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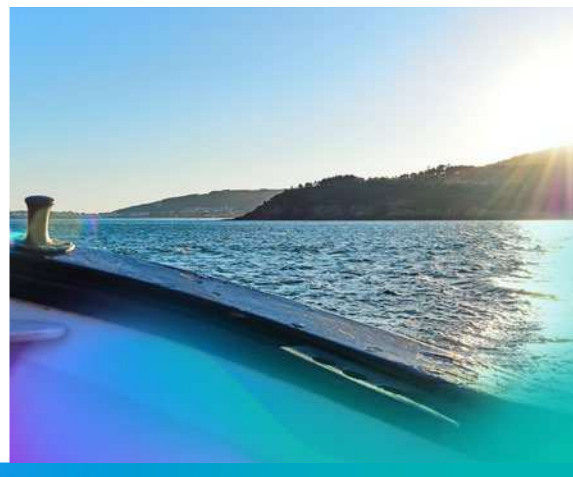

# Commercial real estate debt is struggling— What a great opportunity

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In the classic 1994 film, "Forrest Gump," Forrest bought an old shrimping boat, which he named Jenny, and entered the shrimping business with his first mate and former commanding officer, Lieutenant Dan. In the hypercompetitive shrimping scene of Bayou La Batre, Alabama, things did not go well at first. The established boats caught virtually all the shrimp, and Jenny's nets filled with little more than trash.

Then Hurricane Carmen struck. The other boats, anchored in the harbor for the storm, were taken out of commission, many dashed on the rocks. The Jenny, out that day in the Gulf, ended up as the only one left. "After that," Forrest says years later, "Shrimpin' was easy." The next scene shows a massive haul of shrimp pouring onto the deck of the Jenny, kicking off a business that would quickly grow to 12 Jennys and the multi-million dollar Bubba-Gump Shrimp empire, landing the partners on the cover of Fortune magazine.

## What does the Bubba Gump story have to do with commercial real estate (CRE) debt?

Well, the CRE industry is experiencing its own hurricane. It is a perfect storm: a combination of steeply higher interest rates driving bigger debt service burdens, falling valuations, and severe fundamental problems in the office sector. Meanwhile, a massive maturity wall of low-interest loans is coming due, which could wreak havoc upon the many highly levered lenders with underwater loans. Similar to the established boats that were destroyed, banks and many other debt capital providers have scurried onshore, hoarding cash and refusing to make new CRE loans.

Like Forrest and Dan, we see opportunity in the crisis. We believe the current environment presents a uniquely attractive opportunity for investors with fresh capital to deploy. Lenders who are unburdened by legacy exposures will be able to gain market share while still being very selective. They will have the ability to choose from high quality properties at substantially lower valuations and better terms. We believe CRE debt investors will ultimately look back at this vintage of loans as perhaps the best risk-reward opportunity in the space since the global financial crisis. A few years down the road, they might even say, "After that, lending was easy."

## Key takeaways

1. There are a lot of challenges in commercial real estate, arising from higher interest rates, severe trouble in the office sector, high leverage levels and a wave of low-interest loans set to mature in 2024 and 2025.
2. We believe these pressure points help provide an opportunity for experienced credit managers with fresh capital to deploy. The current environment offers a very real opportunity to generate equity-like returns with lower levels of risk and advantageous downside protection.
3. In our view the best risk- adjusted returns right now— and for the foreseeable future—are in CRE lending. There are many attractive loan varieties, but we favor predominately first-lien, transitional loans to seasoned borrowers with high quality (mostly multifamily) properties. Not only do we believe that the current CRE lending opportunities are better than CRE equity investing in today's capital markets environment, but we also think CRE lending is the most attractive of all debt asset classes as well.
4. Investors can capitalize on the uncertainty, but it is important to choose the right manager with knowledge and experience in CRE lending, as well as the ability to navigate the challenges in this choppy market.

# The storm

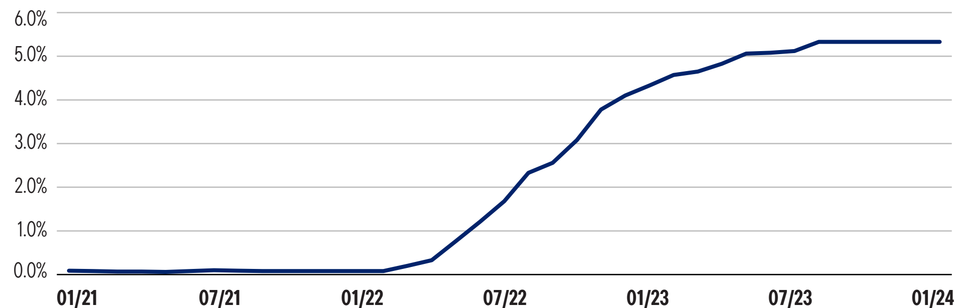
## The swift, steep rise of interest rates

As inflation reached 40-year highs in 2022, the U.S. Federal Reserve raised its benchmark rate from historically low, near-zero levels to more than 5% in 17 months (**Exhibit 1**). The pace and size of the increase, not seen since the early 1980s, has had an enormous impact on the CRE debt market.

The very good news is that for lenders, higher borrowing costs means higher net interest margins. Lenders generate more income, which, given the parade of poisonous headlines around CRE of late, a lot of people seem to forget or outright ignore. **Exhibit 2** spells it out, using a highly simplified example: a lender would earn an additional 11% in income over three years, based solely on the increase in the Secured Overnight Financing Rate (SOFR) base rate we have already experienced. That extra income provides a cushion to help cover declining property values in a lender's portfolio.

Unfortunately, rising rates cause headaches for underlying borrowers. The cost of senior debt, which stood around 4.5% in 2021, now stands above 10%. Thus, debt service payments have doubled or tripled during this period. In reality, lender-required interest rate caps (IRCs) kicked in and temporarily limited the damage for borrowers, because the IRC provider has so far covered the bulk of the difference in payments. However, IRCs expire at loan maturity, leaving borrowers exposed to now higher interest rates. At the same time, loan-to-value (LTV) ratios—the loan amount compared to the value of the property—have increased. Real estate values are highly correlated to interest rate movements: when rates go up, property values fall. By our estimates, the increase in interest rates alone lowered values by 20–25% across the board. As the left half of **Exhibit 3** shows above in a hypothetical example, an as-stabilized LTV, which was 67.5% at origination, rising to 90%. The equity owner is likely taking a loss and could even get wiped out. The existing lender may be fine, but they are left with a much lower margin for error. That, in a nutshell, is the painful reality for the performing assets in legacy CRE debt portfolios today. The non-performing assets, many of which are in the office sector, have a far deeper problem.

