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THE LONG AND SHORT OF IT

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Private Real Estate

Amending & Extending Our Game Plan

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Private Real Estate: Amending & Extending Our Approach

Commercial real estate has struggled to escape headlines for the better part of the past two years. While corporate creditors and the broader economy have generally weathered the rapid rise in rates better than expected, commercial real estate has faced rising delinquency rates, declining valuations, and building ire from regulators and investors as a potential source of financial contagion. **Nevertheless, despite these difficulties, leases have been signed, loans have been extended, deals have been inked and, by and large, the market has continued to muddle through.** In fact, there have even been green shoots of optimism in 2024 as evidenced by solid performance of some public debt issues and most public real estate investment trusts (REITs).

EQUITY: SURVEYING THE LAND

Looking back over this period, we observe that one driver of this outcome has been property fundamentals, which have continued to hold up better than feared. This has been clearest for multifamily and industrial, which had seen the most rapid rise in transactions and valuations during the pandemic cycle as well as increasing allocations in private REITS and institutional portfolios. Over the past year, these asset classes have seen rent growth weaken and vacancies rise as the wave of supply, which we highlighted in a prior report, easily offset moderating demand. For multifamily, the whipsawing of demand, which boomed in 2021 and 2022 before declining last year, has begun to normalize. Indeed, data on institutional apartment owners from RealPage suggests 2024 notched the best Q1 for apartment demand since 2021.[1] While this helps illustrate the potential for improvements in consumer confidence and labor market strength to bolster the apartment market, in our view, it does not give the all clear. Despite the strong start to the year, rent growth has remained below typical seasonal patterns as new units continue to hit the market. Likewise, in the industrial space, the rush of supply built in response to the pandemic has started to hit the market, with supply outpacing demand for the first time in over a decade. While rents in industrial have fared better than in multifamily, the deceleration has been notable, particularly in the larger, primary markets.

Other sectors, such as retail, hospitality, and office have faced their own sets of opportunities and obstacles, albeit with some facing more of the latter than the former. Office has been the clear standout to the downside, driving most of the increase in the overall delinquency rate as the sector adjusts to hybrid work. Hospitality has enjoyed a robust recovery from the pandemic, though occupancy and revenue growth has begun to sway as the extended travel boom wanes. Retail has been the biggest standout over the past year due to the lack of new supply built over prior years, as well as continued strength. Overall, fundamentals have softened, but not deteriorated to an extent that would precipitate issues for the broader economy as many imagined a year ago. However, **we continue to see elevated dispersion within asset classes, as the pinch of tighter financial conditions brings weaker properties to the surface.**

[1] Giving Some Perspective to Big 1st Quarter Apartment Demand. RealPage. (April 2024).

Ultimately, **the consternation within commercial real estate has almost entirely been about the rise in interest rates, and which have shown little sign of budging**. The dramatic decline in construction may help support investors over the longer term, but the current environment is likely to remain challenging for existing owners. Rising rates have challenged valuations and made it difficult for recently developed or renovated properties to find buyers or transition to longer-term fixed rate financing. While existing properties benefitted from fixed rates and the culmination of rising rents and valuations over the prior cycle, rising operating expenses, such as labor, insurance, and taxes, magnified the squeeze of cooler capital markets. **While we anticipate the Fed will be able to ease rates modestly, we do not expect this to provide a platform for a meaningful bounce in valuations.**

From a macro perspective, the soft-landing mix of meaningful rate relief and resilient growth, which would be most beneficial to real estate assets continues to elude policymakers and the market. Moreover, for cross-asset investors, we see greater soft-landing upside in asset classes beyond real estate. In this environment, **we prefer to direct new allocations toward specialized sub-sectors, such as student housing within the broader residential sector, or data centers, which are quickly forging their own categorization.** These niches benefit from idiosyncratic demand and supply drivers that can help provide diversification for existing real estate portfolios and avoid the cyclical headwinds facing more traditional real estate sectors.

