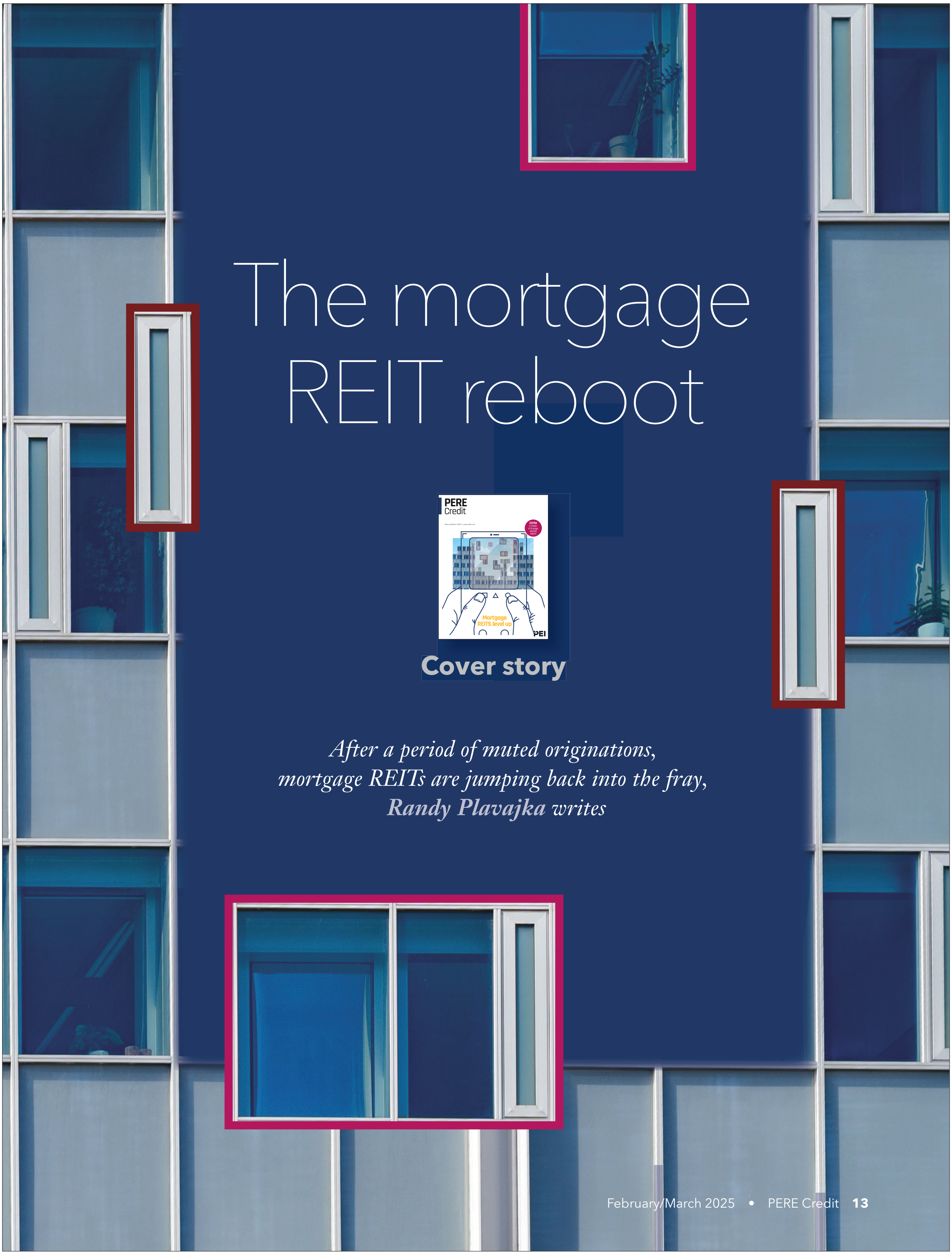


The mortgage REIT reboot

Cover story

*After a period of muted originations, mortgage REITs are jumping back into the fray, **Randy Plavajka** writes*

Cover story

After two years in origination wilderness, mortgage real estate investment trusts are returning to commercial real estate lending in force.

