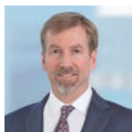
ALTERNATIVES

The Structural and Cyclical Case For U.S. Real Estate Debt

While the ongoing disruption from the pandemic will put downward pressure on market fundamentals until the virus is no longer a threat, opportunities will likely emerge across the risk-return spectrum in advance of a recovery in demand and property income.

BARINGS INSIGHTS



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Highlights

- The U.S. commercial and multifamily real estate debt market is a massive investible universe with hundreds of billions of dollars' worth of mortgages originated annually.
- Real estate debt exposure historically has provided a stable income return; loans are secured by collateral, potentially providing additional downside protection and leading to strong risk-adjusted returns.
- Shifting lender risk appetites and restrictive financial regulations over the past decade have created an opening in the market for non-bank lenders.
- Despite near-term headwinds due to COVID-19, expectations of a robust economic recovery in the second half of 2021 should create opportunities to provide debt capital across the risk-return spectrum in advance of a recovery in occupier demand and property income.

Commercial and multifamily real estate debt (CRE debt) has been part of the U.S. investment universe and institutional portfolios for many decades. However, over the past two market cycles the asset class has attracted growing interest as yields across most fixed income markets have trended lower, and as the real estate debt market has continued to evolve and mature. This paper provides a brief overview of the U.S. CRE debt market and the traditional arguments for including the asset class in a mixed asset portfolio. We also discuss why the current environment may provide an attractive entry point for investors seeking to add or increase exposure to the asset class.

The Structural Case for U.S. Real Estate Debt

The traditional case for private CRE debt in a mixed-asset portfolio rests on three main pillars: (1) the large size and diversity of the opportunity set; (2) the potential for stable and attractive absolute and risk-adjusted returns; and (3) the potentially powerful portfolio diversification benefits.

1. LARGE AND DIVERSE OPPORTUNITY SET

Starting with the most fundamental reason, the U.S. CRE debt market is a large, mature market with about $4.8 trillion of mortgage debt outstanding as of Q3 2020. The market comprises roughly $3.1 trillion of commercial mortgage debt, and $1.7 trillion in multifamily debt. Commercial banks hold the largest share of real estate debt on their books with $2.4 trillion, or about 50%, while the GSEs (i.e., Fannie Mae and Freddie Mac), life insurance companies and the public securitized market also account for significant shares **(FIGURE 1)**.[1]

FIGURE 1: Mortgage Debt Outstanding by Source (U.S.$ billion, Q3 2020)

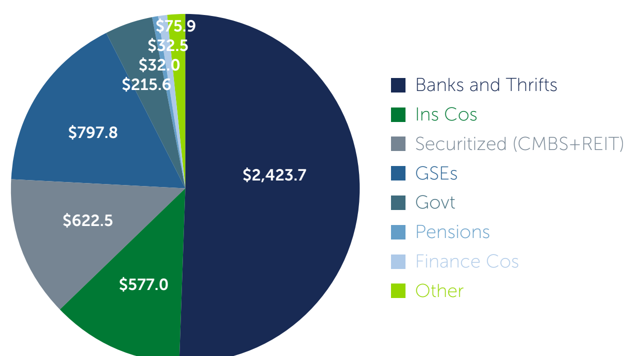
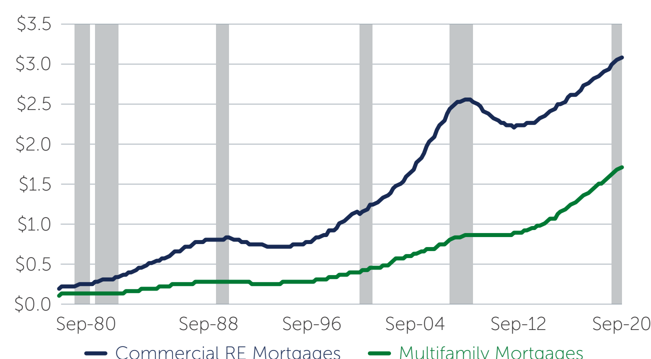


FIGURE 2: Mortgage Debt Outstanding (U.S.$ trillion)



