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May 2022 • perenews.com

2022 Debt roundtable

ROUNDTABLE

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Real estate credit investors seek clarity in challenging times

The participants in PERE's global debt roundtable consider economic opportunities in a world transformed by the war in Ukraine, writes Stuart Watson

The *PERE* debt roundtable took place at the beginning of April, after a tumultuous start to the year marked by the war in Ukraine and the enduring impact of covid. The five private debt providers in attendance – three from the US and two from Europe – grappled with the high-level implications of surging inflation, rising interest rates and steadily increasing yields for government bonds on both sides of the Atlantic, while also evaluating the asset-level impact on loan underwriting of the post-covid reshaping of property sectors, and of measures to combat the climate crisis.

"The hardest thing is that a lot of these risks are coinciding," says Emma Huepfl, managing director and co-head of EMEA credit strategies at CBRE Investment Management. "Rather than any single factor, it is the unpredictability of how they may interact that is challenging when you are trying to underwrite real estate, or real estate credit investments."

As the pandemic gradually becomes a less significant factor in underwriting, it is being replaced by geopolitical and inflationary risks, she observes. The situation also has benefits for the debt market, however: "When there is a lot of uncertainty about valuation and future upside, credit feels like a more secure place to invest your capital. But I think everybody is underwriting cautiously, and wanting to ensure that their loan structures can withstand various potentially quite difficult scenarios."

Because real estate credit is viewed as a downside-protected investment, that is all the more reason to be underwriting conservatively, urges Andrew Gordon, head of European real estate debt at Invesco Real Estate. "You need to make sure you retain that conservative outlook, underwriting based on a range of negative outcomes, and make sure you don't get pulled away from it, especially in markets where there is rising demand. Things like interest rate hedging, and ensuring cost overrun guarantees are in place are far more important when you get into an inflationary environment."

Interest rate risk

There are indications that the era of persistently low interest rates around the globe may be coming to an end. The US Federal Reserve has signaled it is ready to raise interest rates at a faster rate to get inflation under control.

According to Warren de Haan, co-chief executive officer at private debt provider ACORE Capital, this development could benefit issuers of

Warren de Haan
Managing partner and co-chief executive officer
ACORE Capital

One of the largest private debt providers focused on commercial real estate, ACORE is led by industry veterans de Haan, who was formerly chief originations officer of Starwood Property Trust, and Chris Tokarski. Last year, the firm carried out $7 billion of loan originations across the US, expanding its balance sheet to almost $19 billion.

Andrew Gordon
Head of European real estate debt
Invesco Real Estate

Gordon joined Invesco Real Estate in 2020 to lead its European real estate debt business following the transfer of GAM Investments' CRE debt finance business, including its team, assets and investor relationships. The firm manages just over $90 billion of real estate globally, of which $6 billion is in real estate debt, and operates 21 offices across 16 countries worldwide.

Emma Huepfl
Managing director, EMEA credit strategies
CBRE Investment Management

London-based Huepfl is leading the expansion of CBRE IM's debt operation in Europe, which was set up two years ago following the acquisition of Laxfield Capital, a business she co-founded. The firm manages about $2.2 billion of real estate debt across its global platform, which has real assets under management totaling $144 billion in value.

John Lippmann
Managing director and head of structured debt
New York Life Real Estate Investors

Lippmann runs structured debt and is portfolio manager for New York Life Real Estate Investors' Madison Square Structured Debt Fund. The investment management division of insurer New York Life manages $650 billion of assets, around $65 billion of which is real estate, including a real estate lending book of $39 billion diversified across a range of asset classes in the US.

Eric Smith
Chief executive officer and managing partner
Locust Point Capital

Smith is a founder of Locust Point Capital, which launched its first institutional private debt fund in 2016. Now on its third fund, the firm has total assets under management of $851 million, and invests exclusively in the US senior housing or long-term care industry across the capital stack from senior debt to subordinate debt and preferred equity.

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> **EMMA HUEPFL**
> **CBRE Investment Management**

floating-rate debt. "With rising interest rates, we have seen some of the fixed-income investment buckets that were typically buying 10-year fixed-rate bonds, saying that if interest rates rise, their bond is going to lose value, so they're more likely to look for credit managers like ourselves that have LIBOR/SOFR-based products, where, to the extent interest rates rise, their absolute yield rises as well."

