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CRE debt can be a “superfood” for investment portfolios

Recently, **Jonathan A. Schein**, managing director of global business development at Institutional Real Estate, Inc., sat down with **Jack Gay** of TH Real Estate to talk about the factors that make debt appealing, specific routes to investment, and the regional dynamics and regulatory environment in both the United States and Europe. The following is an excerpt of that conversation.

What has caused the increase in investor interest in and allocation to commercial real estate (CRE) debt?

Real estate equity markets are currently experiencing significant volatility, elevated valuations and heightened uncertainty. Moreover, a “lower for longer” interest rate environment is leading investors to seek income ahead of capital returns. In this situation, the investment attributes of CRE debt are becoming increasingly sought after — stability, diversification and contracted income. In addition, while direct comparisons of fixed-rate senior CRE debt and corporate bond returns are imperfect due to differences in duration, credit quality and the like, various research shows CRE debt offers a spread premium relative to investment-grade corporate bonds.

What market conditions are at play today, both globally and regionally?

In the United States, real estate market conditions remain well-balanced, and economic growth is expected to strengthen over the next several years. However, the business cycle and real estate cycle are mature, and the Federal Reserve is expected to continue to gradually raise interest rates. This transitional period creates risk and opportunities for commercial real estate lenders, as stronger economic growth implies stronger demand for all types of real estate but with associated cycle risk.

We see increasing amounts of capital targeting CRE debt, and we believe it is more important to choose a commercial mortgage origination platform and manager that can couple cycle-test underwriting standards with astute loan structuring. Superior execution of commercial mortgage lending requires size, scale and industry relationships.

And in the United Kingdom and Europe, in the context of retrenching traditional lenders and the persistent narrow focus on prime assets, we feel opportunity can be found in “off the radar” assets, particularly core-plus assets in established

Recent TH Real Estate research summarizes the six primary characteristics that make commercial real estate debt attractive:

- **SIZABLE INVESTMENT UNIVERSE** — The \$3.8 trillion commercial and multifamily mortgage market provides a wide array of investment opportunities that vary based on term and structure.
- **STRONG RELATIVE VALUE** — Historically attractive risk-adjusted returns relative to fixed income investments and direct real estate, especially late cycle.
- **STABLE INCOME RETURNS** — Stable, income-based returns derived from a diverse set of tenants of various sizes, in multiple industries and with staggered lease expirations.
- **LOSS AND RECOVERY RATES** — Commercial mortgages exhibit lower loss and higher recovery rates than comparable corporate bonds.
- **ATTRACTIVE RISK-ADJUSTED RETURNS** — Allocations to commercial mortgages can potentially increase expected return and can lower return volatility in a multi-asset portfolio.
- **PORTFOLIO DIVERSIFICATION** — Commercial mortgages provide diversification to multi-asset portfolios due to modest correlations to most asset classes.

markets. Assuming robust underwriting, these underserved markets present the most appealing opportunity for selective “cherry-picking” of transactions with strong fundamentals and return characteristics.

What routes to investment are available to investors wanting to access real estate via the debt part of the capital stack?

Many large investors opt for separate accounts. Typically an investor might give a manager \$100 million to \$200 million with a very specific focus on each strategy, so they might say, “I need to clear 3.5 percent in long-dated fixed-rate mortgages,” or “I want a mezzanine strategy that will clear 5 to 6 percent.” The manager might then match that capital with

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For real estate investors seeking secure returns, private debt is an increasingly inviting strategy given the current environment, which

is marked by low returns from fixed-income investments, high prices for equity investments that may appear risky and political uncertainty in many regions.

"The sector is becoming more mainstream than it was five to seven years ago. Commercial real estate (CRE) debt used to be more of a niche play, and now an allocation is becoming part of institutional investors' fundamental lineup," says Gay.

Gay has dubbed debt the real estate investment industry's "superfood."

"It may not be as appetizing as equity, but it's really good for your portfolios."

its own capital or other separate account capital in proportion that makes sense for them. Large, scaled managers have plenty of appetite for that.

As for debt funds, investors have choices about the kind of return profile they want to adopt via two primary approaches that U.S. managers have taken. One is a closed-ended structure with higher potential returns often driven by loans in the mezzanine space and meaningful leverage incorporated into the fund vehicle. Another is an open-ended structure with a core profile and potential returns in the mid-single digits. Managers offering a lower yielding, open-ended, core strategy are increasingly inclined to add a blend of other loan types, typically transitional loans and some subordinated debt, to provide investors with enhanced potential returns.

The U.K. and European markets have traditionally provided fewer options for investors in terms of products because the genesis of the alternative lending sector in the United Kingdom

really only happened after the financial crisis. Until that point, it was dominated by the banking sector, with only a relatively small proportion available in the capital markets and from certain insurance companies. However, the range of debt fund vehicles on offer is expanding rapidly and generally becoming more sophisticated. There is a full spectrum of products in the market, and some of the more recent funds, such as ours, have been hybrid-type strategies.

Many investors are comfortable with debt in the context of public investments — how does private real estate debt differ and what expertise is required?

In the United States, investors can place their capital in real estate debt by taking the public route via mortgage REIT investments, but the correlation of the income of the REIT compared to the underlying real estate is more volatile. And, in general, mortgages command a premium to other fixed-income instruments. The private market is a little less efficient than the public markets, but that presents opportunities for stronger pricing. There is a higher barrier to entry to get into the mortgage space than there is to buying bonds because of the expertise and resources that you need to run a real estate debt platform. For these reasons and because the debt market is highly competitive, relationships and contacts with industry-leading borrowers, brokers, investment bankers and potential co-lenders are needed to generate consistent transactional flow.

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