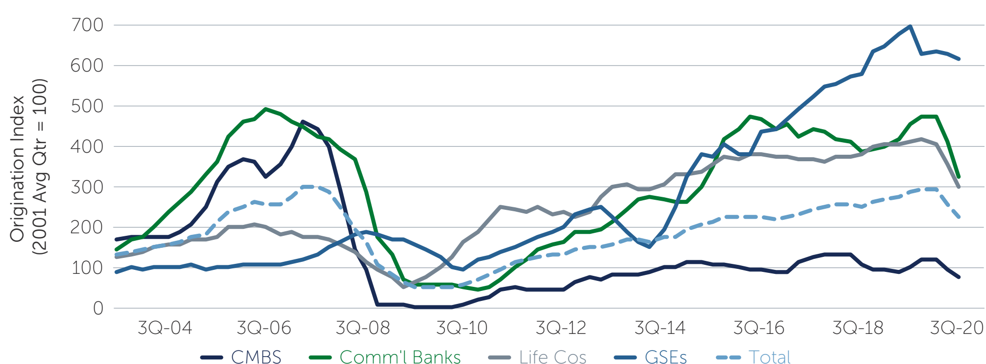
SOURCES: Federal Reserve; Trepp, LLC; BRE Research. As of September 30, 2020.

As shown, there have been two periods of deleveraging since the 1970s: the early 1990s and the Global Financial Crisis (GFC) in 2008/09 **(FIGURE 2)**.[2] Both periods contributed to, and were exacerbated by, deep slumps in property values and sharp increases in delinquencies and defaults—and both led to important structural changes and innovations in the real estate capital markets, and in the debt market in particular. The deleveraging that followed the GFC played out over 15 quarters—from Q1 2009 to Q3 2012—and saw CRE debt outstanding shrink by about 9%. Since then, however, mortgage debt outstanding has grown at a consistent 6–7% annual pace, as the U.S. economy experienced its longest expansion on record. Although growth in Q3 2020 slowed modestly as the pandemic disrupted origination activity, debt outstanding still increased by 5.7% year-over-year.

1. Sources: U.S. Federal Reserve, Trepp, LLC. As of September 30, 2020.
2. The early 1990s deleveraging period followed the collapse of the S&L industry and wave of bank failures that ultimately led to a massive liquidation of distressed commercial and multifamily assets. From mid-1991 through 1994 (14 quarters), CRE debt outstanding shrank by nearly 12%.

The continued growth of the CRE debt market masks important changes in the roles and risk appetite of key debt capital sources due to post-GFC banking and financial regulatory reforms. Prior to the GFC, bank lending and commercial mortgage-backed securities (CMBS) issuance drove origination volume, and banks were more highly levered and more exposed to riskier CRE loans. However, after suffering high levels of distress during the financial crisis, bank and CMBS lending received extra scrutiny in post-GFC regulatory reforms—e.g., Basel III and Dodd-Frank—that have effectively redrawn the debt landscape. For CMBS, risk-retention requirements have kept new issuance at very subdued levels compared with pre-GFC volumes. For banks, new risk-weighted capital requirements have done more to shift the focus of lending away from riskier loans, especially construction lending, than to reduce overall appetite to lend. So, while total CRE debt outstanding has continued to grow, other capital sources, most notably the GSEs, insurance companies and private debt funds, have stepped in to fill gaps in both lending volume and risk appetite.

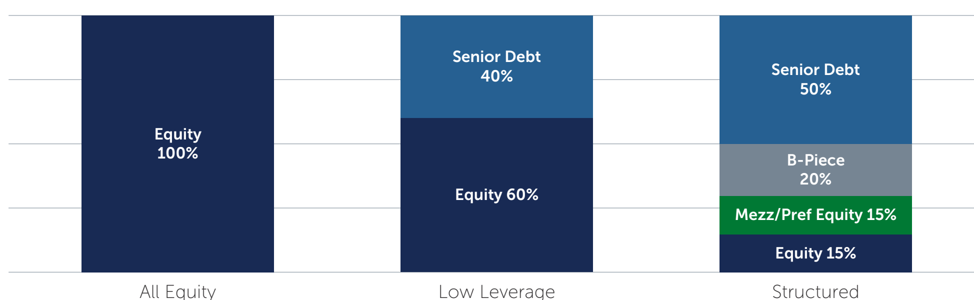
FIGURE 3: Mortgage Origination Volume by Source (2001 avg = 100)



SOURCES: Mortgage Bankers Association (MBA); BRE Research. As of September 30, 2020.