Looking out over the coming years, **the task for commercial real estate operators and investors remains to keep above water** until a mix of rate relief and slowing supply can provide a sturdier base for income growth to support valuation expansion. **The potential for more systemic issues emanating from the commercial real estate market has waned** due to the resilience of the economy and related real estate fundamentals, as well as the navigable nature of the current financing backdrop. That said, **we do not see a meaningful break in the clouds that have pervaded the commercial real estate landscape, pushing us to maintain our preference of debt over equity for new real estate investments.**

DEBT: TO EXTEND OR NOT TO EXTEND

While the opportunity for new real estate equity investments remains less inspiring for multi-asset investors outside of selective niches, instability in commercial real estate can still provide opportunities. **Over the coming quarters, we expect debt dynamics to remain a catalyst for further transactions and price action.**

There is roughly $2 trillion in commercial real estate debt slated to mature over the next two years.[2] Of course, there is always a looming wall of maturities for owners and investors to climb. In reality, maturity schedules come more as wave with borrowers and creditors working together to address upcoming maturities. Today, however, lenders and borrowers face a much larger share of loans maturing over the next two years – nearly 30% compared to the prior peak of 25%, or less than 20% in 2008 prior to the Great Financial Crisis.[3] Moreover, declining valuations and elevated rates make the economics of refinancing less viable. Likewise, the dearth of transactions resulting from wider-than-normal bid-ask spreads as well as receding liquidity have dimmed the prospects for sales to pay off existing debt. **These realities have increasingly pushed lenders and borrowers to amend and extend existing debt, providing the opportunity for resolution should rates reset or income growth improve.** This trend is clear in the CMBS (commercial mortgage-backed securities) market, where new modifications (not including existing extension options) increased nearly nine-fold between Q3 2022 and Q3 2023. The resulting maturity schedule

[2] Q1 2024 State of Capital Markets. Newmark. (June 2024).

[3] 2023 Commercial/Multifamily Loan Maturity Volumes. Mortgage Bankers Association (February 2024).

shows the vast majority of extended loans slated to mature in 2023 pushed out over the next three years.[4]

While the CMBS market represents only a portion of overall outstanding commercial real estate debt, these dynamics can be seen across bank, insurer, and private loan portfolios. The tendency to amend and extend also helps elucidate the long, drawn-out nature of downturns in the commercial real estate space, but **ultimately, these modifications are only a form of temporary relief.**

For investors able to bring new capital to the space, the financing crunch can provide opportunities. In public markets, seasoned CMBS portfolios or single-asset single-borrower (SASB) loans nearing maturity offer the clearest potential to express a view on this dynamic. The secondary market has seen less spread tightening as uncertainty surrounding these extension decisions persists. The rate dependency of these decisions, however, means that these markets can move inline with other public asset classes despite the unique circumstances facing real estate.

Taking a step back, the current environment also presents a larger question for commercial real estate lending. Namely who will be the marginal creditor. Banks have historically dominated real estate lending. While it is unlikely banks will lose their plurality of total lending, pressure from regulators and investors will make it difficult for banks to take advantage of new lending opportunities. Indeed, many banks are actively shopping existing loan portfolios in order to reduce balance sheet pressure. The move toward credit disintermediation is not unusual; it happened decades ago for corporate credit. Insurers have already become a key player in providing credit to the commercial real estate space. This has continued in the current cycle, though the insurers' share of lending remains near the upper end of its historical range.

Earlier this year, the securitized market showed that it is still open to able borrowers when financial conditions ease, but this avenue is likely to remain limited to a narrow subset of borrowers who are able to meet the lofty criteria for the new issue market. **Instead, we believe private debt funds are best positioned to meet the increased funding needs in the current environment.** As with other areas of private credit, these funds benefit from longer duration liabilities as well as greater flexibility in approaching unique situations. **It is always prudent to proceed with caution in approaching growing asset classes, and we would suggest a strong preference for experienced lenders in the space over crossover players.** We would also stress the importance of allocating to new loan pools that are less encumbered by existing workouts. **Altogether, we see real estate debt funds as uniquely well positioned to take advantage of the drawn-out recalibration within the real estate market.**

[4] A Deep Dive into CMBS Loan Modification Trends. Trepp. (May 2024).

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