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US Debt roundtable 2024

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US private lenders eye real estate opportunities as activity ramps up

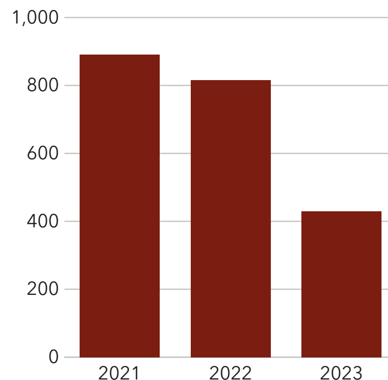
With banks likely to remain on the sidelines amid regulatory changes, participants in PERE's US debt roundtable anticipate openings to deploy capital both in refinancing and new acquisitions. Stuart Watson reports

Over the past 18 months, rising interest rates, uncertainty about property values and secular shifts in demand for some asset classes have combined to suppress commercial real estate lending activity in the US. Meanwhile, both money centers and regional banks have scaled back activity amid concerns over the health of their balance sheets and expectations of stricter capital requirements aimed at reducing liquidity risk.

The Mortgage Bankers Association estimates CRE mortgage borrowing and lending in the US totaled $429 billion in 2023, a 47 percent decline from $816 billion in 2022, and a 52 percent decrease from the 2021 record of $891 billion. Quarterly transaction levels for real estate equity investments have also fallen from a peak of $378 billion in Q4 2021 and have plateaued around the $92 billion mark for each quarter since the start of 2023, according to research from MSCI and Cushman & Wakefield.

However, during *PERE's* US debt roundtable discussion in PEI's New York office in July, participants say they detect early signs of recovery. "Transaction activity is starting to unlock a little bit. Last year almost all of our deal pipeline consisted of refinancings. But in the last three months or so, we have started to see a much more even split between acquisitions and refinancings," says Isabelle Brennan, senior managing director and credit specialist at LaSalle Investment Management.

Commercial real estate lending in the US declined 52% in two years ($bn)



Source: Mortgage Bankers Association

Dan Schapiro, co-head of credit at Los Angeles-headquartered manager CIM Group, agrees there are grounds for optimism. "Last year there was still a 100-basis-point bid-ask gap. This year we have seen cap rates starting to settle, and an uptick in deal volume. Of the originations we have done this year, the vast majority are for new acquisitions." Investment activity is spread across asset classes, with liquidity available for financing good-quality industrial and multifamily assets in particular, he observes.

The construction lending market is also returning to life, says Joshua Crane, co-founder and principal at S3 Capital which specializes in lending to multifamily housing developers. "Once it sank in that interest rates would

PHOTOGRAPHY: **ROBERT RIPPS**

Isabelle Brennan

Senior managing director, product specialist: credit and global solutions
LaSalle Investment Management

Brennan works with clients on a global basis to drive capital raising efforts for LaSalle's credit products and ensure that they meet investor needs. The specialist real estate asset manager manages almost $90 billion of assets globally, including around $5 billion in debt strategies across the US and EMEA.

Daniel Schapiro

Co-head of credit
CIM Group

Schapiro is responsible for leading CIM's credit platform and overseeing its real estate loan origination efforts across all US markets. CIM manages around $30 billion of real estate assets as of March 2024, of which $10 billion is in two debt strategies: an open-ended debt fund which mainly invests in transitional heavy lending, and a mortgage REIT that focuses on bridge lending.

Eric Smith

CEO, managing partner
Locust Point Capital

Smith is a co-founder of Locust Point Capital. The firm's principals have decades of experience providing financing solutions to the lower mid-market within the US senior housing and care industry. Currently, Locust Point Capital manages four investment funds with combined assets under management of $1.4 billion.

Joshua Crane

Co-founder and principal
S3 Capital

Crane founded Spruce Capital and S3 Capital with partner Robert Schwartz in 2007 and 2013, respectively. S3 is one of the most active bridge and construction lenders in New York, providing small loans of up to $20 million, as well as operating in the middle market up to $200 million. The firm focuses on the multifamily sector and has an active portfolio of over 150 loans totaling over $2 billion.

