Opportunities in High-Yield Commercial Real Estate Debt

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Commercial real estate property values across virtually every sector have been under pressure as they adjust to elevated interest rates in response to the high-inflation environment over the past two years. As property values have declined, existing equity holders in some leveraged commercial real estate transactions are underwater, elevating stress levels in parts of the commercial mortgage lending market. We believe that within this environment, high-yield commercial mortgage investments have become more attractive and potentially offer the best opportunity we have seen in this segment in at least a decade.

Historically, the lower rates of return within this sector have been the largest impediment for institutional investors to enter the space. However, given attractive returns in high-yield commercial mortgage loans today, institutional investors should consider allocating to this sector. In this article, we highlight the opportunity and delve deeper into the capital structure to inform investors of the specific high-yield debt investment opportunities that exist today.

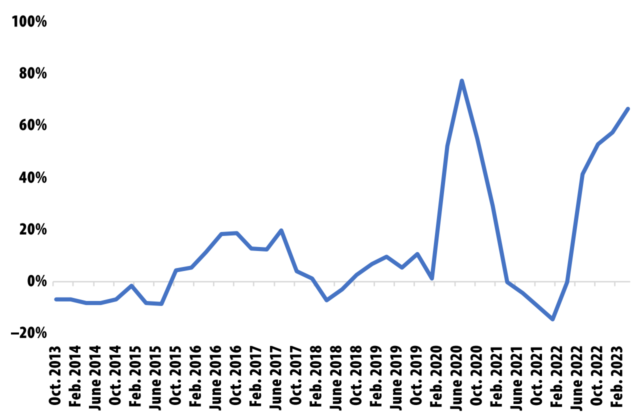
Why Is There an Opportunity in High-Yield Commercial Mortgages?

Commercial real estate opportunities are radically different today than over most of the past decade. Low interest rates and relatively stable property price appreciation have been replaced with a higher interest rate regime and turbulent price volatility. Over the past 18 months, interest and cap rates have been on an upward trajectory, negatively impacting property valuations and causing stress on lenders' balance sheets. Capital markets volatility and a lack of investor appetite have caused private-label commercial mortgage-backed securities lending to be at the lowest year-to-date level since 2012 (down 74% year to date versus 2022 YTD). More important, the recent US bank failures and rising scrutiny from bank regulators are causing knock-on effects that impact commercial real estate capital markets as lending standards from US banks have tightened in recent months to levels not seen since the depths of the COVID-19 pandemic shutdown (Exhibit 1). Increasing capital reserve requirements as a result of perceived challenges in the banking sector may cause banks to continue to curb commercial real estate lending in the short to medium term. According to the Mortgage Bankers Association, banks represent an estimated 39% of commercial real estate lending in the US, so any slowdown in lending activity creates a sizable gap.

In addition, the impact of remote working trends in the wake of the pandemic has negatively affected office fundamentals. Fewer workers are going into offices, and commercial real estate tied to office space is experiencing downward pressure on prices. In 2019, the office sector made up approximately 35% of institutional holdings, according to NCREIF, but that figure was down to 25% as of 1Q2023 because of price declines in the sector, and we expect it to continue falling next year.

Taken together, these factors have created a void in the high-yield commercial mortgage space. Opportunities exist for filling financing gaps for properties with economics that have been turned upside down. There are

Exhibit 1: Net Percentage of Domestic Banks Tightening Standards For Nonresidential Commercial Real Estate Loans