For investors, the growth and evolution of the U.S. CRE debt market offers a diverse range of opportunities and investment strategies across the risk spectrum. Taking a step back, the bond-like nature of real estate cash flows and "real" nature of the collateral make commercial and multifamily properties ideally suited to financing. The real estate capital "stack" illustrates different claims on property cash flows and the underlying collateral ranked by seniority, from the most secure tranche (senior debt) to the highest risk, "first-loss" equity position. CRE debt (including mezzanine) offers some degree of downside protection due to the subordinate nature of the equity and real asset collateral **(FIGURE 4)**. However, the risk and return associated with different tranches vary widely. With the proliferation of private debt investment vehicles over the past two cycles, investors in the U.S. can deploy capital across the capital stack to target different risk-return profiles and to exploit mispricing that can occur between different tranches as liquidity and risk appetite change.

FIGURE 4: Illustrative Real Estate "Capital Stack"

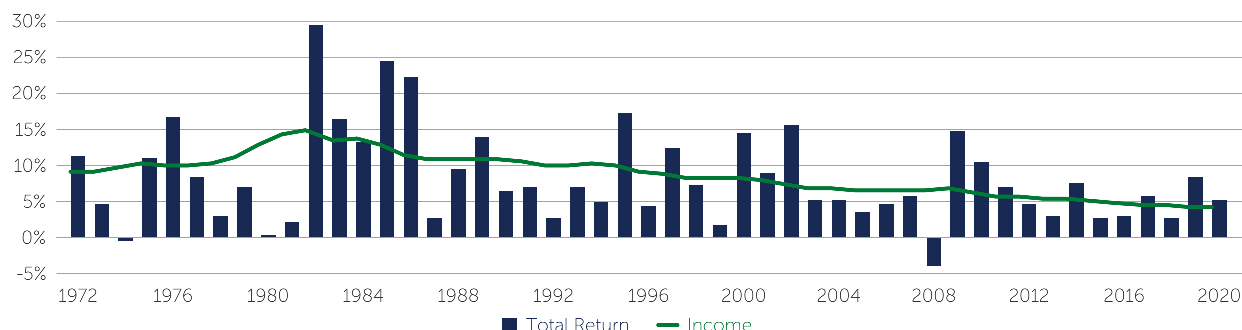


SOURCE: BRE Research. Note: % shares for each "slice" of the capital stack can vary.

2. THE POTENTIAL FOR STABLE AND ATTRACTIVE ABSOLUTE AND RISK-ADJUSTED RETURNS

The second reason for allocating capital to private CRE debt is performance. Historical performance data is limited for most structured segments of the debt market, but the robust data set for senior mortgages makes a compelling case for CRE debt's fundamental risk-return characteristics. As shown, senior commercial mortgages have delivered consistent single-digit total returns underpinned by stable income **(FIGURE 5)**. Since its inception in 1972, the Giliberto-Levy Commercial Mortgage Index, a proxy for the performance of senior commercial mortgages, has experienced only two years of negative total returns (1974 and 2008). Income returns have declined steadily as interest rates have trended lower, but total returns over the past 20 years for senior mortgages (i.e., the low risk end of the spectrum for private CRE debt) have been comparable to investment grade corporate bonds and good enough to outperform CMBS and government bonds on an absolute basis.

FIGURE 5: Commercial Mortgage Performance (Annual Returns)



SOURCES: Giliberto-Levy; BRE Research. As of September 30, 2020.
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Private real estate debt also stands out for having high historical risk-adjusted returns, which reflect commercial mortgages' stable income return and the low volatility of mark-to-market pricing on a large, diverse portfolio of commercial mortgages. Over the past 20 years, only private equity real estate has delivered higher risk-adjusted returns than private CRE debt **(FIGURE 6)**. While the stable income and low volatility make CRE debt returns potentially attractive in institutional portfolios, from a risk perspective, the attribute that sets CRE debt apart from traditional fixed income alternatives is the security of real collateral, which provides significant downside protection. Although loan workouts and defaults require considerable expertise to mitigate losses, assets generally provide a relatively straightforward path to recovery in the event a loan does not perform.

