Principal Asset Management℠

Principal Real Estate

Private real estate debt –

Underwriting niche sectors, underwriting to mitigate market risk

Chase McWhorter, Institutional Real Estate, Inc's managing director, real estate and infrastructure, recently spoke with **Scott Smith,** managing director, portfolio management, and **Kirloes Gerges,** managing director, portfolio management, both from the Principal Real Estate Private Debt team. Following is an excerpt of that conversation.

Principal Real Estate has been in the private real estate debt business for more than 60 years. What is making this market environment different from other cycles you have observed?

Scott Smith: Having just passed my 40th anniversary with Principal, I will say these feel like unprecedented times. We had an almost 10-year run of what were essentially blue skies and tailwinds impacting upon the economy and real estate debt markets. This era was abruptly interrupted by the COVID-19 pandemic. When has that ever happened? And that was followed by massive government intervention and stimulation, now followed by massive fears of inflation, followed by the Fed's death grip on interest rates intended to choke off inflation – but perhaps, at same time, steering the economy into the ditch. That's a lot of "stuff" going on! I am not sure there has ever been a time where short-term interest rates have gone up as quickly and as steeply as they have this past year – and particularly when real estate markets and fundamentals were in a pretty good place. So, while most people have always thought of real estate as providing a great inflation hedge, and in the longer term, certainly it does, this assumes a relatively normal NOI growth rate and normal interest-rate levels. When NOI growth is relatively steady, but interest rates rise incredibly fast as they have this past year, it puts pressure on existing properties' cashflows, creating doubt as to borrowers' ability to pay their debt service. In tandem, higher costs of debt traditionally beget higher costs of equity, which typically leads to lower values in real estate – so in addition to cashflow pressure, you also have loan-to-value pressures. We are seeing this connection begin to play out, but we expect further pressures on valuations and cashflow to play out in 2023, as the Fed continues to raise interest rates. Overall, the confluence of all these various factors has been something we have never seen. And while the US economy is not yet in a recession, the pressures described above sure make it feels as though the real estate debt market has been in a recession for about a year.

Many investors are concerned about real estate values declining in the near term. How does Principal Real Estate plan to mitigate this risk in the current environment?

Kirloes Gerges: We will continue our strong underwriting culture, investing only in quality assets, well-capitalised sponsors, staying disciplined from a terms perspective, and lending on behalf of properties in markets that exhibit strong demographic and economic tailwinds. Inherently, debt investments provide more preservation from value erosion than equity, but we have to keep a focus on loan-to-value ratios and the size of the equity buffers within each sector to help ensure we have the right cushion in place in case of a decline in value. Today, we are placing greater emphasis on structural enhancements to our terms, such as interest-rate caps and debt service coverage–driven escrows. In terms of the assets, we are focusing on more resilient property types where we think the value decline will not be as drastic. All that said, underwriting today and into the next few months can be quite attractive, in that it allows for some post-inflation, value-adjusted underwriting.

Smith: We have some history of investing into declining markets. We put together a couple of separate account programmes coming out of the global financial crisis, for example, which we closed around September 2009. But while we had new capital to invest, we didn't like the market at that time – and so we had patience. We didn't do any business in third or fourth quarters of 2009. The calendar turned, we got into first quarter of 2010, and we still held off on new business. It was finally in the second quarter – May 2010 – before we did the first deals for these separate accounts, as we finally felt the knife was done falling. So, can I describe exactly what happened? What were the new circumstances? Not really, but we knew it when we saw it – we started to see property trades happen, and then gained increasingly more comfort about valuations as more trades happened and more people got involved. That becomes a virtuous cycle. I think this same thing will happen eventually this time. While we've all taken a little knock in terms of interest rates and valuations, as we see valuations firm up and we gain more confidence in those valuations and the breadth and depth of the demand, it will again be the time to get in. Because of our broad platform in both private debt and equity spaces, we have a good feel for the market. We have a platform and a history of providing certainty of execution people can rely upon. These are things gained over time, and people trust we will deliver for them in a market that is still somewhat choppy.

What types of opportunities for lending are you seeing?

Gerges: Overall, we are seeing a transaction slowdown, but transactions are still getting done in certain sectors. We do have a pipeline of deals, primarily featuring multifamily assets and niche property types, such as medical office, self-storage and life sciences. For debt execution, we see opportunities in subordinate debt, whether mezzanine or preferred equity, within those sectors I outlined. Banks have pulled back on lending, and some banks are overallocated to real estate and are providing lower LTVs when they do lend, which leaves a gap in financing our programmes would look to fill.

How do you determine where you would like to invest in the capital stack?