Sources: MIM, St. Louis Federal Reserve

Exhibit 2: High-Yield Debt Comparison

Attribute	Senior Commercial Mortgage Loans	High-Yield Senior Mortgages	Second Lien	Mezzanine Debt	Construction Loans	Preferred Equity
Maturity/Tenor	5 to 10 Years	3 to 5 Years	2 to 5 Years	1 to 5 Years	3 to 5 Years	3 to 5 Years
Fixed or Floating	Fixed and Floating	Fixed and Floating	Fixed and Floating	Fixed and Floating	Floating	Fixed and Floating
Collateral Type	Commercial Real Estate	Commercial Real Estate	Commercial Real Estate	Subordinate Position	Completion Guaranty, Land, Improvements	Subordinate Position
Property Type	All Property Types	All Property Types	All Property Types	All Property Types	Multifamily, Industrial, Hotel	All Property Types
Seniority/LTV Structure	Senior / 0%–65%	Senior / 0%–75%	Subordinate / 55%–80%	Subordinate / 55%–85%	Senior / 0%–50%	Subordinate / 50%–90%
Estimated Current Market Return/Spread	6.5%–7% / SOFR + 150–200 bps	7%–11% / SOFR + 200–600 bps	8%–15% / SOFR + 300–1,000 bps	9%–15% / T + 500–1,100 bps	8%–10% / SOFR + 300–500 bps	12%–20% / SOFR + 700–1,500 bps

Source: MIM

also opportunities with banks looking to sell or receive financing on their commercial mortgage loan portfolios to improve capital ratios. The higher expected returns in the high-yield debt space because of the pullback in lenders, weakening fundamentals in office, and higher interest rates may now be a good fit for many investors that shunned the space in the past citing lower expected returns. This confluence of factors has arguably driven more interest for high-yield commercial real estate debt than for high-quality senior commercial mortgage loans.

A Deeper Look at the Various Types of High-Yield Commercial Real Estate Debt

The high-yield commercial real estate lending universe is diverse and requires distinct expertise given its non-standardized nature. Within this universe, investors should consider five categories: high-yield senior mortgages, second lien, mezzanine, construction financing, and preferred equity. Each sector poses different risk and return profiles. Exhibit 2 outlines some key points of each sector.

High-Yield Senior Mortgages

Senior mortgages are the primary means of financing in the commercial real estate market. Within the broader senior mortgage space, high-yield senior mortgages focus on financing properties with outsized risks. The risks can arise from being concentrated in more-distressed sectors, such as office or mall. Other risks can be from the stage in the life cycle of the underlying property. Commercial real estate assets that are later in their life cycles and require capital improvements or repositioning can secure high-yield senior mortgages. These mortgages can also be underpinned by assets with significant upcoming lease rollovers.

Unlike some of the other high-yield debt sectors that can have accrual pay schedules, high-yield senior mortgages are mostly current pay and generate cash flow. They are first in priority in the case of a credit event and have structural protection from subordinate debt and equity positions that can insulate lenders from price volatility in the underlying asset. We believe this subsector of the high-yield commercial real estate debt universe is particularly attractive now.

Second-Lien Lending

A second-lien mortgage is typically collateralized by the property and is often part of the same mortgage as a senior loan, but it is subordinate in priority of payment in case of missed payments or foreclosures. Historically, second liens were originated by traditional commercial real estate lenders during economic expansions, when lenders were more willing to assume higher levels of risk while also receiving favorable capital charge treatments by regulators. Given the weak economic forecast, we expect second-lien opportunities to remain muted throughout the remainder

of this year and in 2024, although some opportunities from loan restructures will continue to transpire.

To illustrate the types of restructuring opportunities in the space, consider a $120 million mortgage on a property with an initial valuation of $180 million that is nearing its maturity, but an appraiser assigns the property value at $130 million. The borrower agrees to pay the mortgage down with $10 million in new equity capital while also putting a substantial amount of money into the property to help with renovations and leasing. The senior lender accepts these terms and creates a new $80 million loan but structures the loan as a $65 million senior mortgage, which will receive favorable capital charge treatment from its regulator, and finds a second-lien investor to provide the $15 million second-lien financing.

Second-lien notes like in our example would generally price with expected returns between 8% and 15%, with loan-to-value (LTV) ratios typically 70%–80%. Despite potentially attractive returns, we generally favor some of the alternative high-yield debt sectors in the market today.

Mezzanine Lending

Mezzanine loans provide subordinate financing for commercial real estate. They can be used for properties in various stages of their life cycles, ranging from core to development. Mezzanine loans are typically short to medium term with interest rates that are in excess of senior or second-lien mortgages but returns that are lower than preferred equity. They are not secured by the properties but instead are secured by a pledge of the ownership interest in the properties.

