Silence the Noise

Seizing Opportunity in Commercial Real Estate Debt Today

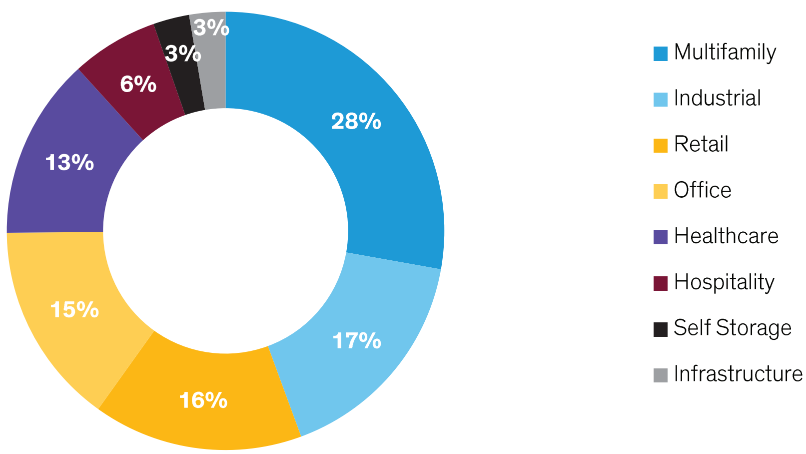
Commercial real estate (CRE) is a "dirty term" these days. Many investors are reluctant to consider the asset class given the oft-discussed headwinds; work-from-home, recession potential, higher interest rates, etc. But today's downturn is not the only downturn CRE has ever faced. Nearly every cycle presents headwinds. Is this time different? Yes, but so too was every other time and those that invested through the downturn benefited from their pragmatic foresight.

The commercial real estate asset class is far from monolithic—there's equity (ownership) and debt (financing), numerous sub-asset classes (**Display 1**), and no two CRE assets are alike. For one to say they're averse to investing in commercial real estate is akin to saying they're averse to investing in corporations (to equity or debt, to which sector and to which corporations, in particular are you referring?).

Below we lay out the argument for investing in commercial real estate debt (CRED) today as a prudent way to gain access to the asset class. This argument for CRED, of course, necessitates being cognizant of the future sectoral winners and losers and making each loan decision as an idiosyncratic opportunity into a unique asset.

DISPLAY 1: SEGMENTATION OF US CRE PROPERTY SECTORS

As a Percent of Total US CRE Asset Value



As of March 2023

Source: UBS

Like all of commercial real estate, commercial real estate debt is a diverse, complex asset class offering a range of investment opportunities. Significant differences exist between sectors, geographies, and individual assets. Performance of CRED is primarily linked to cash flows at the individual asset level, since an investor is only concerned with their loan being repaid, making it important to understand the idiosyncrasies of each property.

Despite the current macroeconomic uncertainty, we consider CRED well positioned to withstand any near-term volatility given its strong fundamental performance recently, as well as historically. Not all investment environments are created equal. Often times, unique opportunities arise from dislocated markets.

In the near term, we see a particularly compelling opportunity in CRED following the recent convergence of several favorable market dynamics, including:

Valuation Reset
Allows lenders to come in at lower prices and at greater discounts to replacement costs

Higher Coupons
Result in more compelling near-term returns for CRED investors

Stronger Loan Structures
Provide increased protection with lower leverage levels, tighter covenants and more attractive collateral packages

Illiquidity Premiums
Offer alternative lenders higher potential returns, reflecting the recent bank retrenchment and resulting liquidity gap

Idiosyncratic Opportunities
Emerge for experienced and scaled managers with differentiated sourcing capabilities

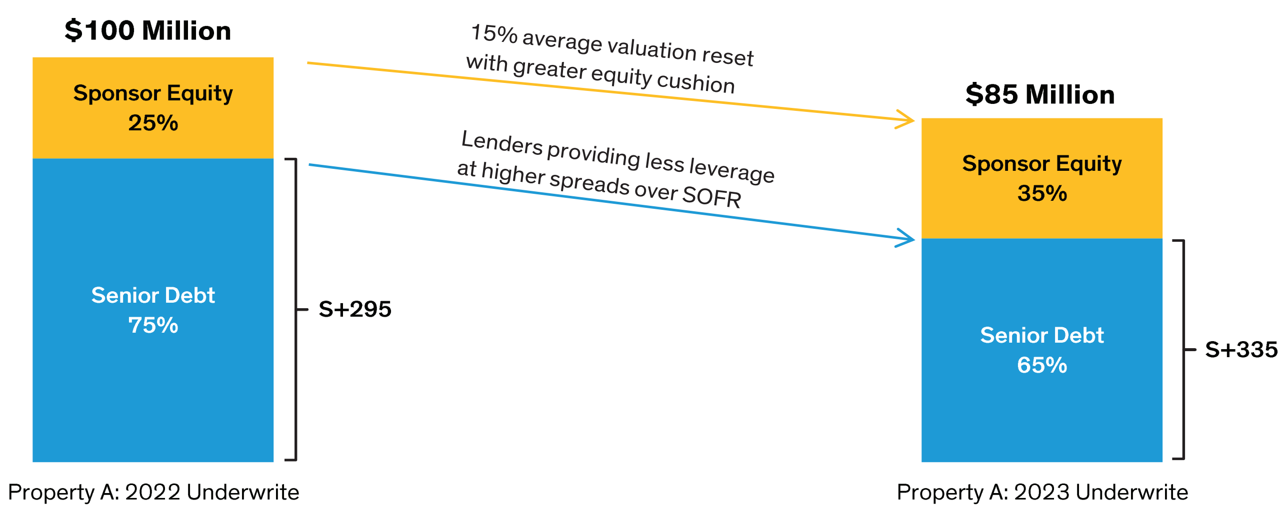
Valuation Reset Allows Lenders to Come in at a More Attractive Basis