There is, of course, also significant potential downside for real estate in rising interest and bond rates, particularly in a market where yields have compressed rapidly for in-demand assets.

John Lippmann, head of structured debt at New York Life Real Estate Investors, poses a crucial question: "Ten-year treasuries have increased 180 basis points since a year ago. That increase will impact cap rates and residual values. Is there really enough cushion between recent cap rates and bond yields to absorb that increase?"

De Haan says, "as a general comment," for each percentage point that interest rates rise, real estate cap rates have widened by 40 to 50 basis points, provided that the asset class does not otherwise demonstrate extraordinary volatility. "And then, as a general rule, our stabilized debt yields are somewhere between 200 and 300 basis points higher than the prevailing cap rates today, so there would effectively need to be somewhere around a 400-basis-point increase in interest rates for us to be impacted."

Eric Smith is chief executive officer at Locust Point Capital, which specializes in providing loans in the US seniors housing sector. He notes that in segments such as multifamily housing, cap rates have compressed to record lows of as little as 3 percent, whereas senior living provides more of a hedge against rate rises. "Cap rates on skilled nursing facilities in the US are 11 to 14 percent, and independent or assisted living memory care cap rates have historically been 6 to 8 percent. So there's obviously a significant cushion compared to other real estate asset classes in a rising interest rate environment."

Huepfl says: "This environment reminds me of when I started in the industry, and interest rate risk was a much greater focus. That slightly faded from view in lenders' minds in the last five years or so. But now it is very much back at the fore and we are all thinking about how to cap our interest costs in line with covenants, and how sensitive to interest rate risk the refinancing is at the end of the loan term."

Tighter structuring

In a time of increased economic uncertainty, structuring loans so that they reinforce the alignment of interest

An ocean between them

The participants reflect on the condition of real estate and debt markets on both sides of the Atlantic

US

Warren de Haan: We were preparing for a record year in terms of production, and it still could be a record year. In the US, 2021 was the biggest year on record for the investment sales market, and that stimulates our business, because about 70 percent of what we do is financing new acquisitions. Private equity of $360 billion has been raised to invest in commercial real estate, and the non-traded REITs are raising exorbitant sums on top of that.

John Lippmann: Year-to-date production is the highest it has ever been, notwithstanding that there are some US cities that have struggled to recover from covid. Post-pandemic, people's desire to go shopping, grab dinner or see a show will revive downtown districts more than businesses just telling employees that they have to be back in the office.

Europe

Emma Huepfl: Credit markets have not tracked the equity markets the same way in Europe as in the US, because generally, equity has de-levered significantly in Europe since the financial crisis. Non-bank lenders have become a very active part of the UK landscape, but continental Europe is still bank-dependent at this point. But many debt funds have positioned themselves in the expectation it will change and open up to new capital.

Andrew Gordon: Borrowers were reaching the level of confidence where leverage was increasing. But first inflation and then war in Ukraine may curtail appetite for high leverage. We could see aggressive US investors entering Europe over the next couple years, with a lot of capital and fund leverage that allows them to lend at lower margins than some other market participants in Europe.

"Some of these liquidity problems will manifest themselves as credit problems within certain sectors"

WARREN DE HAAN
ACORE Capital

between debt and equity is crucial, argues Lippmann. "Real estate lenders are tightening structures in response to recent concerns about rates and economic stability. It has not been a snapback, but rather a slower evolution of structure creeping back into the market. Together with more conservative pricing, it is a healthy dynamic for lenders."

While the situation in Ukraine has provoked unease across global markets, and obscured long-term visibility, the participants agree that there remains an enormous volume of capital seeking a home in real estate in general, and real estate debt in particular. CBRE research shows record investment volumes in both Europe (€359 billion) and the US ($775 billion) in 2021.

Meanwhile, tighter regulation on banks introduced since the financial crisis has created space for debt funds to sweep up more of the demand to fund acquisitions. Capital deployment is a problem for many investors, however. Favored sectors such as logistics and multifamily residential are fully-priced, while a pall of uncertainty hangs over other segments, notably retail and offices, for which the pandemic has intensified and accelerated disruptive factors.

