LaSalle

Resilience and opportunity in real estate credit

The role of real estate credit as a cornerstone strategy

In today's dynamic economic environment, senior real estate mortgage credit is cementing its position as a cornerstone of resilient investment portfolios. This approach combines the reliability of regular loan interest payments with the security of physical underlying property assets, offering investors a steady income stream and a buffer against market volatility. Unlike traditional investments, real estate credit taps into the stability of the property market, while providing the protective benefits of being a lender. As economic uncertainty persists, this investment method is proving to be a valuable tool for building resilient financial portfolios.

The rise of alternative lenders

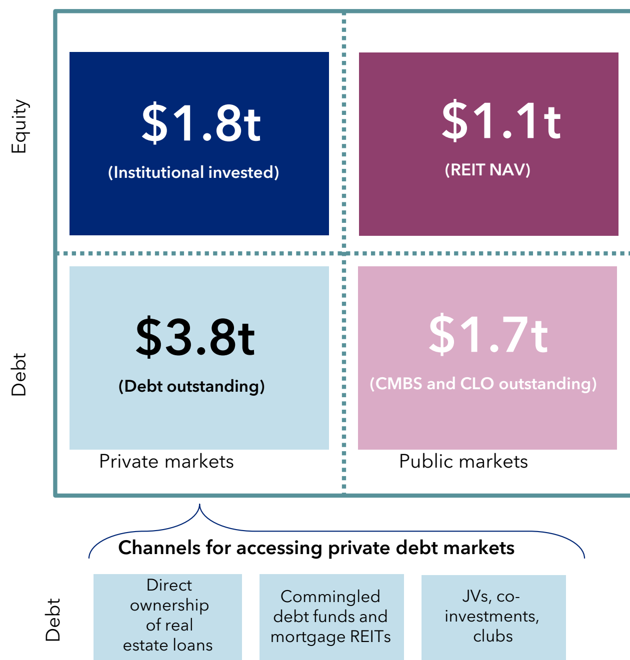
Debt strategies have historically comprised a smaller portion of institutional portfolios relative to their weight as one of the four quadrants of real estate, due to the dominance of banks. This is changing as increased regulation makes direct real estate lending less capital efficient for banks, with the gap increasingly being filled by alternative lenders. As investors continue to seek attractive risk-adjusted returns and stable income, these credit funds are expected to facilitate greater allocations by institutional investors to the private debt quadrant.

Dual strengths: Income generation and downside protection

Real estate credit's appeal lies in its ability to generate steady income, while offering robust downside protection. This combination creates a resilient investment profile that is particularly attractive in volatile markets:

- **A layered approach provides investors with a solid, predominantly current-pay income base,** resulting in a more predictable return profile compared with equity investments, with the potential for enhanced returns through additional fee structures. Returns are built on a foundation of contractual interest payments and enhanced by various fees. The primary return driver is the interest rate, typically structured as a spread over a reference rate, tied to the loan amount and the underlying real estate asset or portfolio. Beyond this core component, lenders can enhance returns through origination fees, extension fees, restructuring fees, exit fees and default interest, where applicable.
- **Investing in first-mortgage positions places investor capital in a protected position within the capital stack.** The equity cushion, which typically ranges from 30 percent to 70 percent, provides a significant buffer against value fluctuations. Moreover, first-mortgage lenders benefit from repayment priority versus the holders of mezzanine loans and equity investors. In the event of a default, lenders on commercial real estate assets also have recourse to underlying collateral that has a more transparent valuation process as compared with corporate bonds. This does require the lender to have asset management expertise to effectively capitalize on the value of the property and underscores the importance of investing with experience real estate managers. Some loan structures also have additional built-in protections against asset value or cash-flow deterioration. It is important to note that this downside protection does mean that debt investors do not participate in the upside from value increases.
- **Real estate credit funds further enhance security through diversification,** spreading risk[2] across sponsors, tenants, geographies and asset types. This approach reduces the risk that a single loan position disproportionately impacts overall performance, contributing to more resilient return profiles. Key risk-mitigation strategies employed by lenders include high diversification in loan pools, limited loan durations (typically three-year initial terms) for more accurate underwriting, and prudent leverage use with narrow, collateral-based margin call triggers.