**Exhibit 1. Federal Funds Rate Rises at the Fastest Pace since the 1980s**




Source: Federal Reserve Bank of St. Louis, Economic Research Division.

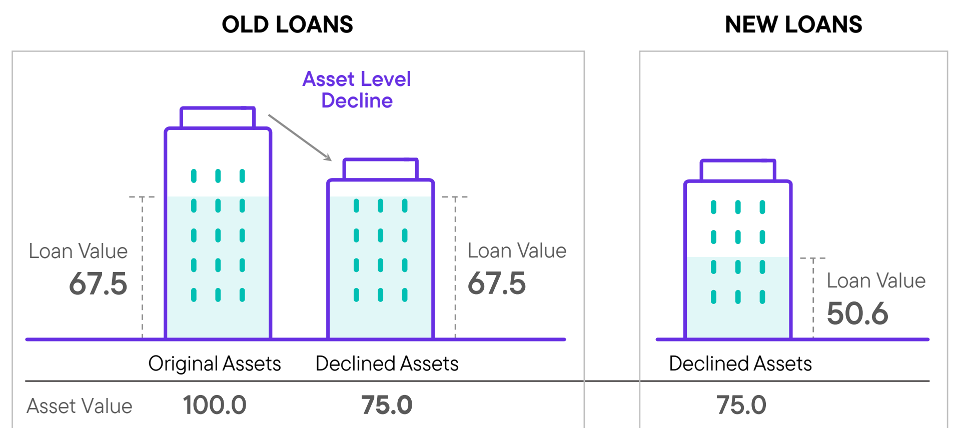
**Exhibit 2. A Net Interest Margin Windfall**

Portfolio Originated in Year 0: $100

| | NO BASE RATE INCREASE | | BASE RATE INCREASE | |
|---|---|---|---|---|
| | WA Base Rate | Investment Income | WA Base Rate | Investment Income |
| Year 1 | 0.50% | $0.5 | 2.50% | $2.5 |
| Year 2 | 0.50% | $0.5 | 5.00% | $5.0 |
| Year 3 | 0.50% | $0.5 | 5.00% | $5.0 |
| **Total** | | **$1.5** | | **$12.5** |
| **Uplift to Investment Income from Base Rate Increase** | | | | **$11.0** |
| **Cushion to Book Value from 3 Year Base Rate Increase** | | | | **11.0%** |

Dollars in millions. Figures are illustrative and simplifications.

**Exhibit 3. High-Quality Properties at Discounted LTVs**




For illustrative purposes only.

## The office problem

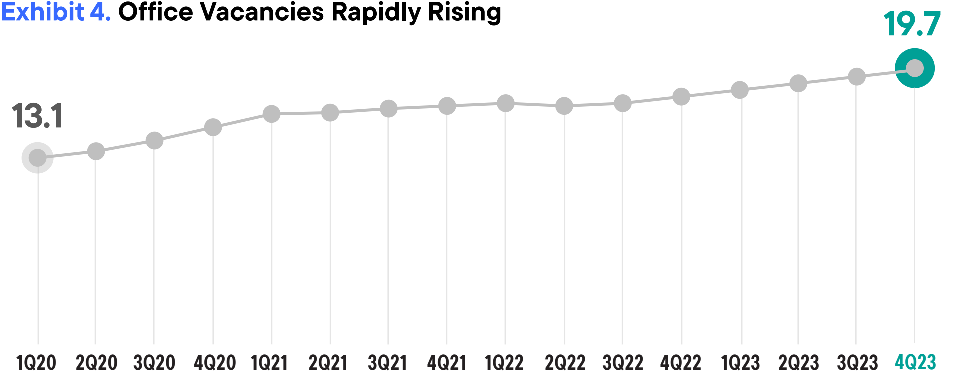
If the rise in interest rates was a left jab that brushed the jaw of the CRE asset class, the office sector was a hard right cross, a potential knock-out punch. Since the pandemic, societal shifts, headlined by the realities of work-from-home and automation/artificial intelligence (AI), have created an oversupply of properties, weighing heavily on asset values. Workers from home don't need cubicles, and AI requires only servers.

Vacancy rates are surging. By the fourth quarter of 2023, just shy of 20% of office space in major U.S. cities remained unleased, according to CRE services firm Cushman & Wakefield (**Exhibit 4**) and even more was unoccupied. Moody's Analytics called it the highest vacancy rate across the sector since at least 1979. More than the number, we see the upward slope of the graph—a trend we believe is going to continue or accelerate—troubling.

Today, we view the CRE universe as bifurcated, with a sharp division between office and everything else. The issues around sectors such as retail, industrial, hospitality and (especially) multifamily generally center on good properties with bad balance sheets. They may be over-levered and/or undercapitalized, but their underlying fundamentals tend to be solid. For the most part, these sectors hold still-viable properties, with loans that may only require some minor to moderate modifications or workouts. We believe those segments are on the road to recovery.

Office, in our view, is a severely ailing asset class. Supply was already oversaturated before the pandemic, and the gap with demand is widening. Valuations are falling, sometimes precipitously, especially in suburban office-park settings and with older, lower-quality buildings.

**Exhibit 4. Office Vacancies Rapidly Rising**




Source: Cushman & Wakefield U.S. National Office MarketBeat Reports, Q1 2019 through Q4 2023.

**Exhibit 5. Delinquency Rates on the Rise (%)**

| Collateral | Deliquency Rate 4Q23 | Deliquency Rate 1Q22 |
|---|---|---|
| Office | 17.0 | 3.0 |
| Retail | 5.6 | 3.2 |
| Hotel | 6.2 | 2.4 |
| Multifamily | 4.1 | 0.3 |
| Industrial | 1.1 | 0.2 |
| Mixed-Use | 13.9 | 2.1 |
| **Overall** | **6.2** | **1.2** |

Source: DBRS Morningstar, February 16, 2024, and May 9, 2022.