FIGURE 6: Risk-Return by Asset Class

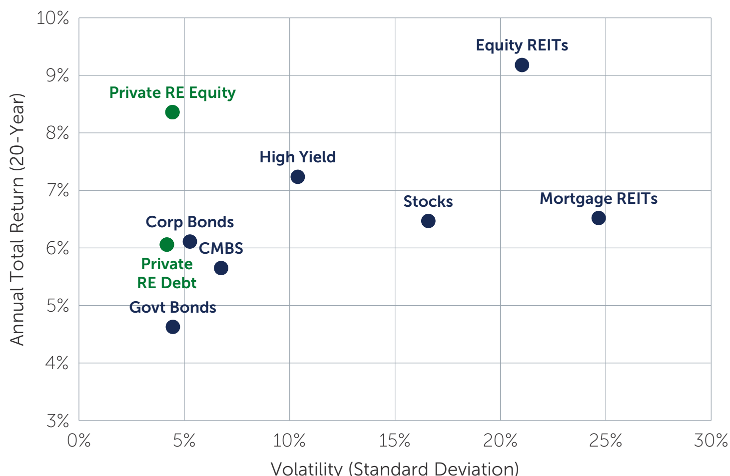
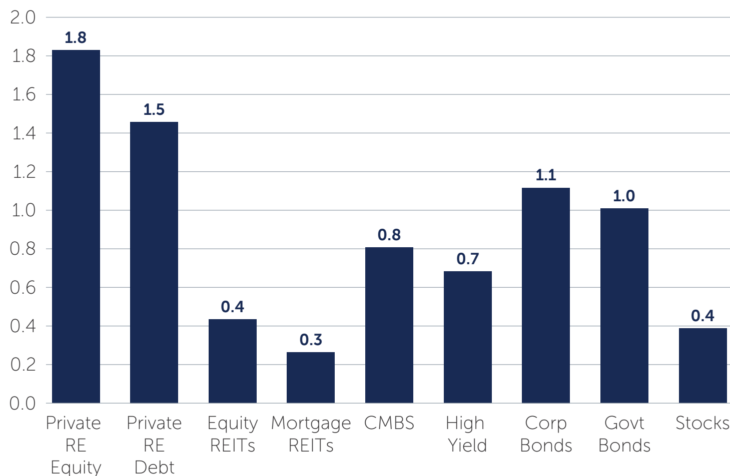


FIGURE 7: Return Per Unit of Risk*



SOURCES: Barclays; Bloomberg; Giliberto-Levy; Moody's; NAREIT; NCREIF; S&P; BRE Research. As of September 30, 2020.
*Risk-adjusted return = (Total Return)/(Standard Deviation). PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

3. POTENTIALLY POWERFUL DIVERSIFICATION BENEFITS

CRE debt's competitive risk-adjusted returns are especially attractive for their potential portfolio diversification benefits, the third pillar underpinning the traditional case for the asset class. Historically, total return correlations have been relatively low between private CRE debt and most other asset classes, including corporate and government bonds as well as both equity and mortgage REITs. Somewhat surprisingly, the long-term average correlation with private equity real estate returns is also close to zero, which implies distinct allocations to both might improve portfolio performance **(FIGURE 8)**.

