Closing the Gap: Real Estate Debt Opportunities for US Pension Fund Investors

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In 2017, we wrote a series of articles for the *PREA Quarterly* discussing the opportunities real estate debt offered pension fund investors. As mentioned in those articles, historical performance data consistently support the conclusion that real estate debt is a strong diversifier in multi-sector portfolios. Despite this, pension fund investors generally struggled to find a home for the sector largely because yields were both lower than those real estate equity offered and in structures that set it apart from traditional fixed income allocations. Those hurdles are less daunting today. After a period of rising rates that appears likely to persist for some time, the return hurdles that once precluded real estate debt allocations are quickly becoming a thing of the past. The question today is not if a pension investor should invest in real estate debt but in what form and where in a portfolio it should sit.

Rising Rates and Rising Yields

The commercial mortgage loan universe comprises both senior commercial mortgages and subordinate debt, such as mezzanine loans and forms of preferred equity. The estimated size of the US real estate debt market is approximately $5.2 trillion in 2023, an increase of $1.6 trillion from the estimate made in the Winter 2017 *PREA Quarterly*. That article, titled "An Opportunity for Stability in Uncertain Times," speculates about the potential impacts of rising interest rates.[1] In addition to discussing potential risks, such as challenging refinancing scenarios and the repricing of collateral, the article highlighted a potential opportunity: rising yields.

Data from the American Council of Life Insurers indicates that the average interest rate of a fixed rate US commercial mortgage rose from 3.83% in 4Q2017 to 5.89% in 4Q2022. Although rates vary significantly according to the terms of each loan, interest rates on US senior mortgages are currently in the range of 5.0% to 7.5% as of May 2023 for most property types and markets. This represents a significant increase in yields since 2017, but it leaves senior mortgages in an awkward position relative to real estate equity and fixed income. Survey data indicate that in recent years, US pension funds expected total returns of 3.0% to 5.0% from fixed income and 7.0% to 9.0% from real estate. The result is that although fixed income professionals may find senior mortgage yields attractive, they may not feel comfortable or competent evaluating individual opportunities. And real estate professionals may feel comfortable evaluating those same opportunities, but they may still fall short of return hurdles, leaving real estate debt floating in a gap between the two. A combination of current market factors and analysis tools can allow both groups of investors to close that gap.

Relative Risk and Return Hurdles

For many real estate specialists, deciding whether to include real estate debt in their overall real estate allocations starts and ends with consideration of expected returns. In 2017, yields on senior mortgages were 3.0% to 4.0%, and yields on subordinate real estate debt were commonly 5.0% to 6.0%—both well below the 7.0% to 9.0% returns pension funds typically required for real estate equity. Moreover, the article "Late-Cycle Lending Strategies" in the Summer 2017 *PREA*

1. James Brusco and Sultane Cosaj, "An Opportunity for Stability in Uncertain Times: Commercial Mortgages in 2017 and Beyond," *PREA Quarterly*, Winter 2017.

Exhibit 1: Profile of Major Commercial Mortgage Debt Subsectors in 2023

Type	Typical Capital Stack Position by LTV	Hypothetical Required Returns	Hypothetical Relative Risk
Senior Mortgage	0%–65%	5.0%–7.5%	Lower
Second Lien	40%–65%	7.0%–10.0%	
Mezzanine Loan	50%–85%	8.5%–14.0%	
Preferred Equity	Varies	12.0%+	Higher

Source: MetLife Investment Management

Quarterly made the argument that based on historical performance, subordinate debt's additional spread over senior mortgages did not adequately compensate for the additional risk.[2] The story is very different today.

In March 2022, the Federal Reserve embarked on a rate-tightening cycle that sent yields higher across asset classes, including real estate debt. As shown in Exhibit 1, yields on senior mortgages now range from 5.0% to 7.5%, and forms of subordinate real estate debt, from lower-risk second-lien notes to higher-risk mezzanine and preferred equity positions, now offer yields ranging from 7.0% to greater than 12.0%. This substantial increase in yields presents US pension investors multiple options across the real estate debt spectrum that offer potential returns within or beyond the target return ranges of their real estate allocations.

Yields across the real estate debt spectrum have increased and spreads have widened. Throughout much of the past decade, yields on mezzanine and other higher-risk real estate debt structures remained clustered relatively close together in a range of 5.5% to 6.5% with only moderate movements to account for investment-specific factors. In the past 12 months, however, this range widened significantly as those same investment-specific factors took center stage. The result is that although spreads in 2017 between senior mortgages and mezzanine loans were often in the range of 200 to 300 basis points (bps), today that range is likely closer to 400 bps to 600 bps.

Employed in "Late Cycle Lending Strategies" was a real estate debt risk management tool, Moody's Commercial Mortgage Metrics, to project expected losses on senior and subordinate loans in multiple economic scenarios. The results at the time suggested that once adjusted for expected losses, subordinate debt yields were only modestly higher than senior mortgages in a positive economic scenario and significantly lower in a negative one. Given that the economy had been expanding for seven years at that time, the probability of experiencing such a negative economic scenario and associated declines in real estate values was not insignificant. Indeed, the decline in values arrived in 2022, and today, we predict the current trend of value declines is already more than half over, even if a modest recession occurs later in 2023. Therefore, contrary to our 2017 opinion, we place a greater emphasis today on expected losses under a positive rather than a negative economic scenario.