> *"We're drinking out of a firehose because of the lack of competition right now"*
>
> **JOSHUA CRANE**
> **S3 Capital**

remain higher for longer, the animal spirit came back a bit. Plus, there was an awareness that with an election due in November things could change again, so developers with schemes ready to deliver were on the clock. That has made 2024 exceptionally busy."

Secular shift

As activity builds again in real estate, private lenders will be better placed to take advantage than banks, suggest the roundtable participants. Eric Smith, chief executive officer at Locust Point Capital, which focuses on construction lending to US senior housing developers, has seen a "dramatic pullback" by the banks. Capital requirements for the banking sector mandated by the Basel III international regulatory framework, due to come into effect next year, will make it "prohibitively expensive" for banks to make construction loans, he explains.

"We believe this will be a permanent change. We have worked with some of the larger regional banks, and many have told us they do not intend to return to this line of business. There will be a huge opportunity for private lenders to fill this gap in the future," he says.

Regional banks have historically been the biggest providers of mid-market lending for multifamily construction, providing around 70 percent of total finance for the sector, says Crane. "There has been an incredible pullback from those guys, so even though construction starts have slowed in a lot of markets, we have a much more robust deal pipeline than we've ever had before. We're drinking out of a firehose because of the lack of competition right now."

While loans are priced at higher spreads than they were previously accustomed to, borrowers that began using alternative lenders through necessity are beginning to appreciate the benefit of working with specialist real estate finance providers, and some are saying they will never borrow from banks again, claims Smith.

"That's because of how the banks are treating their customers given the increased regulatory pressure they are under. If the borrower runs into

an issue, they can sit down with us and problem-solve. Banks are so constrained in this environment that they don't have that ability."

Schapiro believes a "secular shift" is underway from banks to private lenders in the direct real estate finance market. "We expect banks will focus more on the back leverage side because of the way their capital is treated. They will increasingly be providers of structured credit products to private lenders rather than lending directly to real estate."

That is an attractive solution for banks that still want to deploy capital in real estate but feel constrained by regulation, says Brennan. "Repo lines and note-on-note are the most capital-efficient ways for them to retain access."

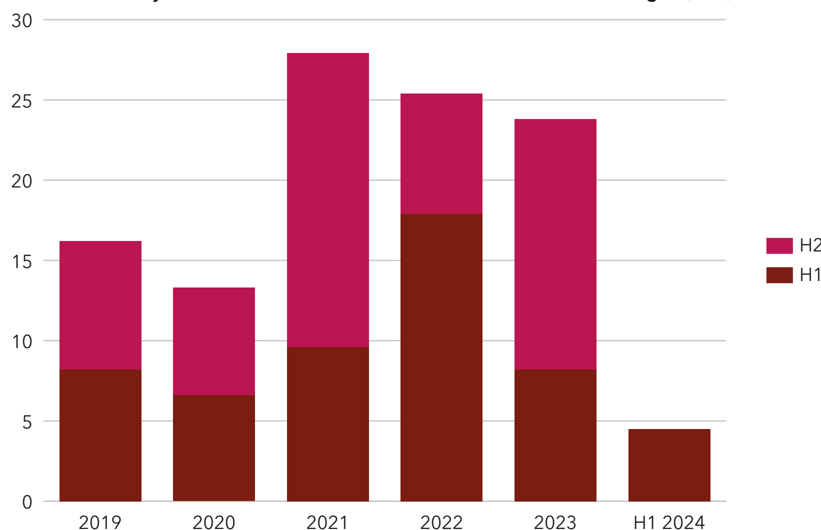
Indirect lending also enables banks to benefit from alternative lenders' real estate expertise, something they often lack in their own teams, says Crane. "If there are a handful of problem children among my book of 150 loans, they know it's my problem, not theirs, and I am going to solve it. Given the capital requirements and how these banks are staffed, it makes much better sense for them to come in behind a private lender."

