



Walton Street Capital

# Perfect storm in real estate creates unique investment opportunity

*A Q&A with Walton Street's co-founder Jeff Quicksilver*

*The recent movement in market values for commercial real estate has been well documented. What got us to this point?*

It is important to set the stage by reflecting on where we were just a few years ago. In late 2021, amid the backdrop of record-low interest rates, strong real estate space market fundamentals – which had been supercharged by the economic rebound in the United States following the pandemic – and a very liquid financing market, capitalization rates across most property sectors reached near-record levels. Beginning with the Federal Reserve's efforts to tame inflation via steep interest rate increases in the first quarter of 2022, we have seen the convergence of a myriad of factors resulting in a "perfect storm" for the U.S. real estate markets. Flattening rental rate growth, coupled with higher interest rates and a significantly more illiquid financing market, have resulted in a sharp decline in transaction volumes and a decrease in real estate values. Today, property level valuations are off approximately 20 percent to 30 percent from their peak. Borrowing costs have increased substantially, as both base rates and spreads have expanded, and traditional financing sources have moved to the sidelines. Major geopolitical events are also contributing to market volatility and uncertainty.

Initially, valuation declines were primarily led by Fed-driven capital markets pressures rather than deteriorating demand. Now, however, we are seeing signs of slowing economic growth and softening property-level fundamentals for most property types following several years of double-digit rent growth.

*You talk about a reduction in commercial real estate lending from traditional sources. Why have they been pulling back?*

Regional banks had been the largest providers of commercial real estate financing, representing approximately 70 percent of outstanding loans. In the current environment, these banks are contending with increased reserve requirements and write-downs of their existing loan portfolios, especially office, alongside a lack of repayments, as transaction volumes remain muted. This deleveraging cycle has increased illiquidity across real estate markets, even in the stronger-performing industrial and rental housing property sectors. Select banks, life companies, agency lenders and debt funds have backfilled some, but not all, of the financing void. It comes at a high price, however. Borrowers are facing both lower proceeds and higher all-in rates, putting downward pressure on values.

*How do you believe this financing shortage will play out in the short-to-medium term?*

While the U.S. economy has been resilient and we have seen evidence recently that inflationary pressures and the Fed's restrictive monetary policy are easing, we nonetheless expect

relatively higher debt costs to continue to weigh on growth. There is approximately \$2.0 trillion of commercial real estate debt maturing during the next two to three years. Much of this debt was originated in an ultra-low-rate environment and at peak asset valuations. While base rates have come down off their highs, the current financing environment and slowing demand still portend a credit-crunch scenario. In addition, for floating-rate debt, expiring interest rate caps have become substantially more expensive to replace and extension tests more difficult to achieve. The loan workout phase of the cycle is under way, with loan sales and restructuring activity increasing. The office sector was the first property sector to showcase the effects of the "storm," but we are beginning to see the effects of this illiquidity and deleveraging environment carry over to the other major real estate sectors, as well.

As a result of these looming credit market maturities, we believe today represents the early innings of a significant valuation reset. There has been an increase in delinquencies and a significant impairment of value in many real estate loans held by financial institutions and mortgage REITs. What were previously cash-out refinancings have turned into cash-in requirements for many maturing loans. Undercapitalized borrowers cannot afford to sit on their hands through a final maturity date, and lenders are motivated to offload commercial real estate exposure due to expanded regulatory pressures. Today's funding gaps should create attractive investment opportunities for well-capitalized, cycle-tested firms over the next several years.

*How is Walton Street approaching the current market?*

Walton Street is tracking an increasing pipeline of stress and distress. It has become apparent that yesterday's capital stacks were not built to withstand today's capital markets environment.

We are targeting actionable, point-in-time distressed and dislocation opportunities as cracks emerge, while focusing first and foremost on the fundamentals of basis and risk. In 2010, following the GFC, real estate delinquencies peaked at 8 percent. Today, they are around 1 percent and rising – we are still in the early stages of the "storm," and investment patience, discipline and timing are critical.

Through the cross-platform sourcing channels of our dual equity and debt platforms, we are seeing increasing opportunities to invest in high-quality assets at attractive discounts to both prior-peak pricing and replacement cost. This has come in several forms. First, undercapitalized owners and operators who acquired or developed assets aggressively the past few years are today motivated to sell or raise rescue capital necessary to manage liquidity needs across their portfolio. Second, open-end funds and nontraded REITs are not active buyers and are instead facing pressure to raise capital and to

sell assets to address redemption queues. Lastly, we are seeing debt positions, both portfolios and individual loans, available for sale at discounts to par value.

