

PRINCIPAL REAL ESTATE

Why it's (still) a good time to invest in private real estate credit

AUTHORS



Kirloes Gerges

Managing Director,
Portfolio Management
Principal Real Estate Private Debt



Troy Kort

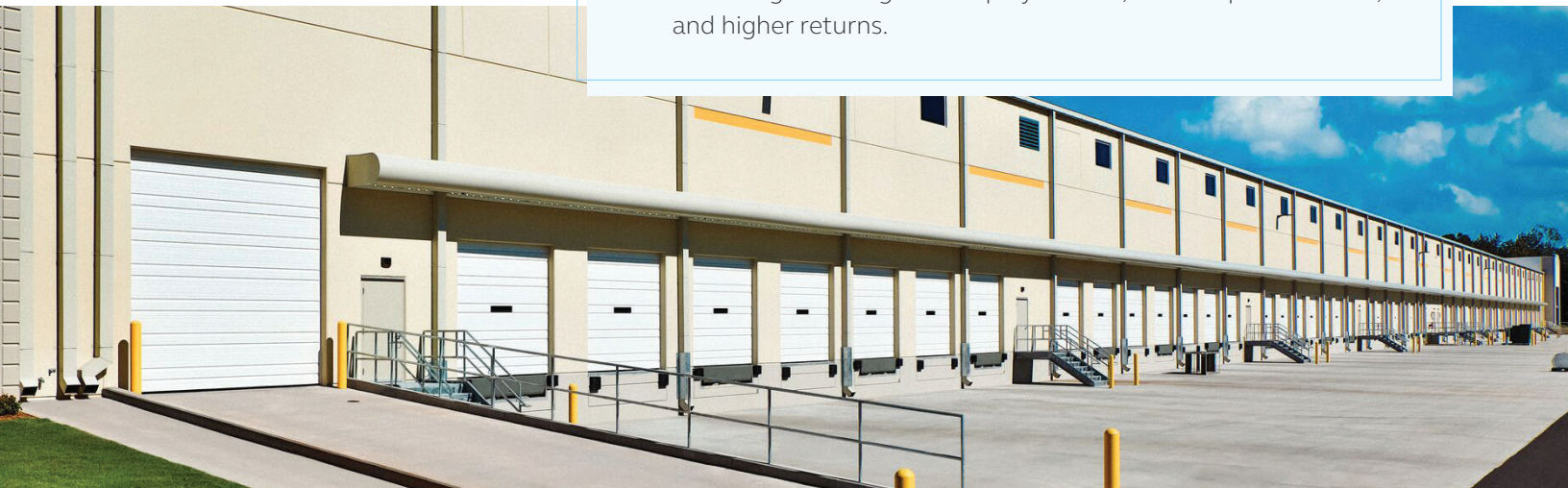
Managing Director,
Portfolio Management
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We believe it's a good time for debt. Benefits include diversification—a lack of correlation to other asset types—as well as returns comprised primarily of income, attractive relative value, and equity cushion to absorb asset stress due to unexpected events. Given current market opportunities, private real estate credit looks particularly attractive today.

AT-A-GLANCE

Private real estate credit funds continue to see steady growth in assets under management, and it's easy to see why:

- Traditional lenders have continued to pull out of the commercial real estate market. At the same time, demand continues to rise (the wall of maturities is now \$2 trillion, according to the Mortgage Bankers Association). This combination has created a lender's market, with favorable conditions including rising spreads and total yields.
- High interest rates have driven capitalization rates higher, which has created opportunities for new investments sized to reset values—generating fresh equity buffers, lower exposure levels, and higher returns.