FIGURE 8: Total Return Correlations (Q4 2000–Q3 2020)

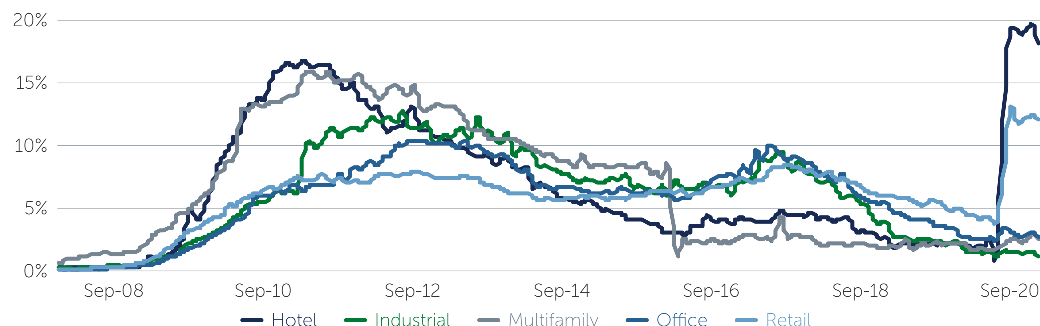
	Private RE Equity	Private RE Debt	Equity REITs	Mortgage REITs	CMBS	High Yield	Corp Bonds	Govt Bonds	Stocks
Private RE Equity	1.00								
Private RE Debt	0.08	1.00							
Equity REITs	0.24	0.31	1.00						
Mortgage REITs	-0.07	0.25	0.55	1.00					
CMBS	0.08	0.74	0.61	0.38	1.00				
High Yield	-0.07	0.25	0.65	0.52	0.63	1.00			
Corp Bonds	-0.21	0.47	0.41	0.55	0.65	0.51	1.00		
Govt Bonds	-0.07	0.34	-0.26	-0.17	0.07	-0.47	0.36	1.00	
Stocks	0.14	-0.07	0.68	0.48	0.32	0.74	0.25	-0.61	1.00

SOURCES: Barclays; Bloomberg; Giliberto-Levy; Moody's; NAREIT; NCREIF; S&P; BRE Research.
As of September 30, 2020.
Based on quarterly total returns for: NCREIF Property Index; Giliberto-Levy Commercial Mortgage Index; NAREIT Equity REIT and Mortgage REIT indexes; Barclays bond indexes (Non-Agency CMBS, High Yield, U.S. Corp, U.S. Govt); S&P 500 Index.

Cyclical Case for U.S. Real Estate Debt

The principal arguments for CRE debt investment today mostly relate to cyclical timing and relative value. The near-term outlook for the U.S. real estate market remains challenging. With the notable exception of warehouses, which have experienced a surge in occupier and investor demand, the disruption caused by the pandemic has affected demand for all types of commercial and multifamily property. The heaviest toll by far has been in the lodging and retail sectors, where travel restrictions and social distancing requirements have greatly reduced hotel room demand and foot traffic at most retail stores. Delinquency rates for hotel and retail loans backing outstanding CMBS bonds have spiked since Q1 2020. For the other major property types, however, delinquency rates have increased only slightly or not at all **(FIGURE 9)**.

FIGURE 9: CMBS Deliquency Rates by Sector



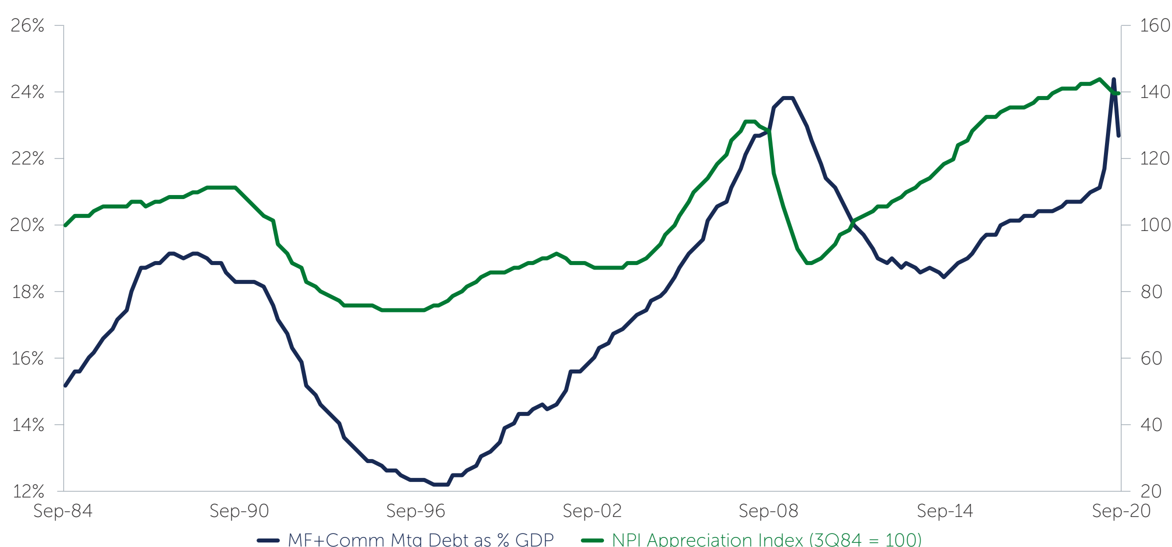
SOURCES: Moody's; BRE Research. As of September 30, 2020.