*Outside of the distress and dislocation you are seeing, you mention a focus on the industrial and rental housing sectors as the key components of your smart-sector investment strategy. What is the thesis for continuing to target these sectors?*

When economic growth is slowing and there is dislocation in the markets, it is more important than ever to identify sectors that have strong long-term tailwinds. If you look at Walton Street's investments and originations over the past five-plus years, you will see both our equity and debt platforms have been focused almost exclusively on what we call our smart-sector investment strategy – investing in property sectors that exhibit the strongest supply and demand fundamentals (e.g., rent growth, absorption, tenant demand) and in markets benefiting from favorable tax policies and positive trends in population and employment growth. We believe this smart-sector investment approach, which has focused our attention mainly on the industrial and rental housing sectors, should deliver strong NOI growth and asset-value appreciation over the long term.

In the industrial sector, we are continuing to see ecommerce expansion and supply-chain reorganizations drive demand for space. While the absorption of larger distribution space has slowed from its breakneck pace from 2020 to 2022, there continues to be durable, long-term demand in this segment. The shift in the United States toward the nearshoring and onshoring of manufacturing should also positively impact fundamentals.

In rental housing, while we have seen some recent volatility and slowing of rental growth, our long-term outlook remains positive. In the short term, there is likely to be some continued turbulence for rental housing performance. Rising operating expenses, particularly insurance and unit turnover costs, are putting pressure on operating margins, while the continued influx of new supply is resulting in limited rent growth and increased concessions. In most markets, we expect the recent moderation of rent growth to continue, while this near-term supply gets absorbed.

In the medium-to-long term, however, both sectors should benefit from a declining future supply pipeline. A positive byproduct of today's credit illiquidity has been a sharp decline in new construction starts, which should ultimately continue to drive demand and rent growth.

*Are there any more niche or tactical sectors you plan to target in the coming months?*

We have been actively investing in student housing during the past two years and continue to have strong conviction in the sector's growth outlook and recession-resistant demand. Occupancy levels and rent growth have shown attractive upward trends post-pandemic. In recent years, we have seen a continued pattern of enrollment shifting from smaller nonconference or private universities to larger, tier 1 universities. This has driven us to invest at universities where lower acceptance rates, strong enrollment trends and pre-lease velocity forecast robust demand. From a capital markets perspective, we see more institutional capital and lenders entering the sector.

*Where is Walton Street seeing opportunities in its debt platform?*

This is an exciting time to be a floating-rate lender. The pullback in lending volume by banks and other traditional sources, combined with the current rate environment, is leading to very attractive opportunities in private real estate credit. With continued regulatory pressures on banks to increase capital reserves, we do not see this reversing any time soon. As such, we expect the market to continue to turn to the private debt sector for financing.

In 2023, we have seen improved credit metrics on new originations, including lower LTVs and higher debt yields, along with more lender-friendly loan structures. At the same time, as credit quality on new loans has increased, yields have also increased significantly. In addition, the inclusion of SOFR [secured overnight financing rate] floors in loans allows us to protect against return degradation in the event interest rates continue to move lower. The current risk/return environment to originate new loans is one of the most favorable we have seen in the past 10 years.

### Contributor



**Jeff Quicksilver**  
Co-Founder and Managing Principal  
Walton Street Capital

As a co-founder and managing principal at Walton Street, Jeff Quicksilver is responsible for leadership of the firm and strategic oversight of its business operations and activities. Quicksilver is a member of both the Management and Investment Committees at Walton Street. Prior to forming Walton Street, Quicksilver was a managing director at JMB Realty Corp.

### About Walton Street Capital LLC

Walton Street is a private equity real estate investment firm that, since its inception in 1994 through its affiliates, has raised more than \$15 billion of capital commitments. Walton Street's principals have collectively acquired, financed, managed and sold more than \$55 billion of real estate and have an average of 22 years of real estate industry experience. Senior management has collectively invested and managed both real estate equity and debt through several real estate cycles over five separate decades and more than 40 years, forging long-term and deep relationships with lenders, public and private real estate owners, operators, brokers, managers, and industry service providers.

*This article presents the author's opinion reflecting current market conditions. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product.*

Copyright © 2024 by Institutional Real Estate, Inc. Material may not be reproduced in whole or in part without the express written permission of the publisher.