Even in "normal" times, running an office property is expensive. Costs for tenant improvements (TI), maintenance and capital expenditures tend to be higher than other CRE segments. The concession packages being offered to tenants today (including TI, free rent, lease reserves, etc.) to keep buildings occupied are exorbitant and cannot be sustained, in our view. Many landlords are facing a very difficult choice, they can enter into uneconomic deals to keep buildings occupied, or they can see vacancies increase. Those landlords who cannot afford to, or choose not to pay the steep price to subsidize new tenants could face the rapid demise of their buildings.

That environment makes it exceedingly hard for office borrowers to meet their loan obligations. In **Exhibit 5**, we see the office sector's rapidly rising delinquency rates. Defaults are increasing, and some sponsors—even well-capitalized, sophisticated big boys—are simply walking away.

The recovery of the office sector is going to take time, in our view. The outcomes will be far-ranging, but few will be good. Many top-tier Class A properties in attractive urban markets will muddle through. At the other extreme, some properties could end up worth no more than their land. In some cases, demolishing the buildings may cost more than the land value. Eventually, supply will catch up with demand as underperforming buildings close down or repurpose, with little to no new construction to replace them, especially given the state of the office market and the lack of availability of debt financing for office properties. Ultimately, office will stabilize, but we think that will likely take three to five years.

# Exacerbating factors

## Leverage

CRE has always been a highly levered asset class. Property owners need leverage to fund projects, and lenders—e.g., banks, private funds and publicly traded Commercial Mortgage REITs (mREITs)—use it to enhance yields. Leverage is great when investments appreciate, because it does exactly what it's supposed to do: amplify returns. But when assets drop in value, leverage magnifies the losses. The negative impact of leverage can be punitive. (**Exhibit 6**).

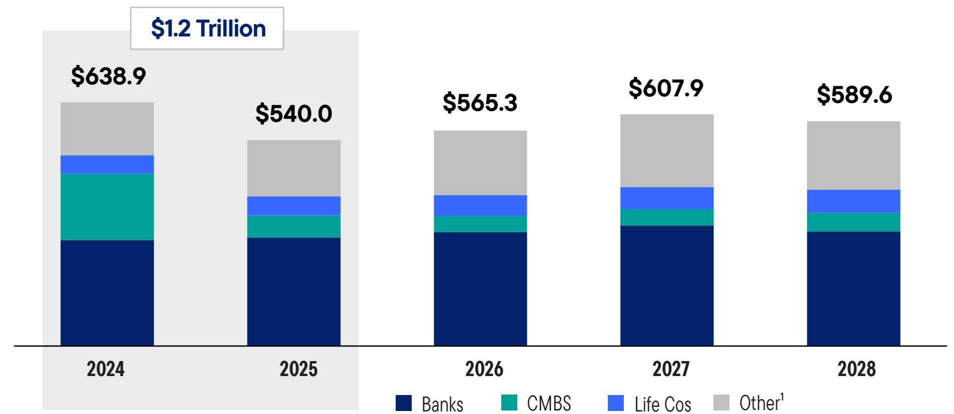
Advance rates can vary by lender type. They can range from 2x leverage for a conservative mREIT or fund to as high as 8x–10x for a bank. At 5x leverage (the midpoint of our chart) a 5% decline in asset value reduces book value by 30%, a multiple of six times the lost value. Even small problems can result in big losses.

Losses at these levels weigh on earnings power. Maybe most importantly, they could create the need for liquidity. For banks, this could cause underfunded balance sheets and regulatory pressures. Non-banks may be required to post margin calls, or possibly buy back assets from credit lines. In severe cases, steep losses could trigger covenants to rapidly amortize a collateralized loan obligation (CLO) pool or a cross-collateralized credit facility. The bottom line is, the borrower may need a lot of money, and fast. In order to prepare for these potential inevitabilities, most traditional lenders have stopped making loans, preferring to build up liquidity and batten down their hatches.

**Exhibit 6. The Cost of Leverage**

| | PORTFOLIO LEVERAGE | | | | | | |
|---|---|---|---|---|---|---|---|
| | **0.0x** | **2.0x** | **4.0x** | **5.0x** | **6.0x** | **8.0x** | **10.0x** |
| Portfolio Value | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| Portfolio Financing | — | 667 | 800 | 833 | 857 | 889 | 909 |
| **Book Value** | **1,000** | **333** | **200** | **167** | **143** | **111** | **91** |
| Illustrative 5% Decrease in Portfolio | (50) | (50) | (50) | (50) | (50) | (50) | (50) |
| **New Book Value** | **950** | **283** | **150** | **117** | **93** | **61** | **41** |
| **Change in Book Value** | **-5.0%** | **-15.0%** | **-25.0%** | **-30.0%** | **-35.0%** | **-45.0%** | **-55.0%** |
| **Multiple of Change from Leverage** | **1.0x** | **3.0x** | **5.0x** | **6.0x** | **7.0x** | **9.0x** | **11.0x** |

**Exhibit 7. Wall of Maturities**
**Total Commercial Real Estate Loan Maturities** ($ Billions)



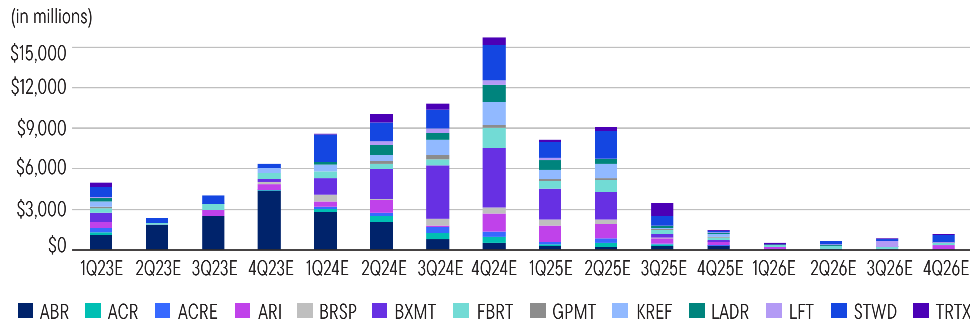

Source: Trepp, Q4 2023.
1. Other: Primarily comprised of multifamily lending by Fannie Mae and Freddie Mac. This could also include finance companies (private debt funds, REITs, CLOs, etc.), pension funds, government or other sources.