CONDITIONS TODAY DIFFER FROM PAST CRISES

The lack of widespread distress across the real estate market is notable because it greatly reduces the risk of a painful deleveraging, similar to what occurred in the early 1990s and in the aftermath of the GFC. As shown below, both periods saw commercial mortgage debt as a share of GDP rise to a cyclical peak and then decline meaningfully, along with steep falls in property values, over a period of several years. Conditions in the CRE debt market today are substantially different from those two periods, both of which were triggered by financial crises. Most obviously, the financial markets do not need rebuilding. The banking system is well-capitalized, and with most major equity and bond indexes at or above pre-COVID levels, there is little allocation pressure at the portfolio level to reduce exposure to real estate (i.e., sell assets).

The industry also was far less levered when the pandemic hit than at the time of the GFC. Although property values[3] over the past cycle recovered fully from GFC losses, CRE debt as a share of GDP stabilized at a lower level post-GFC; and it remained relatively stable until 2020, when the contraction in GDP in Q1 and Q2 caused the debt-to-GDP ratio to jump by about 300 basis points (bps). The ratio already has retreated more than halfway from its Q2 2020 peak, and should settle back into its pre-COVID range (i.e., below 22%) as the economy recovers.

FIGURE 10: Commercial and Multifamily Mortgage Debt (as % GDP) vs. Private CRE Appreciation Index



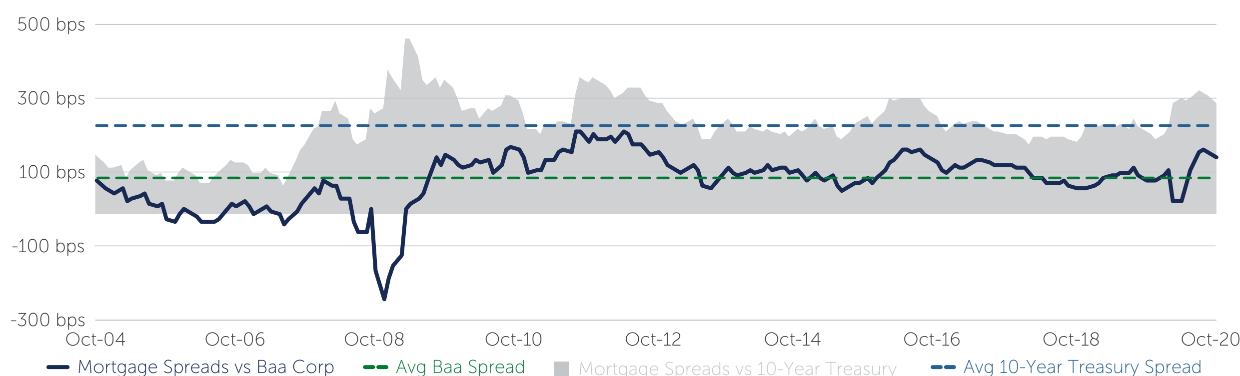
SOURCES: U.S. Federal Reserve; Bureau of Economic Analysis (BEA); BRE Research. As of September 30, 2020.