Gerges: The macro environment now, particularly with banks pulling back, makes us lean more towards the subordinate debt space. When you have a bank lending at 45 percent or 50 percent LTVs, you will probably see more opportunity for subordinate debt. Each deal is unique, and figuring out where you want to be in the capital stack is sometimes based on what is being requested. Some deals can present opportunities for us to participate in either the senior or subordinate option, and you have your whole loans, which can be broken into an A or B pieces. Deciding where we ultimately wish to participate comes down to underwriting. Do we want to hold the whole loan or just keep the mezzanine component, and what do those metrics look like? It's important to compare debt service coverage in the senior space versus the mezzanine space. We constantly challenge ourselves: "Are we being paid for that risk?" These decisions come one at a time, and as they come, our disciplined underwriting approach governs how we look at each deal and where we want to be in the capital stack. Real estate underwriting is fundamental to everything we do.

Smith: You only understand these issues by seeing transactions. If you see five deals, that is your universe. We will look at several thousand transactions every year – and these include both debt and equity deals along the full risk spectrum. Because we are looking at those transactions day in and day out, we can determine where we think the best relative value is at any given point in time. You must have a broad enough view of the market to gain the discernment Kirloes described.

As banks pull back, is there a point where you would enter that senior space, or do you traditionally really prefer being in the subordinated debt space?

Gerges: We invest in both. We are flexible in how we approach the investment landscape. While over the near term we favour opportunities in subordinate debt, we consistently lend across senior and subordinate debt. Even today, we have both senior and subordinate debt deals in our pipeline, as the pullback from many traditional lenders has been broad, and capital is constrained generally. As well, there are investments that banks just won't make at all, either from a capacity perspective or because they can't underwrite the risk because they don't understand a particular property type, regardless of time period. This provides opportunity for us across the capital stack. For example, some traditional lenders may not invest in heavy transitional assets, assets with complex business plans or high LTV deals, which has provided opportunities for our platform to step in and make those higher-yielding senior mortgage loans. Historically across our high-yield platform, you'll find we've invested in both senior and subordinate debt across various cycles.

Smith: The reason we can be flexible is because we have a consistent way of looking at opportunities, whether it is mezzanine or senior debt. We look first at the real estate, to assess the risk with the asset and cashflow. And only then do we look at the capital stack to fully assess the situation. In addition, in most forms of high-yield debt, you are utilising leverage in some form or another. You are either directly levering a senior mortgage or you are levering the deal via subordinate positioning in the capital stack. So, you must then impound the risk that comes from whatever type of leverage you are using. Analysing first the real estate, then the positioning within the capital and then, finally, the impact of leveraging – that is how we determine what we think that overall risk is. This then tells us whether we ought to be leaning into mezzanine or into senior mortgages.

As interest in equity investments in niche property types has grown, has interest in the private debt on those assets grown at the same time, to the same degree?

Gerges: We currently focus on what we call the "DIGITAL" asset space, which means we are pursuing opportunities we expect to benefit from or remain resilient to impacts from demographics, innovation, globalisation, infrastructure and technology. The types of assets that fit into that bucket include housing, industrial, life sciences, medical office, data centres and self-storage, to name a few. They all have unique stories. Take housing. Buying a house today is expensive, yet demographics are supportive of strong household formation, so that leads us to a focus on apartments. Apartments can also provide a hedge against inflation – important in today's macroeconomic environment – due to the shorter-term leases that define this property type. There's been an emphasis on innovation and a focus on health that has benefitted life sciences and medical office assets. While industrial pricing is starting to normalise from record-breaking levels, we continue to see a strong ecommerce tailwind. In the case of data centres, everyone is using more technology, which requires more data storage. There is definitely focus both on debt and equity in the niche property types.

How has Principal Real Estate approached the debt underwriting for these property types?

Gerges: The underwriting for niche properties is not any different from other assets, in that it is still all about the cashflows, the asset, the demand-and-supply story, the location and the sponsor. The real estate fundamentals are paramount. That said, it is important to understand the nuances that make them different. With data centres, for example, you have to think in terms of megawatts and not just metrics such as price per square foot. With life sciences, you need to consider how much of the tenant's capital is coming from outside sources, such as venture capital firms. Will those dollars dry up? Can the company drive its own revenue, and how long before they stand on their own two feet? And these are just different examples of high-level items when considering niche property types. Office properties, and to some extent hotels and retail, are where investors may need to be more cautious today. Those are the property types where we have more concern about downside risk currently.

Smith: There is also increasing concern with underwriting municipalities. Many cities are desperately searching for new sources of revenue and so, in many places, taxes are under pressure. We are also watching closely as various cities implement different initiatives, for example ESG-related regulations, as these invariably have underwriting ramifications. A third item we're keeping a close watch on is insurance costs, which have risen rapidly and need to be monitored. This is an area where having people on the private real estate equity side who are getting these insurance bills, who are paying these property taxes, who deal with ESG regulations help us become better underwriters.

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ABOUT PRINCIPAL REAL ESTATE

Principal Real Estate is the dedicated real estate investment team of Principal Asset Management℠. Our knowledge and expertise span the spectrum of public and private equity and debt. Our specialised market knowledge, dedicated and experienced teams, and extensive connections across all four real estate quadrants allow us to maximise opportunities and find the best relative value on behalf of our clients. Visit our website at **www.PrincipalAM.com/realestate**

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