## The looming maturity wall

At the tail end of a long period of ultra-low interest rates, CRE lending exploded. Money was essentially free, and investors poured it into the asset class, trying to generate better yield at a time when fixed-income instruments offered little or none. In recent history, 2021 was one of the most prolific years for CRE loan origination, which helped create today's maturity wall (**Exhibit 7**). Now, those loans are coming due, like a series of massive waves set to hit the shore over the next few years. Data firm Trepp estimates that $1.2 trillion in CRE loans will reach maturity in 2024–25, with nearly another $1.8 trillion to follow in 2026-2028.

To more precisely calibrate exactly when the eye of the debt maturity storm will hit, we think it may be useful to look at mREITs. The data around banks and some other lenders is fairly opaque, but publicly traded mREITs are more transparent, providing some numbers that can be extrapolated to develop thesis across the CRE world. **Exhibit 8** offers a quarter-by-quarter view, highlighting the surge in lending of mostly three-year transitional loans in the wake of the pandemic, with maturity dates peaking in late 2024. The back half of the chart also illustrates how these REITs slowed their lending as interest rates surged. (Exhibit 7 shows that other lenders, especially banks, were slower to react, which has extended the wall of maturity). The storm is hitting now and won't let up for a while.

**Exhibit 8. Estimated Original Maturity Dates of Commercial Mortgage REIT Loans by Company**




**Note:** These are estimates as very few companies report original maturity dates (only fully extended). Chart shows historical new origination volumes lagged by 3 years for all companies except ABR, which is lagged by 2 years. Source: Raymond James.

## What happens at maturity?

Maturity dates are the true day of reckoning. When interest rates were consistently trending lower, as they were for 40-plus years, most borrowers simply refinanced, often with a better rate and longer term. That is unlikely today because financing costs have doubled or tripled since 2021 (a phenomenon that generally hasn't been seen since the 1970s), and most properties have declined in value. High quality stabilized properties owned by well capitalized sponsors may be able to refinance their loans. Other borrowers may seek loan modifications to allow more time to potentially ride out the storm. In other cases, where the borrowers are underwater, lenders may have to foreclose or borrowers may even choose to allow lenders to take possession of the assets through a Deed in Lieu.

**Exhibit 9**

DOOR 1

### The loan gets paid off.

Most likely this happens with a stabilized and performing property, where the sponsor refinances the loan with long-term, fixed-rate debt through a commercial mortgage-backed security (CMBS), or, for a multifamily loan, potentially through a government-sponsored enterprise (GSE) such as Fannie Mae or Freddie Mac. Amid higher rates and lower property values, such refinancings would likely require additional sponsor equity and/or credit support. It's also possible that the sponsor could repay the loan with the proceeds from the sale of the property.

DOOR 2

### The lender forecloses on the asset, or the sponsor voluntarily transfers ownership through a Deed in Lieu transaction.

This usually occurs once the loan has defaulted and/or when the sponsor believes that their equity in the property is out of the money and is unlikely to have value anytime soon. Rather than managing the building for the benefit of the lender, they may "turn over the keys" and move on. In the case of a struggling, lower-quality office property, the decision to turn a property over to the lender may become obvious, given the time and high cost to manage the asset. In the case of a high-quality but over-levered asset, the decision may hinge on the sponsor's views about the future and their access to the capital needed to fix the balance sheet.

DOOR 3

### The loan is modified or restructured.

When doors 1 and 2 do not present an obvious choice, the borrower may look to negotiate a modification of the loan. The most common request is for a maturity extension. CRE transitional loans typically include one to three one-year extension options, subject to certain performance tests. Unfortunately, given the current interest rate environment, often loans originated before the interest rate spike do not qualify. So when a borrower is bullish about the prospects for the property—either because of locational, macroeconomic or property specific factors which could enhance the value of their equity—they may seek to negotiate with the lender. Real estate investors are generally an optimistic crowd, and will often take the position that with time market conditions, cost of capital, and leasing momentum will improve and so will the chances of recouping their equity contributions. The modification approach is tailored to the specific loan/situation and can differ vastly based on a host of other factors, including the debt basis, the equity contributed to date, the quality of the asset, the strength of the submarket, and the experience and capitalization of the sponsor.

In the case of a high-quality property with good performance potential, solid basis and substantial sponsor equity, the lender may have a lot of negotiating leverage. Back in Exhibit 3, we showed that interest rates may have lowered the value of the equity, but the lender should be in the money and able to sell the asset at a profit, or without losing much or any capital. There are also examples where lenders may even receive sale proceeds in excess of their loan value and book a profit on the sale. With quality assets, the lender would likely demand consideration from the borrower, in the form of cash, recourse, new covenants or structure to consider a loan modification. Most lenders seek to work with borrowers on loan modifications as long as there is an economic rationale that would improve the credit.

By contrast, in the case of non-performing loans like the struggling office tower, the borrower/lender negotiation may be very different. In these cases, foreclosure or a Deed in Lieu might appear to be the most obvious resolution. However, lenders are often extremely reluctant to take possession of underlying assets, especially in office. These properties are expensive and time consuming to run, and many lenders don't have the necessary staffing and expertise to manage them effectively. Further, once an asset is taken back by a lender, current and prospective tenants may view it in a negative light, impacting leasing and/or pricing. Finally, turning a loan into real estate owned (REO) often carries valuation consequences for the lender, which could force additional write downs. As a result, lenders will often provide additional term to borrowers to avoid taking the underlying asset as REO. These types of modifications can be called "extend and pretend" because they are designed to buy time, often without any economic rationale for doing so.