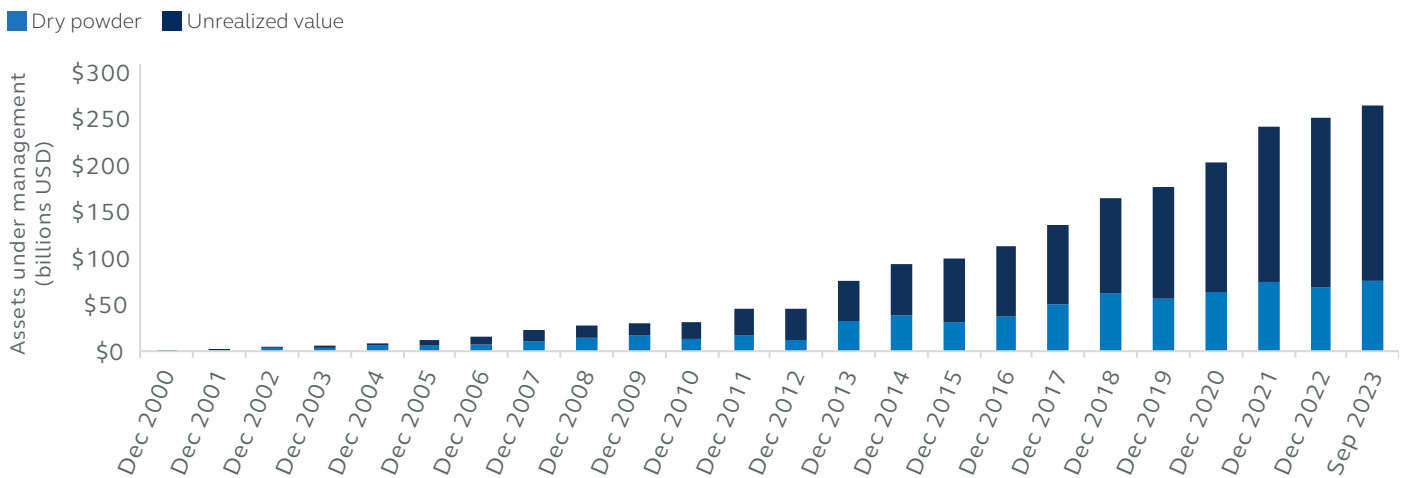


Introduction

In January 2023, we published [The Advantages of Allocating Capital to Private Real Estate Credit](#), a paper in which we explained the top reasons to invest in private real estate credit. At the time, the advantages included: the capital gap, better entry points at lower post-inflation valuations, and attractive relative value. Those reasons are still valid, in large part because the tailwinds that drove opportunities in the real estate private credit market in 2022 are still driving opportunities today.

Given the tailwinds and resulting opportunities that we describe here, it's no surprise that private real estate credit funds continue to see steady growth in assets under management.

EXHIBIT 1: Allocation to private credit funds continues to rise



Source: Preqin, September 2023.

The capital gap persists

Since we last addressed this topic in early 2023, the capital gap that had emerged from a banking sector under pressure and a large wall of coming maturities has not changed for the better:

The banking sector is under pressure on several fronts including bank management teams being concerned about how their books will perform going into the Federal Reserve (Fed) induced economic slowdown. Bank balance sheets are heavy from a flurry of activity in 2021. Banks are also under close scrutiny from regulators and face capital adequacy pressure from stress testing and other factors.

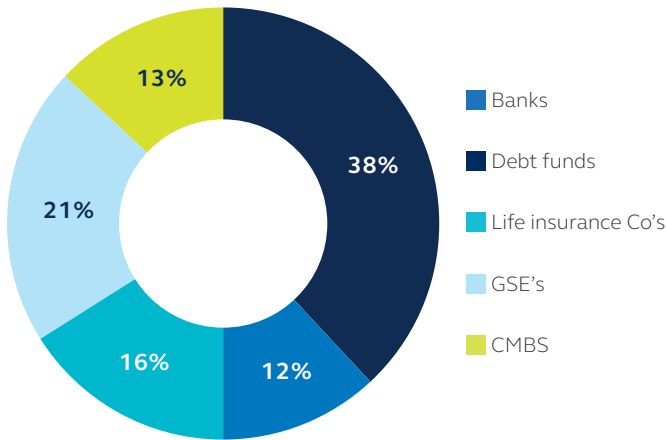
There will be existing loans coming due that need to be paid off and the borrowers will be required to refinance/recapitalize these assets.

Supply continues to wane

Since 2022, traditional lenders have remained muted. Persistent inflation, continued uncertainty about the economic impact of Fed tightening, and failures including Silicon Valley Bank and First Republic Bank, contributed to a 47 percent decline in commercial lending activity in 2023 over 2022. Banks led the pullback, with a 64 percent decline.