Figure 1: The quadrants of real estate[1]



Source: PREA, as quoted by CBRE-EA in their June 2024 report, A Quadrant Approach to Commercial Real Estate Investing

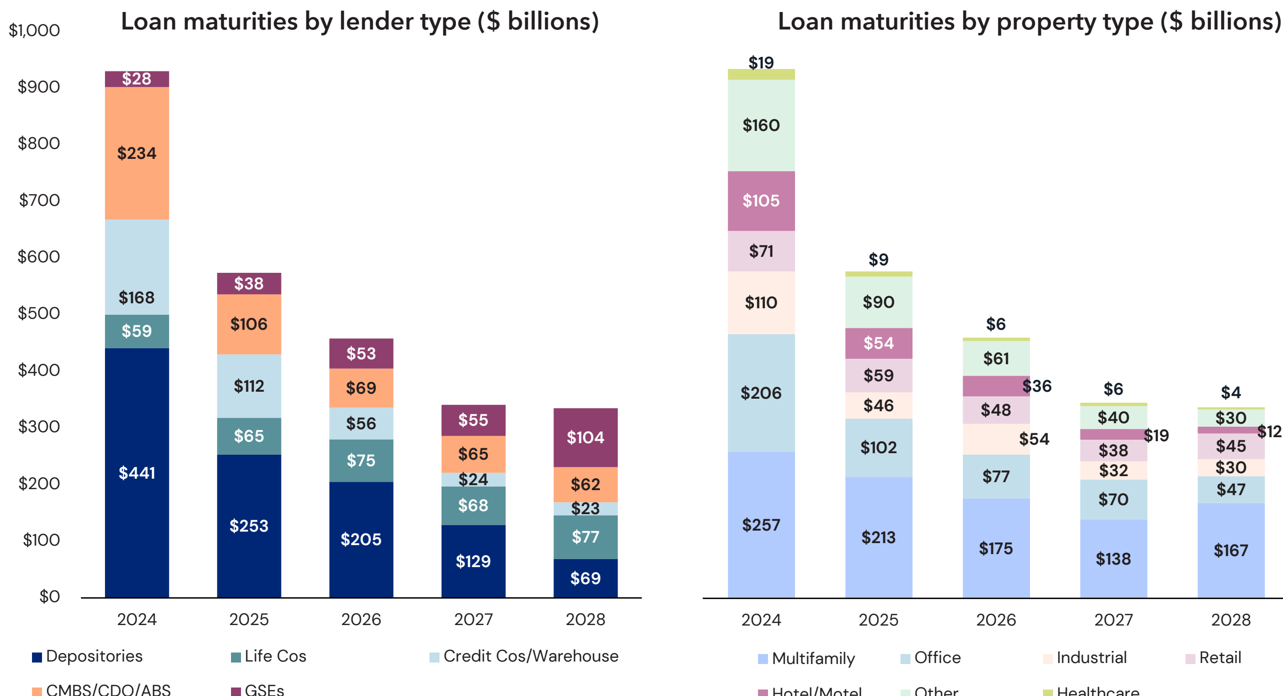
These features drive private real estate credit's attractive risk-adjusted returns, as compared with other fixed-income sectors. During the past two decades, total returns on senior mortgages have outperformed corporate bonds and nonagency CMBS. Real estate credit has also demonstrated lower volatility. It also acts as a diversifier because of low-to-moderate correlations to other asset classes, including other real estate segments.[3]

Investing today

Downside protection and income-driven returns are features that give debt a permanent place in an investment portfolio across market cycles, but the opportunity today is unique. The Federal Reserve has begun to cut rates, which does reduce the interest income from a mortgage loan, but it is expected to increase demand for commercial real estate debt at a time when some lenders are stepping back and allow debt fund spreads to expand.