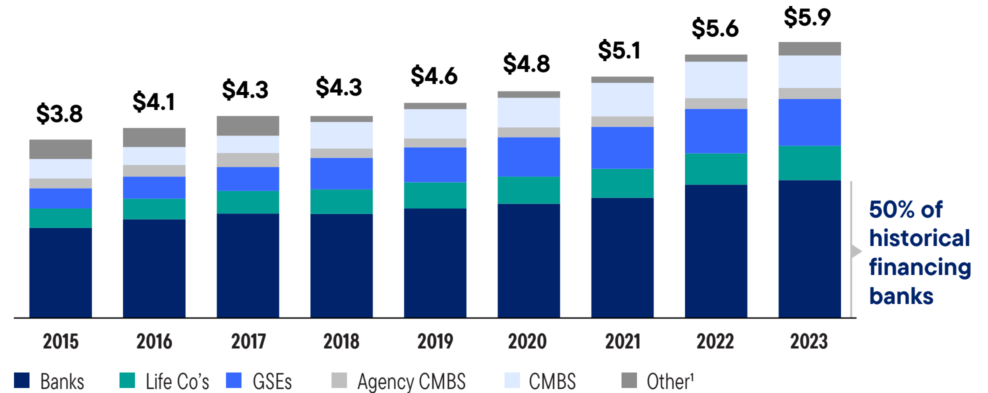
# Assessing the damage

## CRE lending dries up

Many CRE lenders have stopped or limited new loans. How long will that last? It may take several years. **Exhibit 10** shows that there is an eye-popping $5.9 trillion of CRE loans outstanding, and half of those loans belong to banks. This is concerning for the U.S. banking system, given banks' high use of leverage and potential liability/asset mismatches. It also explains why banks were already pulling back on these types of loans, with regulators pushing them to lower their CRE exposure through increasingly rigid capital reserve requirements.

Also noteworthy, we see in **Exhibit 11** that of the 50% of commercial real estate loans held on bank balance sheets, 70% sit within regional banks. Since regional lenders have far less diversified business models vs. their multi-national peers, we think regional banks are very unlikely to be active CRE lenders anytime soon. That is a lot of money taken out of circulation, right as the maturity waves strike. With regional banks representing nearly a third of all outstanding CRE debt, we anticipate there is approximately $2.0 trillion of CRE loans that will need to find a new home over the coming years.

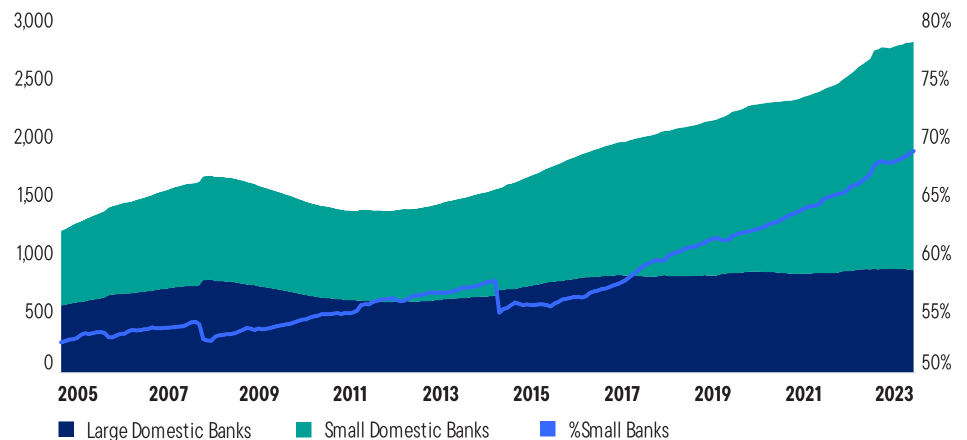
**Exhibit 10. Total Commercial Real Estate Debt Outstanding**




Source: Trepp, Q4 2023.

1. Other: Primarily comprised of multifamily lending by Fannie Mae and Freddie Mac. This could also include finance companies (private debt funds, REITs, CLOs, etc.), pension funds, government or other sources.

**Exhibit 11. Regional Banks Account for Majority of Outstanding CRE Debt Loans by Company**




Source: Federal Reserve H.8 reported U.S. bank CRE holdings. Data is non-seasonally adjusted and as of October 29, 2023.

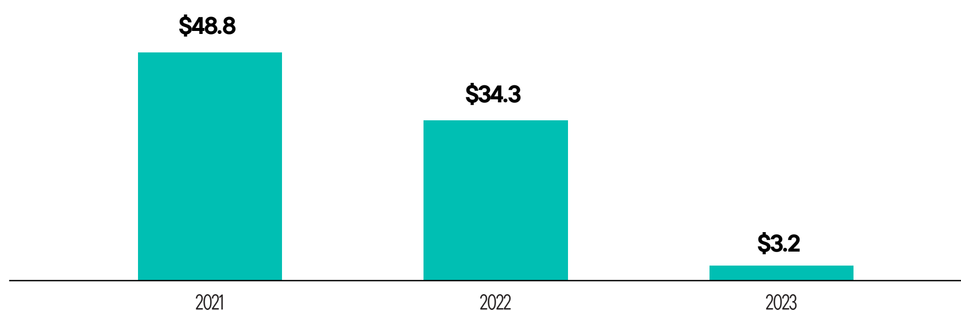
The other statistic that we believe is very important to assess is the amount of distressed loan exposures held by lenders. Again, since it is nearly impossible to obtain robust and consistent data from banks and other lenders, we can look to the available data from publicly traded mREITs. Office properties make up a sizable weighting in their portfolios (25%) as seen in **Exhibit 12**. We believe this percentage is roughly similar, say 20% to 25%, for current bank exposures and other providers of loans to CRE. In other words, in the CRE lending business, it was very difficult to avoid office.

One last place where we think it can be helpful to use mREIT information as a proxy to quantify data is in loan originations. While it is anecdotally obvious that traditional legacy CRE lenders are not currently putting capital to work, **Exhibit 13** clearly shows that mREIT loan originations have ground to a halt. If this is true for mREITs, we can infer the numbers will be similar for banks too.

**Exhibit 12. Office Exposure by Commercial Mortgage REIT**

| | | Q4 2023 |
|---|---|---|
| **Ticker** | **Company** | **Office Exposure % of Loan Portfolio** |
| GPMT | Granite Point Mortgage Trust | 43 |
| BRSP | BrightSpire Capital | 40 |
| ACRE | Ares Commercial Real Estate | 39 |
| BXMT | Blackstone Mortgage Trust | 36 |
| LADR | Ladder Capital Corp | 28 |
| KREF | KK Real Estate Finance Trust | 24 |
| STWD | Starwood Property Trust | 22 |
| TRTX | TPG RE Finance Trust | 20 |
| ARI | Apollo Commercial Real Estate | 19 |
| CMTG | Claros Mortgage Trust | 14 |
| FBRT | Franklin BSP Realty Trust | 5 |
| RC | Ready Capital Corporation | 5 |
| **Average** | | **25** |

**Exhibit 13. CRE Loan Originations, 2021–2023**




Source: Company filings, 2021–2023. Competitors included are STWD, BXMT, CMTG, ARI, LADR, RC, KREF, BRSP, ACRE, TRTX, GPMT. Represents total commitment of new loans and excludes add-on funding.