The sector, typically focused on shorter-term, floating-rate loans, saw its largest-ever year in 2021 with $49.83 billion of new originations. But the impact of the Federal Reserve's cycle of interest rate increases, which began in March 2022, led originations to fall off to $30.7 billion the same year and slide to just $4.69 billion in 2023, according to New York-based data provider Trepp.

While official full-year 2024 numbers were not available when *PERE Credit* went to press in late January, mortgage REIT origination was widely understood to have significantly picked up in the fourth quarter and into the first weeks of 2025 as the Federal Reserve started cutting rates again while telegraphing a less hawkish outlook for 2025. Indeed, according to mortgage REIT executives the issuance figure for 2024 is estimated to land closer to $10 billion – about double the lackluster 2023 total.

However, the story around a mortgage REIT recovery is larger than what is happening with interest rates, argues Katie Keenan, global co-chief investment officer of Blackstone Real Estate Debt Strategies and the chief executive officer of Blackstone Mortgage Trust, the investment manager's mortgage REIT. It is part of a wider revival, she tells *PERE Credit*. "The commercial real estate lending outlook for 2025 has materially improved, with liquidity returning, valuations reset, the cost of capital normalizing, and [the impact of] low new supply and consistent demand."

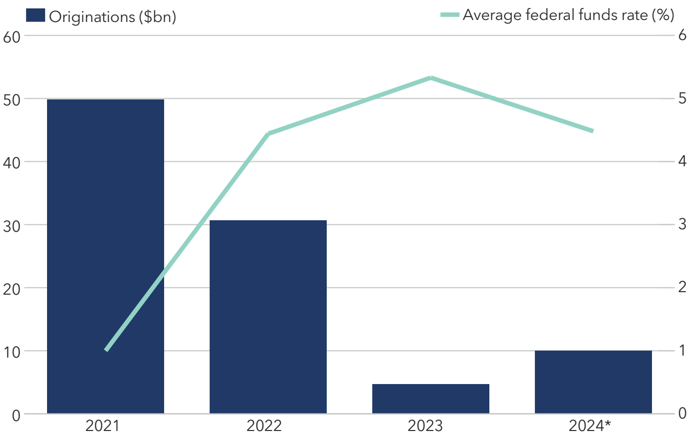
Against this backdrop, Keenan is expecting 2025 to bring increased lending and portfolio growth relative to the prior two years for mortgage REITs, in line with prospects for the wider sector. "We are past the inflection point in the real estate credit cycle, but [mortgage REITs] are still pricing in a significant discount to book value," Keenan says. "Robust repayments have continued through the cycle, with an acceleration over the last few quarters, giving [mortgage REITs] firepower to capture what we believe are compelling new originations today."

Despite its relatively small size, a reboot of the mortgage REIT sector is expected to be important as banks scale back their lending activity ahead of the implementation of Basel III regulations in June, says David Freedman, a partner at New York-based law firm Latham & Watkins.

"Obviously, stock prices have come down in the mortgage REIT sector [over the past two years]," he says. "But it is our sense distressed loans and the interest rate environment have been the real driver of the limited lending activity. If interest rates continue to come in and the capital markets continue to pick up steam, it becomes easier to clean up the distress."

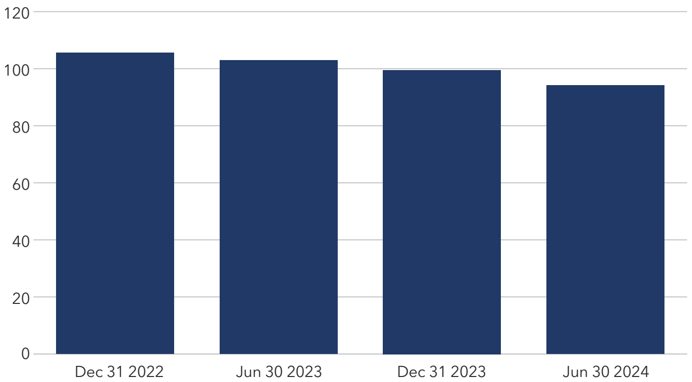
Keenan says the turning of the credit cycle will have a positive impact