CRE INCOME, YIELD LOOK ATTRACTIVE AMID LOW RATES

While the demand shock from COVID and the weakened economy clearly poses a near-term risk to property cash flows, capital market forces remain highly supportive of assets that generate durable, predictable cash flows, especially over the long term. CRE income yields and spreads look relatively attractive in the current low interest rate environment, which is expected to define the investment landscape at least for the next few years, if not longer. Since the initial shock from COVID in March, and the U.S. Federal Reserve's subsequent stimulus, corporate bond yields across the risk spectrum have fallen to historical lows, and more than $17 trillion of bonds outstanding globally now trade at negative yields.[4] Commercial and multifamily mortgage rates also have compressed in segments of the market where debt capital is most readily available (i.e., industrial and multifamily). However, mortgage spreads have widened and are well above their long-term averages **(FIGURE 11)**.

3. Property values as measured by the NCREIF Property Index (NPI), a leading industry benchmark for the performance of institutionally-owned, stabilized, income-producing commercial real estate.
4. Bloomberg Barclays Global Aggregate Negative Yielding Debt. As of December 31, 2020.

FIGURE 11: Commercial Mortgage Rate Spreads vs. Treasuries and Corp Bonds



SOURCES: Moody's Analytics; Real Capital Analytics (RCA); BRE Research. As of October 31, 2020.

The wider spreads partly reflect some additional risk premium in capital market pricing for the uncertain impact of COVID, and partly reflect the structural changes in the debt market noted earlier. Unlike the GFC, however, the spreads are not a reflection of a lack of liquidity. Although banks have tightened lending standards dramatically since Q1 2020, debt capital remains available for much of the commercial real estate and multifamily market. Lenders are being very selective on office assets and have little appetite for retail or hotels, but they are competing aggressively for industrial and multifamily opportunities and most cash-flowing assets with credit tenants and term (i.e., long lease duration).

The uncertainty premium should narrow over the next three to four quarters as visibility into occupier demand and cash flows improves with the rollout of vaccines and re-opening of the economy. However, the balance between demand and supply of debt capital should remain favorable for lenders and investors looking to deploy capital over the next several years. According to the Mortgage Bankers Association, mortgage origination volume in 2020 is expected to fall more than 30% from a 2019 peak of $601 billion to less than $400 billion, with only a modest recovery forecast in 2021 **(FIGURE 12)**.[5] The recent decision by the Federal Housing Finance Agency (FHFA) to reduce the overall lending capacity of the GSEs in 2021 by $20 billion, or about 12.5% of their current caps, and increase the share of their capital allocated to affordable projects will make hitting the MBA's forecast for 2021 even more challenging.[6] With mortgage maturities forecast to exceed origination volume in 2021 and then continue to climb to a new peak by 2024, the potential funding gap should provide a wide range of opportunities to finance assets at relatively attractive yields as the property market stabilizes and transitions to cyclical recovery **(FIGURE 13)**.[7]

FIGURE 12: Commercial and Multifamily Originations by Year (U.S. $ billion)

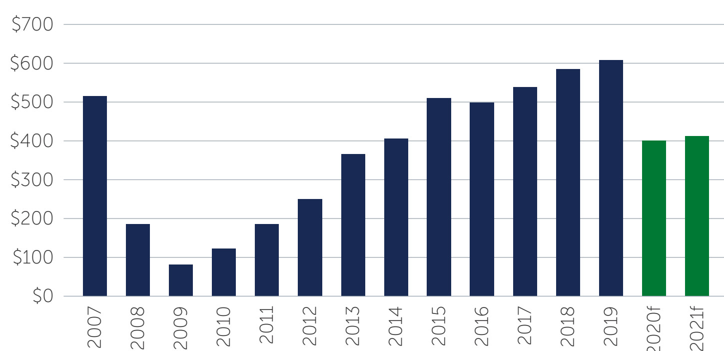
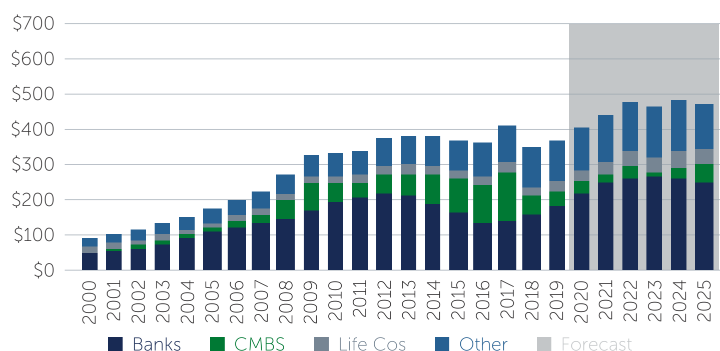


FIGURE 13: Commercial Mortgage Maturities (U.S. $ billion)



SOURCES: Barclays; Bloomberg; Giliberto-Levy; Moody's; NAREIT; NCREIF; S&P; BRE Research. As of September 30, 2020.