# The opportunity

With traditional lenders absent and a now wide-open ocean to explore (similar to Forrest Gump's shrimping story), we see a massive opportunity set, a once-in-a-cycle chance for nimble investors to bring fresh capital to the asset class. All of the pressure points—higher-for-longer interest rates, the lack of available capital, the maturity wall, even the expectations for rising defaults and delinquencies—help to define the opportunity in an asset class that has historically been a great hedge against inflation. Smart investors will look past the short-term volatility to target the right long-term opportunities, because we'd argue they will play out over several years, rather than a few quarters. Here's what every investor needs to know...

## Where to invest? First, we believe debt > equity

Investors have a lot of choices within CRE, starting with debt vs. equity. Is it better to buy properties or loan the property buyers money? CRE prices are a lot lower today than they were in 2022. Presumably, this would suggest equities are cheap. But in our view, right now, the debt side is far more compelling. Over the long term, equity CRE is a solid inflation hedge, offering the potential of mid-to high teen returns as rents and property values rise over time. Investors get steady, growing income streams and a potential big-time reward at exit. With values at their current lows, that's very likely to provide a positive investment experience over 15 to 20 years. However, if the investor's time horizon is five years or less, we believe equity CRE becomes far less attractive. Right now, an equity investor using leverage would likely generate little to no income against today's high borrowing costs, pushing most gains to the exit. It may be a great time to buy, but barring a V-shaped recovery in asset values—which we believe is highly unlikely—the risk/reward equation doesn't make a lot of sense. In contrast (see **Exhibit 14**), debt investments provide immediate cash flow. After all, high interest rates benefit the lender, not the borrower. Debt also provides a quantifiable gain at repayment and stronger downside protection. In the wake of the storm, we believe debt investments can potentially deliver those same mid-teen returns at a 60% to 70% LTV, compared to CRE equity's effective LTV of 100%. In short, our view is debt wins this debate.

**Exhibit 14. CRE Debt's Edge over CRE Equity and BDCs**

| | Private Real Estate Debt REITs<br>vs.<br>Property REITs | Private Real Estate Debt REITs<br>vs.<br>Business Development Companies (BDCs) |
|---|---|---|
| **Similarities** | • **Asset class.** Invest in commercial real estate asset class<br>• **Tax profile.** Pass-through entities for tax purposes, distributing 90% of taxable income to shareholders. Taxation at shareholder level (no double taxation of income) | • **Investment focus.** Primarily floating rate debt investments in senior part of borrower capital structure<br>• **Investment objective.** Current income-oriented vehicle<br>• **Source of return.** Primarily interest income from loans<br>• **Tax profile.** Pass-through entities for tax purposes, distributing 90% of taxable income to shareholders. Taxation at shareholder level (no double taxation of income) |
| **Differences** | • **Investment focus.** Mortgage REITs lend to properties. Property REITs own and manage real estate<br>• **Investment objective:** Mortgage REITs are focused on income and are less exposed to equity risk<br>• **Source of return.** Property REITs earn rental income, but are also exposed to upside/downside from price appreciation/depreciation of owned real estate<br>• **Loan-to-value.** 60-70% LTV for mortgage REITs vs. 100% LTV for property REITs | • **Borrower type.** Commercial properties for mortgage REITs vs. mid-sized businesses for BDCs |
| **Perpetual mREIT Opportunity** | • Current interest rate environment has significantly reduced income for Property REITs, requiring them to rely on sales for equity return<br>• Mortgage REITs are able to generate equity-like returns, with high current income and more downside protection<br>• The underlying assets in property REITs are more illiquid and volatile. This could lead to problems in satisfying tender offer requests | • More dislocation in real estate market relative to corporates, leading to potential for investment at discounted asset values, low LTVs and attractive terms<br>• Less capital investing in the commercial mortgage lending space today relative to the BDC space, which is highly competitive |

## How to invest

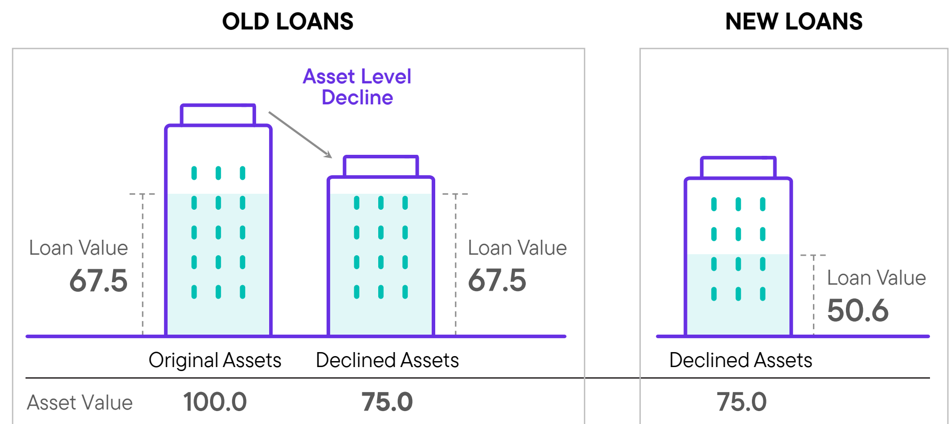
Buying publicly traded mREITs now that they are heavily discounted is one option to play the opportunity. In June of 2024, they were trading at approximately 67% of book value. A wise old trader once told us that if something trades around 70, that mark is just a place-saver, likely to either meander its way back to 100 or plunge toward zero. Buying a discounted mREIT might be a good strategy, because there will be some winners. But we believe many more could be in for some bad outcomes. Picking the gems requires a deep dive: how much office exposure does the mREIT have? Do their borrowers principally consist of syndicated groups with no access to liquidity? How levered are they? How much liquidity do they have to fund forward funding commitments and potential blow-ups? How much of a hole do they need to dig their way out of? There's a lot of nuance beyond those basic questions, but the point is, it's not easy to find the right asset, and it's risky.