Even if Basel III does not take effect as it is currently drafted, and banks recover their appetite for direct real estate lending, there will still be a more substantial role for alternative lenders, says Brennan. "So much capital is needed even just to refinance existing loans, let alone finance new acquisitions, that there is still space for everybody to play, and then borrowers have a choice about what kind of capital they want to work with."

'First stage' of the wall

While the participants say transaction volume is starting to pick up, they also identify a continued opportunity in meeting the demand to refinance maturing loans. MSCI research estimates close to $820 billion of US commercial property loans will mature in 2024, while another $214 billion of loans

H1 2024 saw only $4.5bn raised for North American real estate credit strategies ($bn)



Source: PERE

Will rate cuts encourage the green shoots of recovery?

With the Fed expected to start reducing US interest rates by the end of the year, roundtable participants consider the potential impact on credit markets

Dan Schapiro: It won't change the outlook for lenders too dramatically. It will have a bigger impact on the equity side where players are looking for green shoots so they can come off the sidelines. If more equity players return to the market and start making acquisitions, that should lead to accelerated deal volume.

Eric Smith: For legacy portfolios, a cut should add support for valuations, which will help facilitate refinancings, and it will make it easier for those with loans originated in 2019-21 to exit and generate new activity. Construction projects that were shelved in a higher interest rate environment will start to become financially feasible, so we should see a higher volume of deals being transacted that were previously on the cusp of viability.

Joshua Crane: We are spread lenders, and typically price our loans at 600 basis points above whatever the base rate is, so it probably won't have a big effect on our business. But if rates are cut drastically, that will mean more construction activity.

Isabelle Brennan: On the equity side, it should improve dealflow and investor sentiment a little bit. Credit is in vogue for investors right now, but falling rates won't make them less likely to allocate to debt strategies. We have seen through multiple cycles and with different interest rate dynamics that there is still a place for private real estate credit.

Multifamily and industrial remain favored sectors for US lenders

Office deals find few takers. But emerging asset classes attract more attention

In the coming months, transactions will be concentrated in two in-favor sectors, predicts LaSalle's Isabelle Brennan. "Today, a lot of us like the multifamily sector and industrial. We particularly like multi-let industrial, for the granularity of the income it offers."

"We have been active in multifamily, where we have done a lot of construction take-out financing when developers need liquidity expertise and fresh capital in order to finish their projects," says CIM's Dan Schapiro. In the industrial sector, formerly rapid rental growth has become more subdued, he observes. "While we expect a slight uptick in vacancy across industrial generally, the fundamentals remain fairly strong for long-term outperformance." He adds that CIM is also making a "big push" into limited-service hotels.

Joshua Crane says S3 has gravitated towards lending on multifamily assets in secondary locations within Tier One markets set to reap the benefits of gentrification. Residential projects offering affordable rents are also attractive prospects: "These are buildings for tenants that can't afford to live in a shiny tower. We like that in southern Florida, Nashville, Charlotte and New York. It's a theme we have followed as we have entered new markets."

"You don't necessarily have to have a really exciting equity story to make it a solid debt investment," concurs Brennan. "We particularly like multifamily markets with lower rent volatility. You don't have to underwrite 5 percent rent growth every year to make a good, well-structured debt investment."

The participants show little enthusiasm for the office sector at present. "It's going to take some time for the landscape in that sector to settle, and for investors to understand what the future drivers of value will be," says Brennan.

Emerging sectors outside the main institutional asset classes will attract more attention from alternative lenders looking to step in as banks continue to retreat, suggests Locust Point Capital's Eric Smith. "Credit specialists will be attracted by the yields that they're able to achieve in these smaller sectors of the economy."

were slated to come due in 2023 but were not subsequently refinanced.

"A lot of the loans that matured in 2023 didn't actually refinance, repay or sell. The can got kicked out by a year or two," observes Schapiro. "Over $1.5 trillion of loans are predicted to mature over the next three years, and the first stage of that wall of maturities is probably starting now. Together with increased deal activity, that could lead to a deluge of new investment opportunities."