The Federal Reserve's rapid rate hikes caused new commercial real estate transactions to slow, as interest rate increases made borrowing more expensive, and pricing adjusted. As of July, year-

Figure 2: U.S. loan maturities elevated in the near term



Note: Data pertains to all lender types. *Sources: Mortgage Bankers Association, LaSalle Research. Data for this chart is released once per year (in first quarter) and does not reflect extensions that have taken place.*

to-date volume was down 8 percent year-over-year, and trailing-year volume was only 61 percent of the 10-year average figure.[4] With capital markets frozen, more borrowers sought to extend loans as they waited for interest rate relief, pushing near-term maturities to $1.5 trillion in 2024–2025 according to the Mortgage Bankers Association (MBA) and reducing lenders' capacity for making new loans.

Transaction volumes are expected to slowly increase through the end of 2024 with a more meaningful pick-up in 2025, as investors respond to recent interest rate declines. In addition, the declining 10-year Treasury is likely to motivate some lenders to push existing borrowers to exit. With just under half (46 percent) of the 2024–2025 maturities owed to banks that are shifting toward fund-level financing and being more selective about their direct investments in commercial real estate, this will provide an opening for alternative lenders to fill the gap. (See Figure 2.)

Redefining portfolio resilience

As we navigate the evolving economic landscape, real estate credit continues to demonstrate its value. It is not merely filling a niche but redefining portfolio resilience through cycles, particularly during unpredictable times. For investors seeking to balance stability with growth, real estate credit presents a compelling opportunity to fortify their portfolios against market turbulence, while positioning for long-term success.

Notes: [1] Detailed definitions: Private equity is on a net asset value basis and based on professionally managed properties held for investment purposes (e.g., does not include owner occupied); only includes portfolios with total value greater than $100 million (e.g., does not include small investors). Public equity includes market value of equity REITs, minus their holdings of cash and debt investments. Public debt includes CMBS, mortgage REITs, debt investments held by equity REITs, and corporate bonds of REITs. Private debt includes all multifamily and commercial mortgages except those in CMBS, held by mortgage REITs, or held by GSEs (i.e., not pooled) or by federal, state or local governments. Sources: PREA, MSCI, NCREIF, NAREIT, Federal Reserve Flow of Funds. [2] As with any investment, real estate debt is subject to market fluctuations and economic cycles. Risks include the possibility of property valuations falling below the debt balance and borrower default if property cash flow is insufficient to service the debt *and* is unable to self-fund the payments. [3] Sources: Giliberto-Levy Senior Mortgage Index, FTSE NAREIT, NCREIF ODCE, Citigroup, Standard & Poor's, HFRI, and the Federal Reserve. Senior real estate mortgages are represented by the Giliberto-Levy total returns. Public real estate is represented by FTSE NAREIT U.S. Real Estate Index. Core private real estate is represented by the NCREIF ODCE gross total returns. NCREIF ODCE data reflects the returns of diversified, core, open-end funds including leverage and fund expenses, but it excludes management and advisory fees. Corporate bonds are represented by the Citigroup Broad Investment Grade Corporate Bond Index. Stocks are represented by the S&P 500 Index. T-bills are represented by the U.S. Government 90-day T-bill. Commodities are represented by the S&P GSCI Total Return index. Data as of first quarter 2024. [4] Real Capital Analytics. Note: Closed transactions; excludes privatizations, refinance, hotels, seniors housing and care, and development sites. Excludes transactions with a gross value of less than $5 million.

CONTRIBUTORS

Craig Oram
President and Fund Manager
LaSalle Debt Investors

Isabelle Brennan
Senior Managing Director, Product Specialist, Credit and Global Solutions | LaSalle

Jen Wichmann
Senior Vice President, Research and Strategy
LaSalle

COMPANY OVERVIEW

LaSalle Investment Management is one of the world's leading real estate investment managers. On a global basis, LaSalle manages $84.8 billion of assets in private and public real estate equity and debt investments, as of second quarter 2024. LaSalle's diverse client base includes public and private pension funds, insurance companies, governments, corporations, endowments and private individuals from across the globe. LaSalle sponsors a complete range of investment vehicles, including separate accounts, open- and closed-end funds, public securities and entity-level investments. For more information, visit **www.lasalle.com.**

CORPORATE CONTACT

Alissa Schachter | LaSalle
+1 312 228 2048 | www.lasalle.com

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