Before adding real estate debt as part of their overall real estate allocations, pension fund investors must answer two questions: Do real estate debt investments allow them to meet their return objectives? Do the forms of real estate debt that meet those objectives provide appropriate compensation for risk relative to other types of real estate debt? In 2017, we believed the answer to both those questions was "no." As outlined here, because of the higher yields offered by subordinate real estate debt and their wider spreads to senior mortgages, we now believe the answer to both questions is "yes."

The Financial Lingua Franca

Much like real estate equity, real estate debt instruments can be stratified according to expected levels of risk

2. Sultane Cosaj and William Pattison, "Late-Cycle Lending Strategies," *PREA Quarterly*, Summer 2017.

Exhibit 2: Recommended Spread Pickup by Credit Rating for US Real Estate Debt

Credit Rating	Typical Capital Stack Position by LTV	Attractive Spread Pickup	Very Attractive Spread Pickup
Aa	0%–40%	+35 bps	+70 bps
A	0%–65%	+35 bps	+70 bps
Baa	0%–75%	+40 bps	+80 bps
Ba	50%–70%	+45 bps	+85 bps
B	70%–85%	+50 bps	+110 bps

Sources: MetLife Investment Management, Moody's Commercial Mortgage Metrics

and return. Determining that level of risk, however, is complicated. In addition to underwriting the asset- and market-level risks they share with their equity counterparts, debt investors need to consider a range of additional factors associated with the structure of a loan, its length, and its place within the capital stack. This effort is difficult enough for a single loan, but it becomes even more difficult when judging the relative risks of individual loans against each other. To traditional fixed income investors, this presents a familiar challenge, and one to which they have long had a solution.

In 1909, Ernest Shackleton became the first person to reach the South Pole; William Howard Taft became the 27th US president; and far more important to this discussion, John Moody released the first publicly available bond ratings. These ratings attempted to stratify the risk and potential expected loss of individual debt instruments, revolutionizing the sector and becoming a core component of risk-management practices. In time, the ratings spread far beyond traditional fixed income and are commonly used today to evaluate asset-backed securities, including publicly traded commercial mortgage-backed securities (CMBS). Unlike corporate bonds and CMBS though, credit ratings for privately traded real estate debt are not widely available, but that does not mean they do not exist.

Experienced real estate debt investors have long utilized internally generated bond-equivalent ratings. These ratings incorporate a myriad of market-, asset-, and structure-specific factors and allow investors to compare debt investment opportunities within and across sectors. As discussed earlier, mortgage rating tools offer investors the ability to calculate expected losses on individual real estate debt investments. Each letter grade has an implied expected loss, but mortgage losses are binary, with most loans experiencing no credit losses. For investors that hold to maturity, non-defaulted assets ultimately earn the coupon rate regardless of how market value fluctuates through the life of the loan.

As an example for bond ratings, we examined a $21 million, 65% LTV senior mortgage opportunity, collateralized by an 86% occupied Houston warehouse portfolio in need of moderate upgrades/capex spending. Based on Moody's Commercial Mortgage Metrics tool, a loss of 7 bps per year was expected. Publicly available data on historical corporate bond losses maps that expected loss directly onto a traditional fixed income rating scale, allowing it to serve as a lingua franca between public corporates and private real estate debt. In this example, 7 bps of expected loss would equate to an A rating on the Moody's scale. A-rated corporate bonds were yielding around 5.4%, and this borrower was seeking financing at approximately 7.5%, or around a 210 bp spread (well above the 35 bp to 70 bp pickup suggested in Exhibit 2).

Armed with the ability to map real estate debt investments to a familiar framework, fixed income investors can focus on the question of required spread premiums. Real estate debt is, after all, less liquid than public corporates and typically carries higher fees because of the higher costs and specialized expertise necessary to originate and manage real estate debt investments. Exhibit 2 provides guidance on real estate debt pricing relative to public corporate yields when

categorized by credit rating. For A-rated real estate debt, for example, attractive spread pickups begin at approximately 35 bps and become very attractive beyond 70 bps. We believe that appropriate spread pickups widen when risk increases, such that we would hold the same views for B-rated real estate debt at 50 bps and 110 bps, respectively. Based on bond pricing at the time of this writing in early May 2023, we believe these recommended spread pickups suggest A-rated real estate debt should be viewed as attractive relative to public corporates today and that real estate debt rated from Baa to B should be viewed as very attractive.

Conclusion

As discussed throughout our series of articles in 2017, the potential benefits of real estate debt could justify specific allocations within pension portfolios, but we recognize that the acceptance of new asset classes takes time. For pension fund investors still reluctant to carve out specific allocations to the sector, there are solutions today. For real estate equity investors, subordinate debt opportunities now appear to offer yields capable of meeting or exceeding absolute return hurdles. For fixed income investors, the spread pickup on comparable risk senior mortgages remains attractive, and the challenge of evaluating individual opportunities can be met with familiar frameworks borrowed directly from their own sector. As a result, we believe the full spectrum of real estate debt offers pension fund investors the ability to satisfy allocations and return targets in multiple existing asset classes. ■

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