Indeed, borrowers seeking to extend loans that are approaching the end of their term are being asked by their senior lenders to pay down some of the debt, providing an opening for alternative lenders to plug the gap with short-term mezzanine finance, says Smith. "The sponsors need another 12 to 24 months because they believe that over that period interest rates will start to decline, and they will be able to refinance their debt without a substantial paydown."

He adds the dynamic also creates an opportunity in the preferred equity space for providing "super-pref," which he defines as around 5-10 percent of the capital stack sandwiched between the point where the senior lender detaches and the equity. "You can structure it so you get the cashflow distributions after the senior, and achieve very attractive high-teens returns," he says.

Sponsors recognize their potential pool of capital is changing, and where one source is shrinking, another will step in to replace it, says Brennan. "If, as a lender, you can be flexible in working with sponsors to build up the capital stack, it can work well for both sides – our investors are looking for opportunities across the risk spectrum, and the sponsor gets to solve their issue."

While Crane agrees there are good opportunities in mezzanine and preferred equity, S3's business model is to stick to the senior space. "We already get a pretty nice mid-to-high-teens return, so we like to bring in a friendly fund with deep pockets for the preferred equity part."

Locust Point Capital has separate funds for different risk profiles. "There are some institutional investors who only like senior debt, while others are looking for a higher return and understand the associated risks. We can play across the capital stack while controlling the entire transaction because we don't have to deal with another lender," says Smith.

Underwriting standards

The opportunity for private lenders in today's market is balanced by risk. High interest rates have left sponsors under pressure, and the business environment for commercial real estate

occupiers remains unsettled. "One of the things that investors value most is that no matter what type of market you are operating in, you don't compromise on your underwriting standards," says Brennan. "Borrowers will try to negotiate. But you need to create a structure that protects your capital."

"When we are underwriting, the mantra is to stay at 65 percent loan-to-value or less. That's how you make sure that all your loans make money," says Crane. "Soft" diligence, to check sponsors' integrity, is also crucial, he adds. "For construction loans you will be in a relationship with them doing construction draws, and about half our book is repeat borrowers, so you really need to know who you're getting into bed with."

Recently, even some big-name, apparently reliable sponsors with assets that are underwater have handed back the keys to the borrower and walked away, cautions Schapiro. "One of the lessons for this cycle is to understand how your sponsor is capitalized for that particular deal. Knowing where they are in a fund's life, how much liquidity there is in a fund, and what the motivations are behind that investment helps you manage risk."

The participants agree that 'covenant-lite' loans are a foreign concept in real estate finance, with everyone at the table able to insist on high-covenant structures in what is essentially a lender's market. "I would much rather be in a position where I am issuing a forbearance agreement because the borrower tripped a covenant, as opposed to a no-covenant or covenant-lite transaction where you know that the transaction is not performing, or not going in the right direction, but you really have no recourse," says Smith.

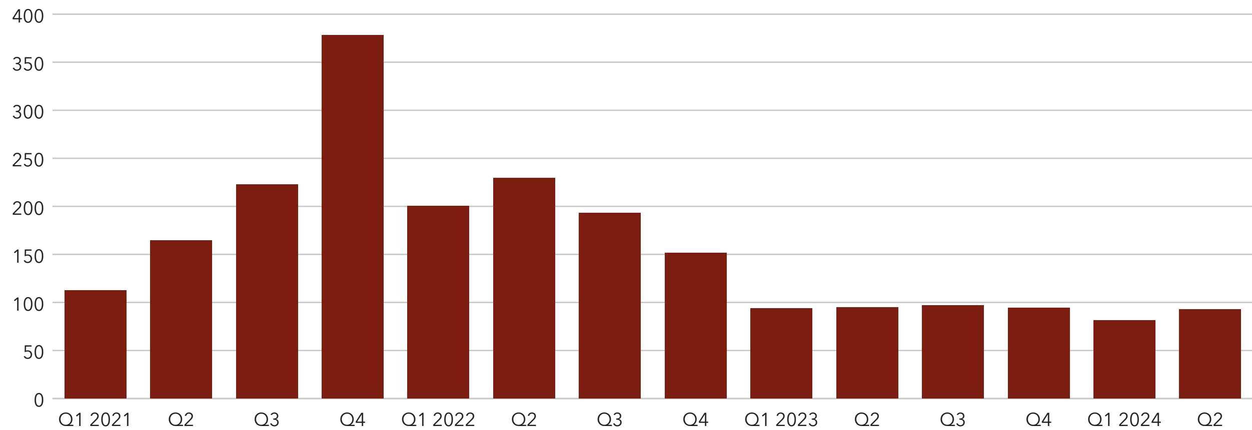
Schapiro agrees: "You can be a little bit more open to giving the borrower flexibility when things are going according to plan. But we are very focused on ensuring that when things don't go as planned, the loan is structured with real teeth."

