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Lower-middle CRE debt market — Not too small, not too big, just right

Ed O'Farrell, managing director of *Real Assets Adviser*, recently sat down with **Cory Johnson,** CEO of Pender Capital, to talk about the state of CRE debt. Following is an excerpt of that conversation.

Why is real estate debt so interesting today?

The real estate market, in general, has had a couple of resets over the past five years. We've seen the impact that COVID had on the sector, plus interest rate fluctuations have caused a significant repricing across the board. That, coupled with the lack of liquidity from the traditional debt players really has opened what we believe is a blue ocean in front of us, especially in the segment that we play in, which is the lower-middle market. We have a lot of tailwinds allowing us to really price ourselves into new, attractive, risk-adjusted deals, where we sit in the senior debt position.

What are some of those tailwinds?

We do a lot of commercial real estate bridge debt in the $10 million to $30 million range. These deals are generally value-add with a one- to three-year life span. This is an extremely fragmented part of the market. There never were a lot of nationwide players targeting this segment, and now there are even fewer. There was some data published recently that looked at origination volume, especially the lower-middle market of commercial real estate debt, that found that regional banks historically have accounted for roughly 59 percent of origination volume. The projections moving forward is 40 percent. Who is going to pick up the slack? The vast majority is going to have come from the private lending space. We have had more than 10 years' experience building relationships and underwriting deals in this space. We are ready to step into this gap.

What else is driving CRE debt investment?

As we have seen volatility creep back into the marketplace, having a low or noncorrelated return profile is starting to get more and more attractive to investors that are looking at ways to further diversify their portfolios and add a segment that can provide some stable source of dependable, low-volatility income.

In addition, pricing discounts are allowing buyers to cover higher loan interest rates, which increases our universe of borrowers. We've seen some acquisitions that have taken place at such significant discounts that the sponsorship groups can withstand higher-cost bridge debt almost indefinitely. Now, of course, we don't want that to happen. We want to have a nice turnover of loan realizations, but it does mean there is no lack of qualified borrowers.

Why is the lower-middle market so attractive?

The larger institutional guys don't really want to go downstream and originate $20 million loans. It's incredibly inefficient for them because of the size of the funds and relationships that they have. We, however, have spent 10 years building relationships and really getting to know this segment of the market. We've developed a nice stable of repeat borrowers and relationships with some of the local brokerage communities. Having these long-term relationships gives us more control over how our loans are playing out. We're the direct originator, underwriter and asset manager, so we're not buying any secondary paper. We can follow the borrower's progress as they move through their value-add rehab over the term of our loan.

How do you mitigate risks?

Our target weighted average loan-to-value is right around 60 percent or sub 65 percent. We want to have that significant equity protection in front of our first dollar debt because ultimately, at the end of the day, there's only so much these real estate assets can absorb in a rising interest rate environment. It really goes back to making sure we're positioning our first dollar at-risk debt properly. We are senior position, lower-term, very limited leverage. We're not over levering our portfolio to generate returns.

Although we're specifically focused on the one- to three-year term, we're very cognizant that every deal that we officially close on needs to have takeout financing capabilities down the road. We want to make sure that we can get out of our loans and these sponsorship groups are going to be able to get out accordingly and have their projects still pencil at the end of the day.

We also like the shorter time frame. One of the questions I get asked without fail is: What does your aging vintage look like?" Many lenders still have loans on their books from 2020, 2021, early '22, before interest rates really started to go all over the place. We've got almost all of that off our book, which has been a very nice place to be able to reset moving forward. Today's returns are based on today's interest rates rather than those from five years ago.

And our strategy works. We've never had a negative month in 10 years. We're not going to ever be in the top 95th percentile of returns. But you look at us over 10 years, we're probably in the top 80th percentile because we just haven't had those negative phases, call it valleys, hit us. We're not looking for home runs. We're happy making steady progress around the bases with bunts and singles.

CONTRIBUTOR

Cory Johnson, CEO

CORPORATE OVERVIEW

Pender Capital provides CRE sponsors short-term private credit solutions, with an emphasis on originating and servicing loans in the $10 million to $30 million range, secured by the underlying real estate collateral in senior lien position. Pender Capital Management, LLC, an SEC-registered investment advisor, seeks to capitalize on inefficiencies in the mid-market and small-balance commercial real estate credit markets via funds that provide investors the opportunity for risk-adjusted returns, portfolio diversification and income.

CORPORATE CONTACT

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