5. Mortgage Bankers Association. As of November 5, 2020.
6. Per the FHFA, lending caps for Fannie Mae and Freddie Mac will be reduced from the 2020 level of $80 billion to $70 billion (each) in 2021 (Federal Housing Finance Agency, November 17, 2020).
7. Trepp, LLC.

OPPORTUNITIES ACROSS THE RISK-RETURN SPECTRUM

At the lower risk end of the spectrum (i.e., senior mortgages), while demand for acquisition financing will take time to recover, current low interest rates should encourage demand for refinancing and for new debt on unencumbered, cash-flowing assets. Intense competition for assets leased to credit tenants on long-term leases has compressed expected returns and spreads on assets meeting that description, but with bond yields at historical lows, those returns and spreads still look relatively attractive, especially on a risk-adjusted basis. In most cases, the risk profile of the cash flows and valuations of the underlying collateral should improve meaningfully as the cyclical recovery unfolds.

For investors and lenders seeking higher returns, the abrupt and unusual end of the previous real estate cycle also has expanded opportunity set for "bridge-to-core" financing to recapitalize properties that either delivered during the pandemic or were in lease-up to stabilization. Most sectors (ex-retail) were at or near their cyclical peaks in new supply at the start of 2020, and completions in many markets were—and will continue—running at elevated levels. Due to the disruption caused by the pandemic, a much larger pool of these projects will require refinancing over the next several years. While the spread premium on bridge-to-core opportunities can vary widely, the return profile typically includes some level of cash flow, possibly enough to cover debt service, an elevated initial loan-to-value (LTV) ratio, and a low debt-service-coverage ratio (DSCR).

Lastly, at the upper end of the risk-return spectrum, in addition to opportunities to recapitalize distressed assets, the ongoing disruption and reduced risk appetite in the CRE debt capital markets should cause spreads for construction lending to widen meaningfully. As noted, regulatory reforms have significantly reduced banks' ability and willingness to make construction loans, and many of the debt funds that stepped in to fill the gap in the last few years of the recent cycle are on the sidelines. According to Real Capital Analytics (RCA), debt funds expanded rapidly in construction lending in the last few years of the previous real estate cycle, more than doubling their share from 8% in 2016 to 19% by the end of 2019. For investors seeking higher returns, limited appetite among existing lenders for construction financing should allow lenders to be selective and disciplined in terms and structure.

"...in an aging world starved for current return, CRE debt should continue to attract capital and gain wider acceptance in institutional portfolios"

Closing Thoughts

The U.S. CRE debt market is a large, mature market that offers a wide range of opportunities across the risk spectrum for investors seeking competitive risk-adjusted returns, stable yields and the potential for downside protection that comes with having real assets as collateral. Although the U.S. property markets face a challenging road ahead in the near term, the case for CRE debt in a diversified portfolio is well supported by strategic (i.e., portfolio) and cyclical considerations. Unlike the GFC, there is very little pressure currently to deleverage or to sell assets, which greatly mitigates the risk of widespread write-downs in asset values and the attendant increase in mortgage delinquencies and defaults. Assuming the economy can regain traction in the first half of 2021, occupier demand and transaction activity should begin to recover in 2022. With relatively attractive yields—and the potential funding gap between demand for, and availability of, debt capital likely to persist over the next couple years—investors seeking exposure to CRE debt should see a wide range of opportunities to deploy capital at attractive spreads as property income and values recover. Longer term, in an aging world starved for current return, CRE debt should continue to attract capital and gain wider acceptance in institutional portfolios.

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