Nevertheless, when deciding which finance providers to work with, potential sponsors are taking note of whether lenders have shown themselves to be supportive partners when loans run

"Banks will increasingly be providers of structured credit products to private lenders rather than lending directly to real estate"

DAN SCHAPIRO
CIM Group

Since Q1 2023, US quarterly commercial real estate deal volume has averaged $92bn ($bn)



Includes office, industrial, retail, apartments, hotels, dev sites and seniors housing & care for all types of transactions (individual, entity and portfolio)
Source: MSCI Real Capital Analytics and Cushman & Wakefield Research

into difficulties, he adds. "For new relationships we have seen the borrower community really focused on how lenders have behaved during this time, and whether they have been constructive when working with borrowers on their existing book."

'Strong' argument for credit

PERE research shows $23.8 billion was raised for North America-focused private real estate debt funds in 2023, a slight decline on the $25.4 billion committed the previous year. Looking forward, Brennan suggests the segment will attract an increasing volume of capital. "One effect of the rising interest rate environment has been the increasing interest from investors who historically haven't considered real estate debt. They are now turning their attention to the sector and exploring a wider range of opportunities."

With interest rates expected to

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ISABELLE BRENNAN
LaSalle Investment Management

"As the Fed begins to cut rates, investors shouldn't pivot out of credit and back into equity as credit can serve as an effective hedge against equity volatility"

ERIC SMITH
Locust Point Capital

remain elevated for the foreseeable future, Crane says it makes sense to be in the credit arena instead of, or in addition to, real estate equity. "Institutional investors can get really nice, risk-adjusted returns at a fixed point of value. There is a strong intellectual and practical argument for them to concentrate a lot of their allocation towards credit," he explains.

Even when interest rates fall, investors should continue to allocate to credit strategies, argues Smith. "As the Fed begins to cut rates, investors shouldn't pivot out of credit and back into equity, as credit can serve as an effective hedge against equity volatility. Right now, many real estate equity investments are not paying distributions as all the cashflow is going to pay debt service."

Schapiro says current conditions make this the most attractive time to invest in debt he has seen in his career. "For a bridge multifamily deal, you're getting 300 basis points over base rates of 5-plus percent. You are getting 8 to 9 percent yield on that investment unlevered. Meanwhile values have come down by 15 to 25 percent so you're lending at a lower basis, and at a lower LTV. You're getting paid more for it, and you can structure that debt in an attractive way."

The participants all expect to be more active in the coming year. Crane says S3 will "expand judiciously" and stay focused on the quality of its sponsors, Schapiro identifies transitional heavy construction lending as a growth area for CIM, Smith expects Locust Point Capital's senior lending to ramp up to fill the void left by the banks, and Brennan says that in the US LaSalle will concentrate on the senior space and light transitional loans.

Market indicators look increasingly favorable for US private debt investors. But lenders will not get too carried away because they are "pessimists by definition," concludes Brennan. "We look at the downside protection, because we don't get to benefit from the upside unless we are sitting in a pref equity position, so we are not trying to shoot the lights out. We are just trying to write good debt, and make sure that we get paid back at the end of it." ■