EXHIBIT 2: Commercial lending activity continued to decline in 2023

Market share by participant



Commercial lending activity in 2023 was 47% lower than in 2022

Banks ↓ 64%

Debt funds ↓ 51%

Life insurance companies ↓ 39%

GSEs ↓ 21%

CMBS ↓ 21%

As of 31 December 2023. Source: (left) Mortgage Bankers Association. (Right) Newmark Capital, RCA as of 3Q 2023. Data is based on preliminary loan sums, which are subject to future revision – potentially significant. GSE – Government-Sponsored Enterprise

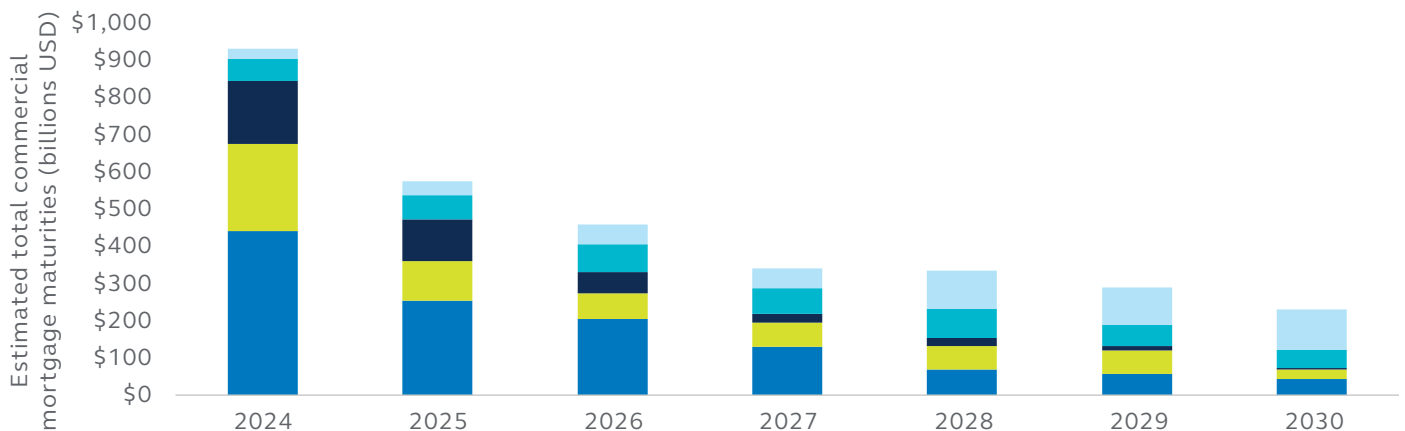
Bank lending is likely to remain muted for the foreseeable future, as the drivers of the conservative mindset persist—including the Fed’s fight against inflation and a lack of visibility on the contour of the slowdown that may result.

Demand continues to grow

The ‘wall of maturities’ continues to grow. There are now approximately \$2 trillion in loans maturing over the next three years. Borrowers will be required to refinance/recapitalize these assets—driving huge demand for capital in an environment marked by waning supply.

EXHIBIT 3: \$2 trillion in commercial mortgages will mature over the next three years

Legend: Banks (Blue), CMBS (Yellow), Debt funds, mortgage REIT and warehouse (Dark Blue), Life insurance Co's (Cyan), GSE's (Light Blue)



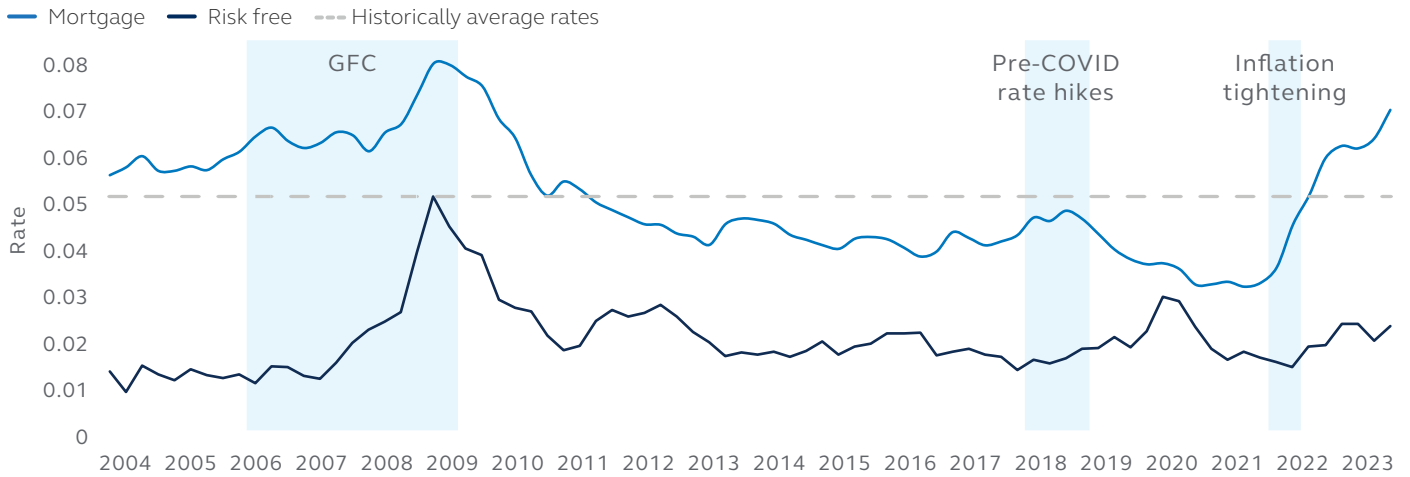
Source: Mortgage Bankers Association, 31 December 2023.