The largest mortgage REITs saw originations drop as the Federal Reserve raised rates



* Full-year 2024 numbers were not available when *PERE Credit* went to press, but mortgage REIT executives estimated volume would be at least double 2023.
Source: Trepp

Mortgage REITs' gross loans volume has dropped steadily as interest rates have risen, per a study of the 10 largest players (Gross loans, $bn)



Source: Fitch Ratings

"I see mortgage REITs having the opportunity to get a bigger seat at the table from institutional capital"

COLIN HILL
Meketa Investment Group

The REIT niche

Although mortgage REITs are responsible for billions of dollars in loan originations, their scale is small

Mortgage REITs are a relatively small part of the broader US commercial real estate lending market, with a mid-year estimate from Trepp projecting a total portfolio of about $87.51 billion in mid-2024. Full-year 2024 data was not yet available when *PERE Credit* went to press.

"We like to look at the mortgage REITs and what they're doing because it is transparent but they're like a pimple in the [estimated] $6 trillion of commercial real estate loans," says Rich Bryne, president of New York-based manager Benefit Street Partners and chairman and chief executive of the firm's mortgage REIT, Franklin BSP Realty Trust.

One of the benefits of this transparency is greater ease in tracking changes in origination and performance, Bryne notes. "It went from two or three companies that made any originations at all, to about double that number in Q3 [2024]."

Mortgage REITs are distinct from closed- and open-ended real estate debt funds. From their 1960 establishment by Congress onward, REITs have been positioned for retail investors as a more accessible means of generating income from a portfolio of real estate investments.

This income is generated through loans on performing real estate assets, including senior mortgage financing, mezzanine financing, conduit lending and other means such as acquiring mortgage-backed securities.

Mortgage REIT transparency is most apparent in the quarterly earnings reporting standards they are held to, regularly disclosing gains, losses and market expectations. The trusts pay out according to cashflow and are more competitive when lending on assets with stable debt service coverage and higher proceeds, though this does not exclude modern mortgage REITs from taking on transitional and value-add opportunities where viable yield is perceived.

on credit performance and mortgage REITs will be among the lender types to benefit. "Most sectors are exhibiting strong performance, the pace of new challenges in commercial mortgage loan portfolios is decelerating, and greater price discovery is allowing lenders to resolve non-performing loans and recycle capital into new investments."

The question of distress

Like their lending peers, mortgage REITs have struggled with a rise in distressed loans over the past two to three years. An August report from Fitch Ratings found credit quality continued to deteriorate in the first half of 2024. "Problem loans now make up close to 15 percent of gross loans, for the top 10 largest commercial mortgage REITs," says Bain Rumohr, a senior director at the New York-based rating agency. "We expect these firms to be focused on asset resolution efforts in the near-to-medium term, which may include foreclosure."

There is a direct link between mortgage REITs seeking to reduce problem loans and muted loan originations, Rumohr adds. Per the Fitch research, the 10 largest mortgage REITs funded about $5.3 billion of new loans in the first half of 2024, a level on par with the same period in 2023.

Earnings have also declined due to smaller balance sheets, compressed net interest margins and higher provisions, Rumohr adds. Reported pre-tax income for the largest mortgage REITs averaged around $600 million for the trailing 12 months that ended in June 2024, a drop from $2 billion the year before, he says.

Fitch is projecting a rise in realized losses from the sector as asset resolutions continue, with Rumohr anticipating more management teams cutting dividends to preserve liquidity.

While Benefit Street Partners' Byrne is seeing this play out, he says not all mortgage REITs are created equal, with some of the larger organizations better weathering the storms of the past two years.