Crises create a liquidity problem, says de Haan, which might be resolved only when the cause of the crisis comes to an end. But if the liquidity problem lasts long enough, it can turn into a credit problem.

"In certain sectors, there were liquidity problems that started pre-covid which were exacerbated by the pandemic," he says. "And now, with the consequences of war in Ukraine being felt – higher inflation, middle-income consumers feeling pain as a result of energy prices going up, and some supply chains becoming problematic – we should expect that some of these liquidity problems will manifest themselves as credit problems within certain sectors. That is where we as lenders need to be very thoughtful. Some sectors will be hyper-challenged. I will not finance B-grade shopping malls, and I just do not know what will happen to B-grade office space. Those are in that credit problem category."

Illiquidity problem

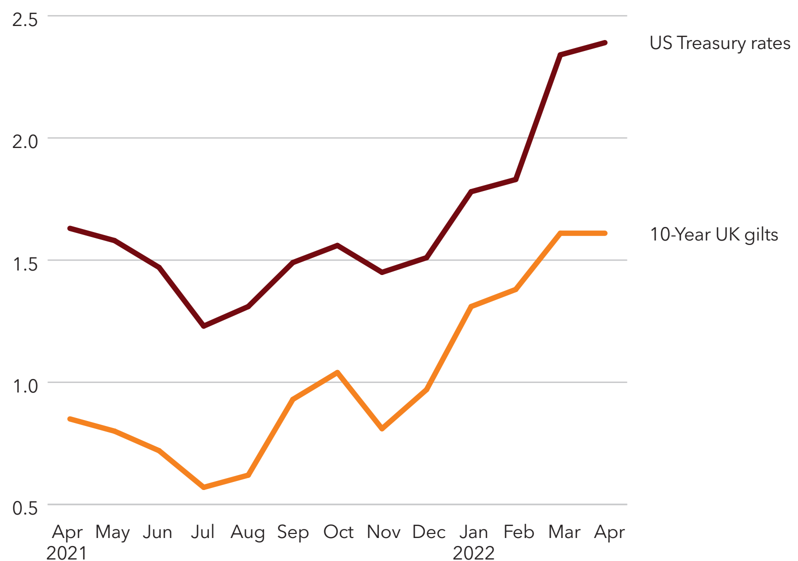
The change in working behavior following the pandemic affects take-up in the office sector, says Lippmann. "That's creating trepidation among debt and equity office investors, who are also facing increased capital costs. Illiquidity could translate into a value problem, which could become a credit problem. Sustained leasing velocity would make equity investors and lenders more comfortable that the underwriting is intact. We will see how that underwriting evolves as tenants return to the office and which investments will hold water, and which will not."

The process of transforming under-utilized property for alternative use has begun in the European market with out-of-town retail parks being repurposed as logistics hubs, says Invesco's Gordon. "In the last cycle, the Netherlands was a hugely over-built office market, and after the financial crisis we saw a 10-year exercise in converting that space into hotels, residential and student accommodation. I would expect, especially when it comes to assets that are heading towards being obsolete, that we can rely on the equity market to be creative enough to find other uses for buildings. But we will see."

Smith notes that in the US, lower-grade hotels have been successfully converted into affordable senior housing and independent assisted living facilities. "When the asset is in a secondary or tertiary market which has undergone a fundamental change, the owner really has to think of a new strategy for the asset, not just renovate it. That is where we see full adaptive reuse."

But it remains difficult for debt providers to underwrite loans to finance repositioning, says de Haan. "The issue that arises most of the time is that, to get comfortable with them, the basis on which the buyer is acquiring the asset

US Treasuries and UK gilts have been rising steadily with steep increases seen year-to-date, demonstrating how the benchmark for new loans is rising and increasing the overall cost of capital for borrowers (%)



Source: MarketWatch

has to be so low as to be almost land value."

With a cloud of ambiguity hanging over the future performance of so many asset types, which market segments still look to be a good bet for credit providers? Those in which rents can track inflation increases for starters, says Gordon. "Assets where you have inflation-linked leases, or short, flexible leases, like self-storage and accommodation, are attractive because you do not get a situation where interest rates are going up, but the top-line rent is unable to grow until you reach the next rental review in five years or however long it may be."

