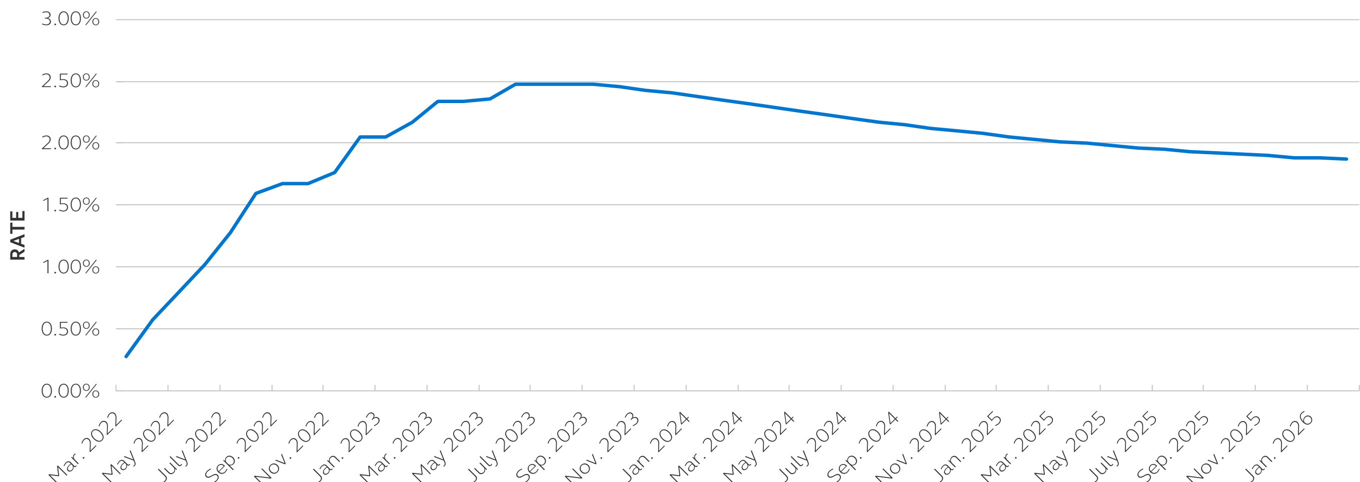
Private real estate credit has experienced heavy investment flows aided in part by record levels of property trades and ultra-low interest rates. Meanwhile, inflation has moved beyond the initial transitory characterization into a period where the financial markets are significantly concerned about its containment. In response, the Fed has switched from quantitative easing (QE) and near zero rates to quantitative tightening (QT) and raising short-term rates. The end goal is to reel in inflation without putting the economy into a recession.

EXECUTIVE SUMMARY:

- Uncertainty around how many rate hikes will be needed to bridle inflation - Ukraine conflict reduces visibility
- Higher Secured Overnight Financing Rates (SOFR) impact interest coverages on transitional loans until higher CFs achieved
- Term credit risk unlikely to be material with substantial cash equity and capable sponsors
- Long-term rates will drive valuation changes although a materially higher SOFR could slow transaction activity
- Equity buffer afforded private real estate credit insulates sector except for extreme scenarios

Now that short-term rates are increasing, the level of Secured Overnight Financing Rates (SOFR) will have a more meaningful role on the risk assessment of loan opportunities. With near zero interest rates, an asset's ability to generate enough cashflow to pay debt service while the sponsor executes its business plan (renovations, repositioning, lease-up, etc.) generally penciled out with little concern for potential interruption. In this new higher short-term rate environment, floating rate lenders will need to spend additional time on an asset's projected cashflows to gauge the potential reliance on the sponsor to infuse additional equity in order to "carry a loan" or make shortfall payments, should one occur.

EXHIBIT 1: Daily SOFR forward curve



Source: Chatham Financial, 21 March 2022

Debt Service Coverage Ratio (DSCRx) is back in play

To keep things simple, the focus here will be on the bridge loan market (levered senior mortgages secured by transitional properties). A common investment profile in today's market is for a sponsor to buy a multifamily asset, renovate the units and then sell or refinance with a permanent loan. As part of this process, it can take time to complete the property improvements and start turning over the rents to the point where a significant increase in cashflow is realized. During this period, increases in SOFR could push the DSCRx (Net Operating Income (NOI)/debt service) below 1.0x. How high can SOFR climb before NOI growth is needed to stay above 1.0x? One example is outlined in Exhibit 2 below. The lower end of the table is in our rear- view mirror but it helps to establish where things were going into this tightening cycle.