The result: Wider spreads and total yields

This combination of diminishing supply and increasing demand has created a lender’s market, with favorable conditions including rising spreads and total yields.

EXHIBIT 4: Mortgage rates and spreads continue to rise

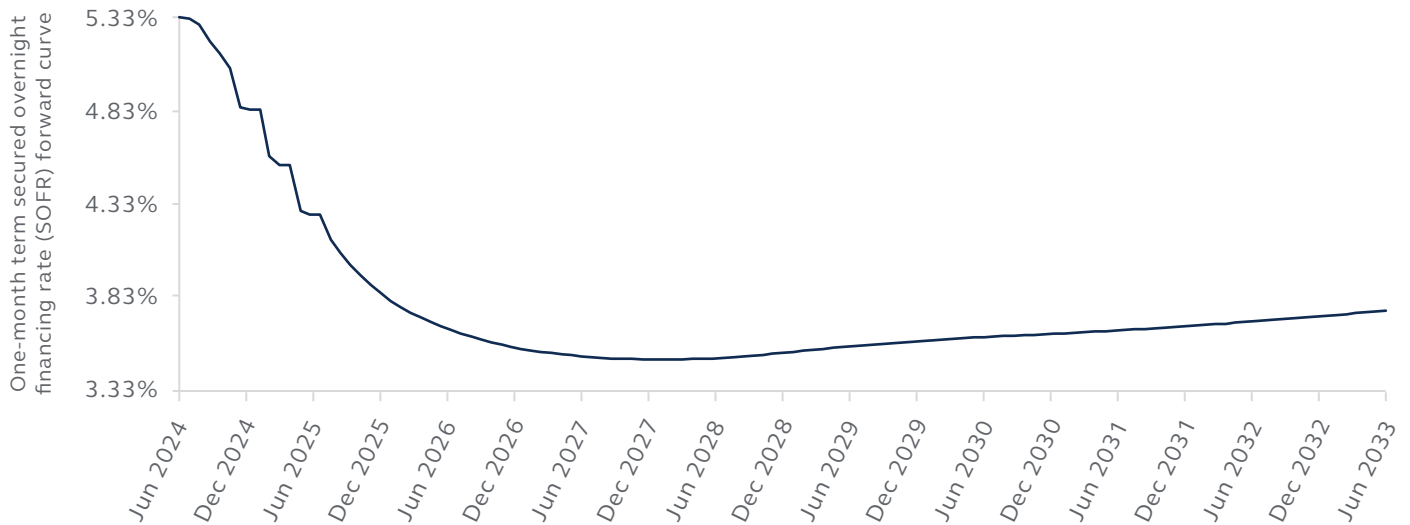
Commercial mortgage rates vs. risk free rate



Source: Moody's Analytics, Principal Real Estate, 4Q 2023

Looking forward, there's no indication of aggressive rate cuts coming to fruition or spreads tightening significantly. Relatively high rates allow for outside yields.

EXHIBIT 5: Market expectations for short-term rates remain high



Source: Chatham Financial, June 2024.

Higher cap rates, lower valuations, more opportunity

The Fed's series of interest rate hikes and a persistent high interest rate environment have driven capitalization rates higher. That, in turn, has driven valuations down. It has also created opportunities for new investments sized to reset values—generating a fresh equity buffer, lower exposure levels, and higher returns.