Even where there are some misgivings over an asset class in general, there may be opportunities to structure a good value-add debt investment as long as the assets within a portfolio have "occupational resilience," says Huepfl. "We look at how motivated the equity will be to protect that structure, and whether it will be in a position to keep refreshing the asset offer and making it attractive to occupiers for the next cycle."

Underwriting ESG risk

Another increasingly crucial factor in underwriting is sustainability. "Converting low-performing 'brown' assets into sustainable 'green' ones helps to protect value and avoid stranded asset risk, which is a growing feature in European markets," says Huepfl.

As EU regulations continue to raise the bar on energy performance, failure to keep up could hurt owners, she warns. "Combined with the reduction in structural demand in some sectors, that could leave quite a lot of property obsolete. Some of that stock is sitting within large loan books, and the problem will emerge when those positions come up for refinancing. There will be a rebasing of value because fresh debt will no longer be there at the same level to support them. That is a shock that's yet to come."

"Real estate lenders are tightening structures in response to recent concerns about rates and economic stability"

JOHN LIPPMANN
New York Life Real Estate Investors

"You need to make sure you retain that conservative outlook, underwriting based on a range of negative outcomes"

ANDREW GORDON
Invesco Real Estate

Aging gracefully

The pandemic has not caused US senior housing lending to wither, says Locust Point Capital's Eric Smith

Community banks that were the principal providers of debt to US senior housing operators reduced loan-to-value ratios during the pandemic, leaving a substantial opening for debt funds, says Smith. "Our transaction volumes nearly doubled last year because of that pullback by senior lenders. Groups like ourselves fill that void by offering senior debt or subordinate debt which allows owner-operators to continue to grow."

While banks are now lending more, they remain reluctant to provide value-add and construction finance, he adds. "I don't think that is going to come back to the level that it was pre-covid, so there will be increased opportunities for non-bank financial institutions."

He notes that the sector overall has gradually recovered as vaccines have reduced the coronavirus mortality rate, with around half of the drop in occupancy of acute care facilities so far made up. Distressed situations are rare. "Within our portfolio, none of our owner-operators missed any debt service payments, and valuations are being maintained."

Smith anticipates robust growth in independent assisted living and memory care, although he warns that it is vital for lenders to have a thorough grasp of the sector's nuances: "It's not just a real estate asset class, it is an operating business that really generates most of the value."

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> **ERIC SMITH**
> **Locust Point Capital**

The environment for underwriting ESG risk has transformed in recent years, Huepfl observes. "Borrowers are proactively seeking interaction about how credit investments can be structured to reflect ESG goals. They want that within the structure, and to make sure they can continue to satisfy lenders so that those assets can be refinanced in the future."

Invesco Real Estate has experienced the same paradigm shift in Europe, says Gordon. "If we had sent our 24-point ESG questionnaire to borrowers a couple of years ago, many of them would have shrugged their shoulders and had no idea what to do. Now, they expect the questionnaire, and know how to fill it in. Brokers have asked us to share it with them because they want to ensure that they have the information available to advise clients on how to meet the ESG standards they need to get competitive borrowing."

The participants agree the sustainability agenda is further along in Europe than in the US, but convergence is underway. "I just got back from a fundraising tour of Europe, and in almost every meeting ESG came up throughout the conversation" says Locust Point's Smith. "On ESG, Europe is probably about five years ahead of the US. But it's slowly catching on over here. In the US, probably a half to a third of investors we talk to will bring it up at some point."

ESG analysis is already an essential element of all New York Life investment briefs, says Lippmann. "It impacts our analysis because it is important to us and to our investors. These investments improve operating results for assets while we own them and ensure that the quality of the assets meets both our requirements today and buyer mandates that we expect to be in place in the future."

Financing the transition to net zero will be a challenge, but also a huge investment opportunity, says Huepfl.

The same could perhaps be said of many of the disruptive factors affecting real estate. Private equity managers leading the transformation of property asset classes on both sides of the Atlantic will need debt finance to make it happen. And there is plenty of capital keen to find a home in real estate credit. That represents a substantial opportunity for debt fund managers that can identify deployment strategies that enable them to balance risk and return in these unpredictable times. ■