



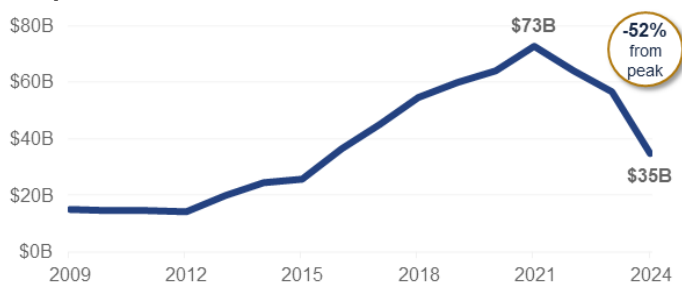
CRE debt markets: Unique cyclical opportunity for attractive risk adjusted returns

A Q&A with **Richard Ratke**, managing principal and co-founder of Walton Street's debt platform

Why is now a great time to be a debt investor?

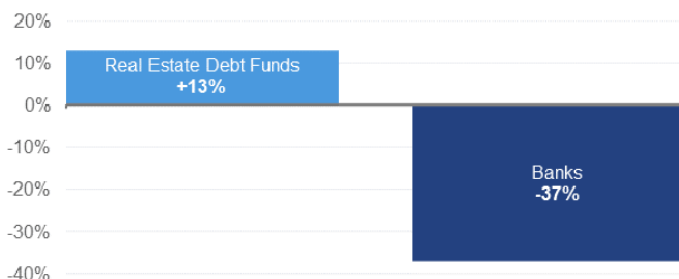
Two key reasons – limited competition and the superior credit profile of new loans. The competitive dynamic today is similar in many respects to that of the post-GFC era. Banks have pulled back for a myriad of reasons – increased regulatory scrutiny; problematic legacy loan exposure in sectors like office, for instance; and challenges with underwriting low debt-service-coverage loans in a higher-rate environment. Since the start of the Fed tightening cycle in 2022, banks have given up 37 percent market share, with debt funds and insurance companies primarily filling the void. In addition, many competitor debt funds and mortgage REITs are saddled with legacy office exposure – anywhere from 20 percent to 40 percent of loan portfolios – and are generally far less active in the market than even a few years ago. Finally, debt fund dry powder has fallen off a cliff – \$35 billion today versus \$73 billion in 2021, more than a 50 percent decline. On the credit side, property values have reset with an approximately 20 percent decline from the 2022 peak, LTVs continue to trend lower, averaging 60 percent today versus 70 percent or more pre-GFC, and loan covenants and structures are much more lender friendly. Low LTV loans secured by properties with recently reset values and fresh equity capital should help to insulate lenders, providing both downside protection and substantial alignment of interest.

Real estate debt funds' dry powder down approximately 50% from 2022 peak (\$billions)



Source: Prequin as of Sept. 30, 2024. Represents all U.S. real estate debt funds reported. Full-year 2024 represents an annualized figure.

Bank market share has decreased since 2022, with debt funds filling the void



Source: MSCI Real Assets, as of Dec. 31, 2024

How has Walton Street's debt platform grown over time?

We launched our debt platform following the GFC to capitalize on many of the same themes, interestingly, that we are seeing in the market today. We started with a very small, dedicated debt team, a seed loan secured by an office building in Orange County – funded by our own personal capital and, fortunately, repaid long ago! – and the intent to raise a closed-end transitional loan fund. Now, more than a decade later, our team has grown to 20-plus debt investment professionals, all headquartered in Chicago. The team has sourced nearly \$10 billion in loans across 130 borrower relationships and raised \$3.5 billion of capital from more than 80 investors across the platform.

What distress do you see in the market today, and how has it affected Walton Street?

Much of the distress in the market today is related to office – both loans and properties. Aside from a few select CBDs with newer vintage, state-of-the-art product, most pre-pandemic office investments are even worse than reported. Keep in mind many older, suburban office buildings were not well leased even pre-pandemic, and now, they are essentially obsolete and often vacant. Our platform was fortunate in that we pivoted away from most office lending in 2017, long before the pandemic and remote work trends emerged. We had a general discomfort with net effective rents in most markets and the trading nature of office buildings – sellers were always hoping the next buyer had a more inflated view of future rents that would justify the extensive, recurring capital required for leasing. Back then, we began shifting heavily into industrial and housing – multifamily, student, manufactured and single-family for rent – and industrial. And today, those two sectors represent more than 90 percent of our loan portfolio, with office at just 2 percent.

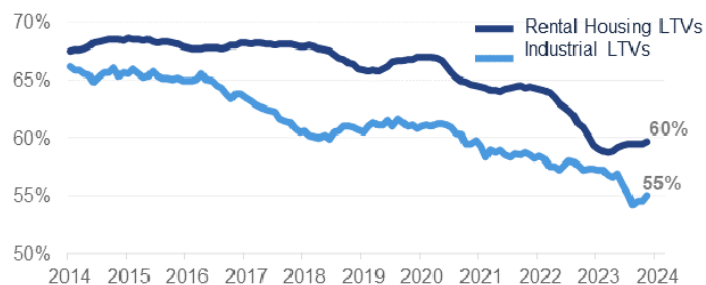
What risks do you see on the horizon for loan portfolios with office exposure?