EXHIBIT 2: Impact of SOFR on DSCRx

	SOFR											
	0.25%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%	2.75%	3.00%
DSCR Loan A	1.66	1.53	1.42	1.33	1.25	1.17	1.11	1.05	1.00	**0.95**	0.91	0.87
DSCR Loan B	1.42	1.33	1.25	1.17	1.11	1.05	1.00	**0.95**	0.91	0.87	0.83	0.80

Source: Principal Real Estate Investors, March 2022
Note #1: Loan A has a Spread of 275 bps; Loan B has a spread of 325 bps.
Note #2: The loan used to model the DSCRs in the table was 70% LTP/LTV based on a 3.75% cap rate. Inclusive of additional fundings, the loan has an approximate debt yield of 5%, prior to rent/NOI increases.
For example and illustrative purposes only. Not actual loans that are available for investment and not a guarantee that future loans will have similar characteristics to those shown above.

As you can see, in this example the loan does not dip below 1.0x until SOFR gets in the range of 2% to 2.5%, depending upon the loan's spread. There are several factors which affect the outcome of the analysis including the cap rate (NOI/ Value), initial loan-to-value, and how the additional fundings are structured.

Lenders can use escrows or recourse to credit enhance the loan should a material shortfall be expected. For example, a debt service reserve calculated using the forward curve is an option with the proceeds returned to the borrower after the property starts generating a higher level of cashflow. Certainly, any holdback which enhances the credit quality of the investment will require a lower quoted spread to win the loan relative to lenders comfortable the sponsor will make the shortfall payments, if needed. In addition, although the market for multifamily loans has moved away from the following construct, additional fundings could once again be hurdled to debt yield thresholds. Interest rate caps will also be part of a loan structure. However, due to the cost to purchase, the market generally utilizes interest rate caps to mitigate scenarios where short-term rates exceed the market expectations embedded in the forward curve.

Positive property fundamentals and equity buffer protect private credit investor

The outlook for the multifamily sector calls for continued rental growth driven by a solid economy, elevated single-family housing prices, and higher construction costs. In addition to growing NOIs, lenders benefit from 25% or higher equity cushions (Value – Debt). Should the DSCRx drop below 1.0x it does not mean the loan will automatically default. Absent a major change in multifamily fundamentals and expected property performance, it is highly likely the sponsor carries the loan in the event of a shortfall, infusing additional capital allowing time for the business plan to be realized. In the case of acquisitions, the recent fresh equity strengthens the sponsor's commitment to the asset. Shortfall amounts totaling 5% to 10% of the initial capital contribution should not be of concern for capable sponsors.

CONCLUSION: The private real estate credit market can absorb higher short-term rates but of course there are limits to this statement

As long as exit debt yields (debt yield at loan maturity) remain at reasonable levels, the expectation is the market will accept the pressure on loan term DSCRs and will attempt to mitigate with additional loan structure, asset selection, and quality sponsorship. However, should short term rates start to get into the 2.5% to 3.0% range, leverage levels and/or the cost of debt will likely be impacted. This in turn would slow acquisition activity, and potentially could seep into valuations depending upon the level of long-term rates and the state of the economy. The equity buffer afforded to private real estate credit can help protect investments should the Fed's campaign against inflation be prolonged or end up being too aggressive (recession occurs).

Risk Considerations

Past performance does not guarantee future results. Investing involves risk, including possible loss of principal. Potential investors should be aware of the risks inherent to owning and investing in real estate, including: value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate.

Important Information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided. All figures shown in this document are in U.S. dollars unless otherwise noted. Investing involves risk, including possible loss of principal.

This material may contain 'forward looking' information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is issued in:

- The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- Europe by Principal Global Investors (EU) Limited, Sobo Works, Windmill Lane, Dublin D02 K156, Ireland. Principal Global Investors (EU) Limited is regulated by the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). The contents of the document have been approved by the relevant entity. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (EU) Limited ("PGI EU") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGI EU, PGIE or PGI EU may delegate management authority to affiliates that are not authorized and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland.
- United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorised and regulated by the Financial Conduct Authority ("FCA").
- United Arab Emirates by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation.
- Singapore by Principal Global Investors (Singapore)Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act (2001). This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
- Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission. This document is intended for sophisticated institutional investors only.
- This document is marketing material and is issued in Switzerland by Principal Global Investors (Switzerland) GmbH.
- Hong Kong SAR (China) by Principal Global Investors (Hong Kong) Limited, which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance.
- Other APAC Countries, this material is issued for institutional investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

© 2022 Principal Financial Services, Inc. Principal®, Principal Financial Group®, and Principal and the logomark design are registered trademarks of Principal Financial Services, Inc., a Principal Financial Group company, in the United States and are trademarks and services marks of Principal Financial Services, Inc., in various countries around the world. Principal Global Investors leads global asset management at Principal®. Principal Real Estate Investors is a dedicated real estate investment management group within Principal Global Investors.

MM12799 | 2065328-123123