One could also buy troubled assets. Banks will need to sell loans or properties to generate liquidity. That means there will likely be some great deals, but in our minds, buying someone else's problems is a tricky proposition. It requires expertise to determine values, find the right price and accurately measure the level of risk.

We believe making new loans is the play most akin to Forrest and Lieutenant Dan filling the Jenny's deck with massive piles of shrimp. New loans are very attractive. M&A volumes may be light at the moment, but we think there are plenty of great deals to be had. We showed **Exhibit 15** previously as Exhibit 3, but it is worth revisiting. Here, we are lending at a 67.5% LTV on the new value of $75 million. But compared to the asset's value in 2021, we are getting a 50.6% LTV on a repriced asset, with a strong probability that long-term, values will climb. Putting it a different way, the asset would have to lose approximately 50% of its 2021 value for this new loan to start potentially taking a loss. That would be a massive valuation correction that has very rarely been seen throughout history. In addition, interest rates are much higher, so we are generating much more income. Lastly, in 2024, with heavily discounted collateral values, we are seeing new loan LTV ratios actually moving even lower, to the 60%–65% range, creating even further implied downside protection.

Beyond LTV ratios, today's opportunity is marked by the lack of competition. Demand is not keeping up with the supply of debt, putting lenders with liquidity and a willingness to make new loans in an ideal position. We're getting to pick from the best shrimping areas in the Gulf and lending to solid borrowers at lower leverage levels. We are receiving calls from typical bank borrowers that we never received before with deals on really high quality, larger Class A properties in great markets, even for construction loans, mezzanine loans and CMBS loans. Most offer stronger equity cushions and better terms than in the past. That's why we believe that in five years or so, people are going to look back at this time period as one of the most attractive vintages of commercial real estate loans they've ever seen.

**Exhibit 15. High-Quality Properties at Discounted LTVs**




For illustrative purposes only.

# Where to invest?

## There is multifamily, then everything else

We view multifamily as the most promising sector of CRE credit, with the best credit quality and risk-adjusted returns. The sector has a history of recession resiliency and tends to enjoy a built-in hedge against high interest rates and inflation. We believe that multifamily will likely recover the fastest from whatever damage it suffered in recent years. After all, the sector is still performing, with the vast majority of units leased and tenants largely paying their rent.

Why multifamily? People need a place to live, and home ownership is getting harder and harder to achieve. Housing prices are very high, and inventory is low (**Exhibit 16**). Mortgage rates have soared, and so has demand for rentals. We believe that will create a tailwind for multifamily for years, amid higher-for-longer interest rates.

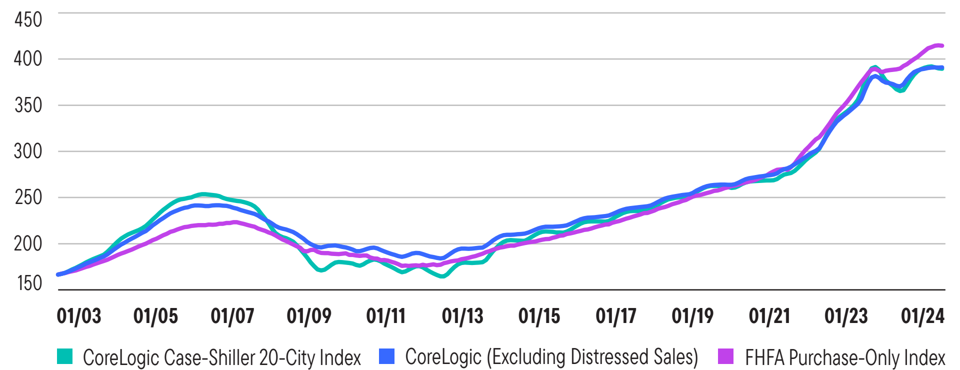
Another compelling reason to invest in multifamily, especially today, is liquidity. In an otherwise illiquid asset class, multifamily properties can almost always be sold within 90 days. Unlike other sectors, the government supports multifamily liquidity. GREs such as Fannie Mae and Freddie Mac, the federally backed mortgage companies, exist to drive that liquidity, even in times of meaningful credit dislocation.

The principal argument against multifamily right now is oversupply. Many sub-markets, especially in the Sunbelt, have seen an influx of new capacity, particularly from 2021-era projects undertaken when capital was very cheap. Lots of these new projects have come online recently, with many more scheduled for completion over the next year or so. This new supply has put pressure on rent growth, with rent contraction in many sub-markets.

That's likely to accelerate as new units exacerbate oversupply issues. On top of this, operating expenses have been increasing, mostly from higher insurance and tax costs. Fortunately, there is a bright side: as the cost of debt surged in 2022, developers began putting away their shovels. We believe that is likely to remain the case for multiple years, until the world adjusts to the new interest-rate reality. **Exhibit 17** shows that a lot of projects will reach the market in 2024. Then, the new supply drops sharply.

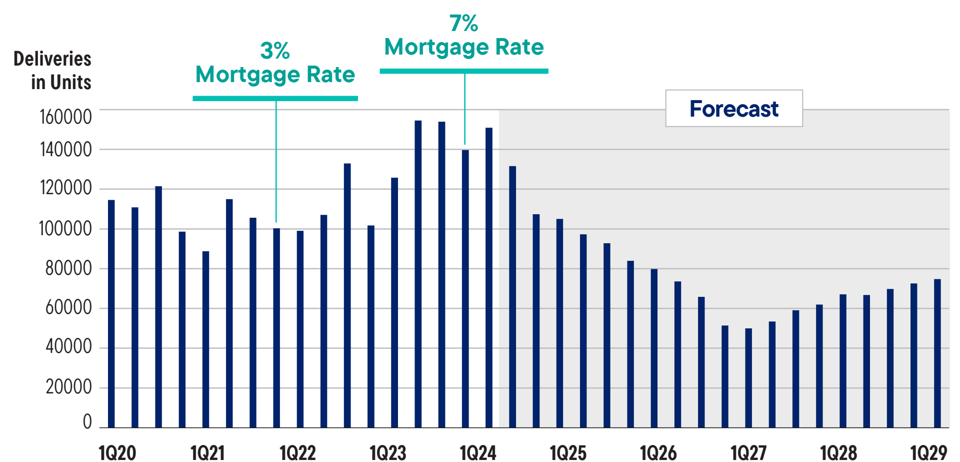
In our view, as excess capacity unwinds, rents and values will likely climb, quickly putting the market back in line with historical trends. Of course, not all properties are equal. We favor newer-vintage, Class A and B multifamily properties located in primary and secondary markets of areas with sustainable population growth. Within multifamily, and even in growth regions and high-quality properties, selection and pricing are paramount.