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Higher cap rates drive collateral valuation drift

For existing loans, higher cap rates means higher loan-to-value (LTV) ratios—and collateral valuation drift. Appraisal valuations are still in the process of catching up with market declines, so portfolio valuation metrics on legacy collateral may appear to be better now than where they may ultimately land in another two to three quarters. Allocations to real estate credit strategies should be made in vehicles targeting new investments.

Get more insights on collateral valuation drift and the challenges with legacy loans in our recent paper [Out with the old and in with the new](#).

Higher cap rates also drive attractive returns on reset values

Another reason allocations to real estate credit strategies should be made in vehicles targeting new investments is that new investments will be sized to reset values—which should generate a fresh equity buffer, lower exposure levels, and higher return potential.

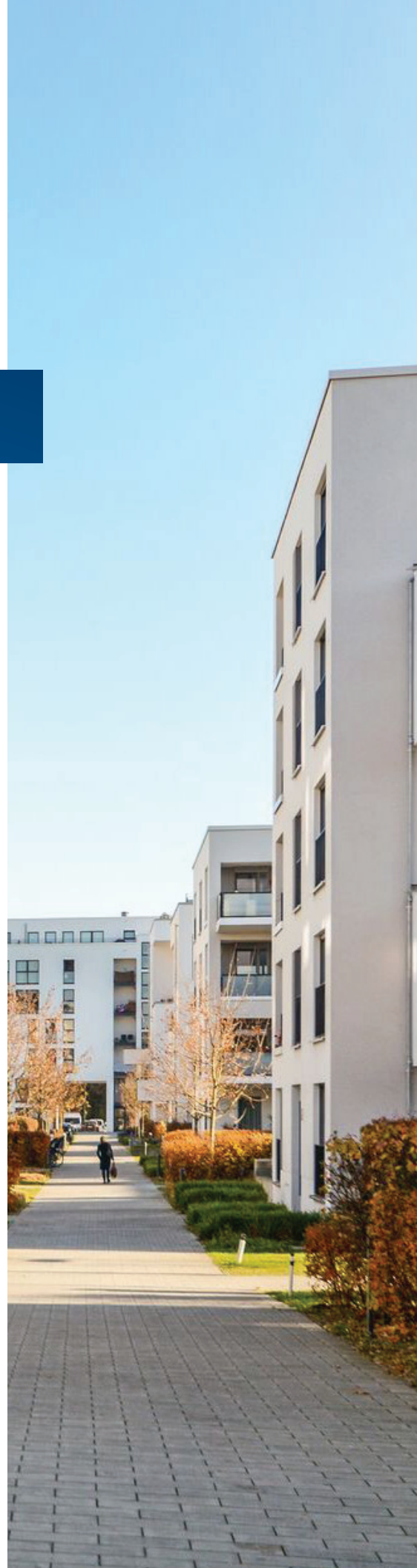
EXHIBIT 6: After cap rate increases, legacy LTVs rise

Multifamily example	2021	2024
Valuation		
Cap rate	4.00%	5.50%
Value	\$50,000,000	\$36,400,000
Leverage		
LTV range	70% - 80%	65% - 75%
70% LTV	\$35,000,000	\$25,000,000
Debt yield (70% LTV)	5.71%	7.86%
Debt service coverage (70% LTV)	2.00x	.98x
Pricing		
SOFR	0.10%	5.32%
Spread	2.75%	2.75%
Return: unlevered (gross)	3.50% - 4.00%	7.75% - 8.50%
Return: levered (gross) (75% advance)	8.00% - 9.00%	11.00% - 12.00%

Source: Principal Real Estate, March 2024. Example assumes no use of subscription line. Market fees of 1.00% upfront and 25 bps for extensions. Returns include forward curve. Return range is from 24 months to 60 months. For illustrative purposes only. The example provided is intended to demonstrate the application of a Principal Real Estate investment strategy. The investment identified and described is not intended for any specific strategy or fund of Principal Real Estate. The Secured Overnight Financing Rate (SOFR) is an interest rate set by the U.S. Treasury that determines the cost of overnight borrowing for banks through Treasury repurchase agreements.

Summary

Historically, the best risk-adjusted credit 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 and the role of private lenders is expected to continue expanding. In other words—we believe it is still a good time to invest in private credit.



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