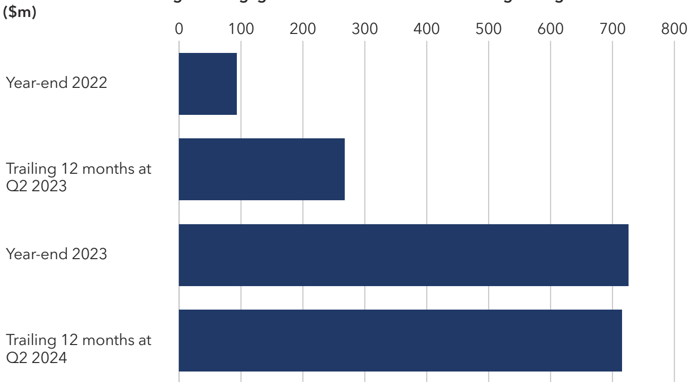
"Maybe there are more write-downs to come, especially since the average mortgage REIT is six times levered," he says. "We saw [mortgage REITs] over-covering their dividend because rates went up so much."

It is not hard to project the reason behind potential losses, Byrne says. "The mortgage REIT market is comprised mostly of a collection of groups issuing three-year transitional loans or post-construction loans – most of which the lenders would expect to be taken out by an agency. But many of these loans were extended and not refinanced.

"Three years plus 2021 equals 2024, and I think 2024 was the year of figuring out your exits. And here were two types of exit: office and everything else. Unless you got lucky, or were in a big MSA [as an office owner], more likely than not it was some form of amend and extend."

Indeed, loans in the office sector are a particular problem for mortgage

Gross write-offs are rising as mortgage REITs and borrowers are working through troubled loans ($m)



Source: Fitch Ratings

Largest mortgage REITs as of January 2025 (Market cap, $bn)

Source: NAREIT

REITs, which Byrne estimates make up about 25 percent of the market, at a time when asset values are 20-30 percent lower than they were in 2021.

"How do you pay off your [office] loan?" Bryne asks. "A lot of that hasn't been resolved yet and [beyond office loans], the maturity wall is only getting bigger. It is now close to $3 trillion through 2027 because we kept pushing a giant chunk of the 2024 maturities forward and extended them out. How does that get fixed?"

Portfolio role

Despite near-term challenges, mortgage REITs are still considered good for offering investors high dividends, according to an October report from Chicago-based trade group NAREIT. Mortgage REITs posted a dividend of 11.52 percent at the end of 2023, the report stated. Equity REITs, by comparison, produced dividends of 3.92 percent during that same period. This performance continued into 2024, with mortgage REITs producing dividends of about 11.83 percent compared with 3.65 percent for equity REITs, through the end of October.

Today's higher interest rate environment is leading more institutional investors to ask if they should be making investments in real estate debt, says Colin Hill, managing principal and real estate consultant at Massachusetts-based investor advisory Meketa Investment Group.

"When we are asked about real estate portfolio construction, the range

> *"It's a bad idea to stretch for a yield. Just play for singles and doubles"*
>
> **RICH BYRNE**
> **Benefit Street Partners**

for inclusion of real estate debt is typically zero to 20 percent," Hill says. "More often than not, it is on the lower end of the range. Sometimes real estate debt isn't even contemplated, or it is situational, where an opportunity may be equity-like in its returns and so gets considered."

Mortgage REITs, however, are not often the first stop when an institution is considering a real estate debt allocation within a dedicated real estate portfolio, Hill adds. "We generally talk more about mortgage REITs in the context of our equity fund managers borrowing capital than investing directly in mortgage REITs. There are certainly some big sponsors with non-traded mortgage REITs that we track, or the debt fund managers will compare themselves to the mortgage REIT universe."

It can be hard for transitional real estate debt to find a home in institutional real estate portfolios, partly because of the potential for quick repayment of loans, Hill says. This means an institution, after underwriting a debt investment, might find itself having to return to that investment more quickly than would be the case with an equity allocation.

"You also have to factor in the speed at which many of our clients are operating," Hill adds. "Some only have four investment committee meetings a year, and some are only targeting one or two real estate investments per year. When there is precious time to be spent on manager diligence and selection, investing in an equity opportunity with potential upside and an expected 1.4x-1.6x net multiple can be much more efficient than having to more frequently evaluate shorter-term real estate debt strategies with target multiples in the 1.2x-1.3x range."