Interest rates have a significant impact on property valuations given the levered nature of the asset class. When interest rates rise—especially as sharply as they have in the past 18 months—the cost of borrowing increases, dampening demand. In turn, this can cause property valuations to reset to lower levels, undermining returns for CRE equity investors. Conversely, when interest rates are low, borrowing costs decline, which tends to stoke demand and drive up property valuations.

Over the last 18 months, the one-month Secured Overnight Financing Rate (SOFR), has climbed by over 500 basis points, or 5.0%. As SOFR has risen, commercial real estate property valuations have come under pressure due to higher implied short-term borrowing costs.[1] Valuations have reset lower by an average of 15% across the market and by asset type (**Display 2**).

As values have fallen, lenders have lowered their leverage levels. They've also increased spreads (i.e., the incremental return above the base rate, or SOFR, required to compensate lenders for the risk of the loan) to account for the perceived change in risk and uncertainty in the market. Taken together, that means CRED investors in newly underwritten deals benefit from more sizable equity cushions, better returns, and enhanced downside protection relative to prior periods.

DISPLAY 2: LENDERS COMING IN AT A RESET BASIS AND AT LOWER LOAN-TO-VALUES



As of June 30, 2023
Source: AB

What if valuations don't bottom in the near term? The benefit would be further felt if 2024 shows an economy that continues to soften. Of course magnitude matters, but a 30%–40% equity cushion on a cash-flowing asset mutes the need to invest at precisely "the bottom."

Higher Base Rates and Wider Spreads Are Boosting Investor Yields

Besides pressuring valuations, the surge in base rates has had another effect. Lenders can now expect higher coupon payments on their loans, resulting in stronger absolute returns. This is good news, especially since the prevailing consensus is that interest rates will remain elevated for the foreseeable future, creating a favorable environment for lenders.

The wider spreads referenced earlier also come into play. The combination of higher rates and wider spreads has propelled debt yields significantly higher over a short period, as illustrated in **Display 3**. Both these forces present a unique window for investors to capitalize on current market conditions.

1 SOFR is the traditional US index used in floating rate debt coupons.

DISPLAY 3: ILLUSTRATIVE COUPON—2Q 2022 VS. 2Q 2023

Percent

	2Q 2022	2Q 2023	Delta
1-Month SOFR	1.09	5.07	**+3.98**
Illustrative Spread	2.95	3.35	**+0.40**
Coupon	**4.04**	**8.42**	**+4.38**

Past performance does not guarantee future results.

As of June 30, 2023

Source: AB

Stronger Loan Structures Favor Lenders

Amid ongoing volatility and a significant wave of upcoming debt maturities, lenders hold the upper hand in structuring loans. Those who are willing to do their homework and take calculated risks can benefit from additional protective covenants, such as higher debt service coverage ratios and more stringent financial reporting requirements. More desirable collateral packages and lower loan-to-values (LTVs) are also more common, providing investors with added security.

It may seem counterintuitive, but a slow or cautious market can actually signal a healthy dynamic where only the strongest players can participate. While some hesitate or avoid jumping in, those with capital to deploy and the discipline to be selective are well positioned to benefit from attractive originations with significant protections. By taking advantage of these market conditions, investors can potentially earn higher returns while minimizing risk.