While most legacy office loans are distressed, mainstream media and research often ignores perhaps the most troubling aspect: These distressed office loans held by debt funds are often levered, in some cases with repayment recourse, and cross-collateralized together in a pool with otherwise healthy housing and/or industrial loans. The future realized losses of these distressed office loans are not ring-fenced and are likely to adversely impact full recovery of these other healthy loans. This is rarely addressed but is on the near-term horizon.

How has Walton Street capitalized on lending market distress?

Not necessarily how you may suspect. We've passed on all office lending opportunities during the past couple of years. While these recent, deeply discounted office investments could be interesting from an equity perspective in the long term, the risk today feels asymmetric as a lender. You're essentially targeting a capped return while likely taking on some equity-like risk, given the inability to underwrite stabilized office rents and occupancy in the future. Instead, we've been focused on mining our existing

LTVs in target sectors continue to trend downward



Source: MSCI Real Assets as of Sept. 24, 2024, and based on independent reports of properties and portfolios \$2.5 million and greater.

loan portfolio for opportunities to increase duration in credits we like in the housing sector. Given the run-up in benchmark rates, many loan extension tests predicated on, for example, 1.25x debt service coverage are non-compliant. That same loan, however, may only be, for instance, 75 percent to 80 percent of current value today – up from 60 percent to 65 percent at origination. This does not necessarily imply the loan is distressed or in imminent default, but new equity from the borrower will be required to deleverage and rebalance the loan on current market terms. Our borrowers generally prefer to rebalance their existing loan with us, rather than seek a new loan – fewer friction costs, including mortgage brokerage fees, legal costs in loan documentation and a new origination fee. Our loan asset managers have been proactive in identifying these opportunities, and we've been able to increase duration in high-quality credits broadly across our portfolio.

What are the advantages of having both debt and equity platforms?

We believe Walton Street's sourcing network and asset-intensive credit approach have competitive advantages over pure-play debt-only managers. Our debt team is fortunate to be able to leverage proprietary data and market intelligence from our in-house 15-plus asset managers overseeing \$15 billion of real estate assets on behalf of our equity and debt platforms. While our lending strategies are focused on performing loans – with an average 66 percent LTV since inception – we have the platform ability to take over problematic assets, if necessary. Finally, our bank relationships commonly mention they view Walton Street as a credit enhancement and cushion between their loan and the borrower, given our asset-ownership expertise. This dynamic has resulted in reduced financing cost to us and enhanced structure for our senior loan facilities. We, in turn, can pass some of that savings to our borrowers and be more successful in a competitive process.

How does Walton Street differentiate from other debt platforms?

Primarily risk profile and leverage. In today's market, there's a wide spectrum of what is considered a "debt strategy." On the high-risk end of the risk spectrum, funds may focus on distress, loan-to-own and nonperforming loans. We view these strategies as equity risk, and we execute these strategies out of our equity platform. The other end of the risk spectrum describes our debt

strategy – originating performing loans secured by cash-flowing assets at low to moderate LTVs to provide for an attractive current distribution yield to our investors. We are further differentiated by our focus on high-quality, performing assets – 2017 median vintage across the debt platform – with nearly all institutional borrowers. In addition, more than 85 percent of our \$9 billion of loans since inception have been either acquisition or cash-in/neutral refinancings and approximately 65 percent LTV on average – this alignment of interest with borrowers has proven to be critical, especially in recent years. Overall, we believe our debt platform generates a highly attractive risk-adjusted return with a focus on capital preservation, current income and downside protection. Finally, our leverage strategy is unique in that we have secured \$7 billion of senior financings, all nonrecourse and match term, with no mark-to-market provisions.

What is Walton Street's outlook for the lending markets in 2025?

While the supply of debt capital – for instance, debt funds, banks, insurance companies – is relatively restrained compared with a few years ago, the best lending opportunities have been competitive as borrower demand for debt capital remains similarly depressed. Transaction volumes fell from a peak of \$900 billion in 2021 to less than \$400 billion in 2023 – nearly a 60 percent drop. Given the rate market has largely stabilized and cap rates have now adjusted to account for increased financing costs, most expect transaction volumes to increase in 2025 closer to the 2019 to 2024 average of approximately \$600 billion annually. This should drive a meaningful increase in borrower demand amid the backdrop of a more limited supply of debt capital and is expected to offer a favorable pricing dynamic for lenders.

CONTRIBUTOR



Richard Ratke
Managing Principal, Walton Street Capital

Richard Ratke is a managing principal at Walton Street, co-founder of the debt platform and member of the management and investment committees. He is responsible for the strategic direction, investment and management of the equity and debt platforms and the management of the firm.

ABOUT WALTON STREET CAPITAL

Walton Street Capital LLC is a private real estate investment firm that manages a diversified equity and debt platform on behalf of its global institutional clients. Since its inception in 1994 through its affiliates, Walton Street has raised nearly \$17 billion of capital commitments from global institutional investors and has acquired, financed, managed and sold more than \$55 billion of real estate. Walton Street has sourced more than \$14 billion in lending opportunities for its affiliates since inception. Walton Street's core lending strategy provides efficient debt capital targeting newer vintage, income-producing real estate assets, spanning a range of property types in major U.S. markets. Through the cross-platform synergies of its investment groups, Walton Street seeks to make real estate equity and debt investments with attractive risk adjusted returns. For more information, visit waltonst.com.

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 © 2025 by Institutional Real Estate, Inc. Material may not be reproduced in whole or in part without the express written permission of the publisher.