**Exhibit 16. Home Ownership is Getting More Elusive**




Sources: Standard & Poor's, Federal Housing Finance Agency, CoreLogic, and HUD.
**Note:** Monthly house price trends, shown as changes in respective house price indices applied to a common base price set equal to the median price of an existing home sold in January 2003, as reported by the National Association of REALTORS®. Indices shown: S&P/CoreLogic Case-Shiller 20-metro composite index (NSA), January 2000 = 100, FHFA monthly (purchase-only) index for U.S. (SA), January 1991 = 100, and CoreLogic-Distressed Sales Excluded (Monthly) for U.S. (NSA), January 2000 = 100.

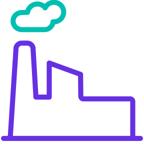
**Exhibit 17. Spike in Multifamily Supply, then a Cliff**




**Note:** Views expressed are those of BSP and are subject to change. Such statements have not been independently verified. **Past performance is not indicative of future results.** Forecasts are inherently uncertain and subject to change. Actual results may vary. Please see the disclaimers at the end of this Presentation. Source: Costar US Multifamily Report, April 2024. Mortgage Rate source from National Association of Realtors.

## But that's not all: looking beyond multifamily

We are also finding opportunities elsewhere in CRE.



### Industrial

The sector has been quite resilient, thanks in part to the ongoing wave of demand for e-commerce related logistics and warehousing buildings. We believe another secular tailwind, the movement of production and manufacturing to domestic sites known as reshoring, is in its infancy, and likely to provide long-term support for the sector.

### Hospitality

There has been a bifurcation between leisure and business travel. Business travel is unlikely to recover to its pre-pandemic levels anytime soon. On the leisure side, though, checkpoint levels for the Transportation Security Administration returned to 2019 levels in 2022, and in 2023, they rose another 16.6% to an all-time record. Leisure hotels also enjoyed a strong 2023, showing occupancy levels at their highest since 2019, with record-setting average daily rates and revenue per available room, according to real estate data provider CoStar.

### Retail

The retail apocalypse many envisioned, due to the rise of Amazon and the e-commerce revolution, never came to pass, outside of some lower-class malls in secondary and tertiary markets. Open-air retail properties in strong markets have fared very well. Amid a lack of new construction, supply slowed dramatically, keeping centers full. Indeed, Amazon and other delivery services have changed our everyday lives, but brick-and-mortar retailers can co-exist and even thrive, especially those offering restaurants, nightlife and/or other experiential draws. Performance at the asset level appears to be fundamentally stable.

### Office

It may still be too early to deploy fresh lending capital into this sector. Traditional valuation measures like net operating income (NOI) multiples, cap rates and debt service coverage no longer seem to apply. We think the recovery will take time. However, if high quality loans with equity-type returns present themselves, we think the sector deserves consideration.

# How will the lending void be filled?

Right now, investment opportunities abound in CRE lending because so many of the traditional players are on the sidelines. But markets are efficient, and this window won't likely be open indefinitely. Capital providers will emerge to fill the funding gap. It is already happening.

## But there are two things to consider:

**First,** new capital is unlikely to come from banks, especially small regional ones. It will take some time for them to work through their existing office exposures. Until they do, some may face liquidity and regulatory pressures. In our view, this will make it difficult for them to consider adding new CRE exposure. As discussed earlier, banks represent an enormous share of the CRE lending market (50%). Without banks in the mix, it will be extremely difficult for other lenders to fill this void.

**Second,** there are many sponsors looking to raise opportunistic CRE debt capital right now to take advantage of the dislocation. A lot of this capital is being geared toward lending to or equitizing distressed assets. To date, very few new funds are targeting basic, middle market ($25–$100 million), transitional lending, especially in multifamily. This is where we see the best and most enduring opportunity.

Those who have looked to enter the middle market lending space typically have had property buying expertise, but not necessarily lending expertise. Other new capital sources are likely to be launched by first-time sponsors to CRE lending or by legacy lenders, the over-levered, office-heavy debt guys. We believe these sponsor categories are not the right choice for investors looking for CRE debt exposure and outsized returns. CRE debt is a labor-intensive asset class, and not everybody can do it well. Good managers need to identify, structure, and asset manage large portfolios of loans.

Smart investors will want a partner with capital to deploy, a longer-term perspective, and the ability to build a quality portfolio to creatively lend throughout the capital stack. That requires a deep asset management team with people on the ground to identify properties, expose pain points, find attractive metrics through due diligence and make great loans. Creating favorable terms through strong structures and covenant packages is vitally important, as is extracting the right premiums to account for risk. Strong managers will bring the willingness, resources, and ability to protect their investors through restructuring, foreclosing and even running the properties. That's a lot to ask of newbies or troubled legacy lenders.

## Conclusion

The CRE world has been rocked by this hurricane, and we believe the impact will continue for years. Interest rates are likely to stay high compared to recent decades. Property values will likely continue to drop in some segments and areas. That all spells trouble for legacy portfolios, especially highly levered books that are loaded with office properties. We believe that for experienced investors with cash to deploy and limited legacy exposure issues, the next few years represent the best CRE debt (or equity) opportunity we've seen in at least a decade.

There are many ways to approach this post-storm opportunity, but we believe making new, high-quality loans into the CRE space is the best bet. A similar storm has hit corporate direct lending, making newly raised Business Development Companies (BDCs) another good investing choice. They feature a similar structure and some of the same benefits of Private Real Estate Debt REITs. However, as the right side of our Exhibit 14 shows, we believe the outlook for CRE is expected to be far worse relative to the dislocation in corporate direct lending, creating a better landscape to invest new capital.

In CRE credit, all the boats are onshore, awaiting repairs. But not the Jennys. They are ready to take advantage. They are well-equipped and poised to head out into the Gulf at just the right time.

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