Alternative Lenders to Benefit from Bank Credit Contraction

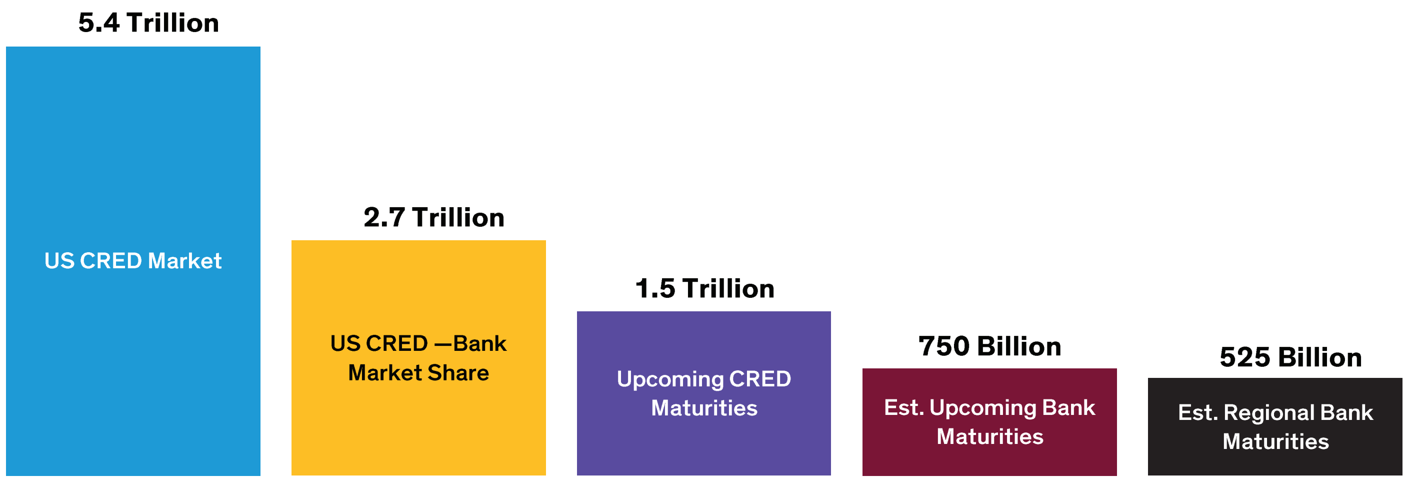
The US CRED market is a behemoth, clocking in at a staggering $5.4 trillion in outstanding debt. To put it in perspective, that exceeds the GDP of both Germany and Japan. And while banks hold a whopping $2.7 trillion—nearly half the market share—the landscape is shifting.

The recent, high-profile failures of both Silicon Valley Bank and Signature Bank have put the banking system under increased scrutiny and stress. As a result, many market participants expect banks (particularly regional ones) to reduce their commercial real estate lending activity in the coming months and years.

A looming wall of maturities, with approximately $1.5 trillion of commercial real estate debt coming due by 2025, will create further strains. Banks have funded an estimated $750 billion of that total—with regional banks financing 70%, or $525 billion. Alternative lenders have an exciting opportunity to fill the void, particularly in markets where regional banks are unable to participate.

DISPLAY 4: SIZING THE US COMMERCIAL REAL ESTATE DEBT FUNDING GAP

US Dollars



As of March 17, 2023

Source: UBS

Evolving Markets Create Idiosyncratic Opportunities

Today's macroeconomic uncertainty is causing a dislocation in the supply and demand for capital, creating reward potential that's not typically available. One such opening is the ability for alternative lenders to purchase existing assets from traditional players—such as banks, insurance companies, and institutional investors—that may wish to pare back exposure due to full balance sheets or increased regulatory scrutiny.

Take traditional banks, many of which entered 2023 needing to trim their CRED exposure. Some will initially reduce lending activity, while others will look to sell down a portion of their existing portfolio. This presents an opportunity for alternative lenders to acquire these assets at compelling discounts, providing attractive entry points to generate differentiated, idiosyncratic return streams.

It's important to note that these transactions are neither widely available nor easy to access. Experienced managers with well-established platforms and strong market reputations are best positioned to source and structure such deals. By working with a skilled manager, investors gain valuable access while benefiting from the expertise of a seasoned team with a broad platform and capabilities.

The Takeaway

Current real estate fundamentals, such as cash flows, vacancy rates, and new supply, are still in balance in most sectors. Certain sectors face idiosyncratic challenges—like waning office demand following the COVID-19 pandemic. But such issues are not unprecedented in the industry and will likely work themselves out over time. The real estate industry has dealt with other secular events, such as the rise of e-commerce and the destruction of the regional mall sector, on numerous occasions. These types of shifts often breed new asset classes, such as life sciences and data centers, both of which present exciting opportunities.

Many of today's market challenges stem from rising interest rates, rather than fundamentals. Unlike previous down cycles, overbuilding has not been an issue. Ultimately, we believe CRED presents a compelling near-term investment opportunity, and that experienced and disciplined managers can position themselves and their investors for long-term success.

BERNSTEIN

BPWM-409492-2023-07-28
BER-2036-0823
Bernstein.com