The flip side, however, is that mortgage REITs have the ability to recycle capital and are not in a closed-end format. "In perpetuity, that mortgage REIT can recycle that capital and generate a target return. If you're a director or trustee plan, looking at a

$1.424trn

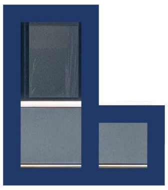
Market cap of all REITs in the FTSE NAREIT All-REIT index, as of January 2025, according to NAREIT

performance report, you're often focused on total return," Hill says. "I do see mortgage REITs having the opportunity to get a bigger seat at the table from institutional capital."

It is important not to get too caught up in structure, especially with many

$30bn

Market capitalization of the 10 largest mortgage REITs, as of January 2025, per Statista



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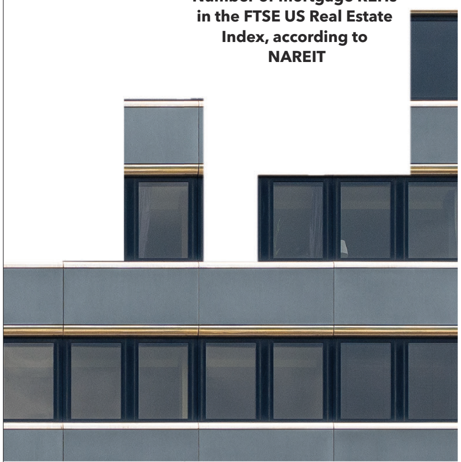
Number of mortgage REITs in the FTSE US Real Estate Index, according to NAREIT



investment management companies offering mortgage REITs alongside other debt and equity products, Freedman says: "It is just another vehicle to raise capital for asset managers. Mortgage REITs are subject to different governance procedures, tax regulations and public disclosures. But it's typically the same underwriters and transactions managers doing the work of underwriting and originating loans for related debt funds and mortgage REITs."

There are, however, important differences between an REIT investment and a debt fund investment, Freedman says. "One of the more fundamental differences may be that REIT investments generally are more liquid and the dividend rules to retain REIT status may yield more cashflow during the period of investment as compared with a debt fund. While the underlying source of value is the same, the nature of the investment is different, and investors will allocate accordingly."

Market ahead

There is a broad sentiment that mortgage REITs have the potential to increase originations in 2025, albeit with the understanding that significant changes in monetary policy could affect the outlook. "I bet if you gave truth serum to every originator, every mortgage lender, no one would deny it's a great opportunity," Byrne says.

In fact, Michelle Kelban, global co-chair of Latham & Watkins' real estate practice, sees a likelihood of consolidation as a possible consequence of a wider anticipation of this opportunity. "In that vein, for those mortgage REITs that underperform as the cycle takes off, we'd expect the trend of consolidation at the top to continue. We anticipate the stronger shops will continue to grow and will execute strategic acquisitions as and when they are able. Shops not yet in the real estate private credit space [could] potentially take advantage of the opportunity to enter the space through such an acquisition."

Latham & Waktins' Freedman notes mortgage REITs often have more ability to mix and match investments than debt funds. "We think mortgage REITs will play a similar role as the other non-bank lenders. In terms of their specific role, mortgage REIT capital is often deployed in value-added scenarios. But they have the flexibility to originate development loans, stabilized loans and invest in CMBS bonds. Some debt funds have very targeted ROIs [they need to achieve] and therefore less flexibility."

> *"If interest rates continue to come in and the capital markets continue to pick up steam, it becomes easier to clean up the distress"*
>
> **DAVID FREEDMAN**
> **Latham & Watkins**

But as is always the case with commercial real estate, the health of the mortgage REIT market is always tied to the cost of capital. Winning in 2025 and beyond is not a simple matter of 'lend now, benefit later,' market analysts note.

As such, Byrne warns of overextending and taking on additional risk where a proven investment thesis is already at work. The biggest dividends today do not always equate to long-term upside, especially when investors are evaluating real estate investment vehicles on a wider set of considerations like any investment product. "We think it's a bad idea to stretch for a yield," Byrne says. "Just play for singles and doubles."

In a US market speckled with emerging opportunity, Byrne and other market analysts say the role of mortgage REITs in the wider real estate debt reboot cannot be a solo endeavor solved by any one manager, or indeed segment of the private debt universe. It will take a collective effort. And it will take time. "It is going to take two or three years to just work this all through." ■