



REAL ESTATE

Real Estate Debt: Highest Yields in Decades

Discussion

August 28, 2023

Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with William Pattison, Head of Real Estate Research & Strategy at MIM to discuss opportunities within the real estate sector, including why he believes strong opportunities currently exist with high-yield commercial mortgage investments.

Guy: *It seems to me that Commercial Real Estate has received a great deal of negative press in 2023 and yet you believe that opportunities currently exist. Could you help bring clarity to that disconnect?*

Will: I don't think investors are accounting for the positive effects that the high inflation of the last 3 years will have on real estate returns later this decade. Inflation was low from the mid-1980s until 2021, causing construction cost growth to remain low, and therefore causing new supply to keep up with demand. Due to the relationship between construction costs and real estate supply, the market rent that real estate investors could command also grew at about the rate of inflation, or about 3%. In my view, that 3% rent growth assumption has become so engrained in the real estate underwriting and valuation industries that no one is questioning if it should be higher, given we are

coming off a 6% or 7% inflationary environment. It's unfortunate there is virtually no one still working today who was underwriting real estate in the 1970s as I don't think the 3% rent growth assumption was always treated with such reverence.

Guy: How do you square the positive relationship with real estate returns and high inflation with what has happened to the sector over the last year?

Will: Real estate prices have been declining since mid-2022 because of the higher interest rate environment. Outside of the office sector, these declines have been essentially only driven by the higher interest rate environment as occupancy rates and property income growth has remained strong.

Within the office sector, remote work is causing occupancy and property incomes to fall, and office sectors values are also declining due to the same higher interest rate effect. Today, it's probably best to categorize office as one sector, and the dozen other commercial real estate property types as another sector, although they are sometimes all being lumped together by investors and regulators.

Guy: To monetize such opportunities, don't you need a long investment horizon to let the imbalances work themselves out?

Will: The transactional costs of private commercial real estate have always made it a longer-term investment sector than public markets - with most core buyers targeting at least 5 years hold periods. I don't think a longer-than-normal investment horizon is needed today, as higher construction costs are already causing a pullback in new construction that may be realized in rent and occupancy levels within the next 5 years. Within the industrial property type, for instance, tracking of new projects suggest that completed construction in the U.S. should total about 560 million square feet in 2023, followed by 300 million in 2024, and only 190 million in 2025.¹ I think there could be an argument to wait on making new investments until the construction pipeline is further along the path of decline, but I don't think investors need longer holding periods to realize the benefits.

Guy: Has the pullback from regional banks caused any market dislocations?

Will: Many traditional lenders, including regional banks, have pulled back from the commercial real estate sector.

For banks this has been partially driven by regulators, which I believe is contributing to growing levels of forced selling at discounts to net asset value. For other investor types, concerns over potential losses from existing office mortgage investments has made them halt new investments on all commercial real estate property types. MIM has been active in the debt space this year, and with an emphasis on higher yielding debt. In my view, buying money-good assets from banks or identifying and quickly acting to fill gaps in the capital market structures is one of the best areas of focus in today's market.

Guy: Outsized returns could certainly result from capitalizing on distressed sellers unloading assets at uneconomic prices. But let's discuss yields. What generally are commercial mortgage yields today; and to gain some perspective, could you compare them to before the pandemic?

Will: Before the pandemic target yields on senior mortgages were generally 3.5% or 4.0% with targets on subordinated real estate debt commonly around 6%. With the current rate-tightening cycle, yield targets on senior mortgages are now in the 6% to 8% range and forms of subordinated real estate debt are closer to 12%.² Of equal or more importance is the spread commercial mortgages are offering to sectors like corporate bonds, and we think that looks favorable from this perspective as well.

Guy: The range you mentioned, 6% to 12% is quite wide, is that the result of the type of structures?

Will: I don't think so as I believe structures have generally stayed the same or become more favorable for the lender. One metric that we consider is the spread between senior mortgages and subordinate mortgages, which rose from 200 or 300 basis points pre-pandemic to around 400 basis points³ today. It's not possible to give a full account as to why this has happened, but I suspect the pullback from traditional lender types has played a role. Although these higher risk loans should always be expected to have higher losses than senior mortgages, we think investors are being paid for the risk.

Guy: What constitutes an acceptable level of risk and how it is determined?

Will: That's a good question. There are many people within MIM who are more focused on modern portfolio theory across a multi-asset portfolio than I am but what

my team can provide to a CIO or portfolio manager is bond-equivalent rating estimates. MIM has been one of the leaders in estimating bond-equivalent ratings for commercial real estate debt, including supporting the development of many of the research reports and modeling tools that rating agencies and third-party rating model providers use. MIM also has the longest known historical commercial mortgage performance dataset which, in my opinion, can be helpful when estimating and pricing risk in the commercial real estate debt space.

Guy: *What are the most important factors when estimating the risk of a commercial debt investment?*

Will: MIM and Moody's co-authored a research report on that topic about a year ago, although I'm not sure it was very well read as we gave it the somewhat bland name of "Commercial Mortgage Lending". In the report we summarized and evaluated the efficacy of some of the most common metrics and ratios that investors typically use to assess commercial real estate debt risk, using MIM's full commercial mortgage performance history dataset as well as the CMBS history available in

more recent decades. We found that measures like the loan-to-value ratio are sometimes more and sometimes less useful at different points in the real estate cycle, and developed opinions on what market signals to look for to determine when different indicators should be relied on when making new investments. We also found that the commonly cited "debt yield" ratio could potentially be improved by considering it in relation to property cap rates, which has become an especially relevant point over the last year as cap rates have been rising. Those nuances aside, the core of our bond-equivalent rating process is based on our more than half century of performance history, with loan level datasets showing factors like the underwritten loan-to-value ratio and then how the loan ultimately performed. MIM, and my personal career, owe a debt of gratitude to whoever the MetLife employees were in the 1950s and 60s that decided to start the archive.

Endnotes

¹ MetLife Investment Management, CoStar

² MetLife Investment Management

³ MetLife Investment Management

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