Mezzanine debt can have a coupon and current-pay structure but also can include some equity features. The mezzanine lending space is much less standardized and transparent than the senior mortgage sector. LTV ratios of mezzanine debt vary based on property type and can range anywhere from 55%–85% of a project. However, mezzanine LTVs are generally lower than they were in 2022 and earlier, primarily driven by cap rate expansion and general lender pullback.

Because of the drop in property values over the past year, we expect growing opportunities at more attractive terms and lower leverage levels to provide gap financing for properties with values that have declined. Risk premiums for mezzanine financing have increased relative to senior mortgages, and underwritten LTVs have become more conservative, providing opportunities for a stronger risk-adjusted return, in our view.

Construction Financing

Construction financing is short-term financing developers use during the construction phase of a new project. A construction loan is at a floating rate and is typically the senior debt position in the capital structure. After the completion of development, a higher-yielding construction loan is typically refinanced by a senior mortgage at a lower interest rate. Apart from recourse to the project, many construction loans require recourse to the borrower to provide additional credit support. Current construction loan-to-cost levels are roughly around 50% today versus 65% as recently as two years ago.

This subsector requires distinct expertise and understanding of a borrower's experience and ability to navigate some of the unique aspects of lending on a construction project. Unlike some of the other high-yield commercial real estate debt, construction lending typically has a delayed draw feature in which a borrower draws down funds over time to complete various stages of a project. This feature can create a drag on returns of unfunded commitments. Another unique feature of a construction loan is the interest reserve account, which is a budgeted line item from which the lender funds on a monthly basis to pay accrued interest during the construction period. The interest reserve account essentially uses borrowed money to pay its own interest, meaning that the borrower pays interest on the interest.

Primarily because of the recent pullback in lending from banks, pricing has moved up faster in this segment of high-yield lending than in any other. The amount of new commercial real estate development is cyclical with the economy, and therefore we expect future development to focus on property sectors that have a positive outlook, including industrial, hotel, and multifamily. Additionally, leverage in the construction financing space is lower because of higher interest rates and more stressed mortgage metrics such as stabilized debt yield and debt service coverage ratio.

Preferred Equity

The final major form of alternative real estate debt is also the most nebulous. Preferred equity terms have the most variability from transaction to transaction in the high-yield debt universe. Preferred equity is normally found at higher LTV ratio positions in the capital stack, but the range is extremely wide, from as low as 50% to as high as 90%. The type of funding can also vary, with some preferred equity opportunities consisting of a single lump sum payment akin to a senior mortgage on a stabilized asset, and others consisting of a series of fundings tied to progress on a capital project much like in a construction loan. The blend of how much of that interest is paid currently versus accruing to be paid off at maturity also varies widely, typically ranging from 0% to 50%. In cases in which there is no current pay, the position may also come with limited upside potential, bridging the gap between equity and debt. We believe the higher possibility of default for higher-yielding real estate debt gives a distinct advantage to investors that also possess real estate equity experience. We also believe real estate debt experience is a distinct advantage for preferred equity investors (despite its name) because the modern form is much closer to debt than to common equity.

The flexible and highly diverse structures of preferred equity positions make it difficult to stake out a firm for or against position, but attractive forms continue to emerge. Preferred equity is increasingly filling the gap in the construction lending market where many lenders are now reluctant to rise above 50% LTVs and is playing a vital role refinancing stable assets in troubled sectors along with one of the few structures more broadly available at higher LTVs. With interest rates commonly in the low teens even at moderate LTVs, those who have expertise in both real estate debt and equity may find many compelling opportunities.

Conclusion

Investing in real estate credit requires broad real estate debt and equity experience given its diverse nature made up of idiosyncratic subsectors. Although core senior mortgages offer lower risk, high-yield senior mortgages, second liens, mezzanine loans, preferred equity, and construction financing offer higher returns that now better align with institutional investors' return targets. These opportunities for higher returns, coupled with more-conservative structures create an appealing case for commercial real estate high-yield debt that now offers the potential for some of the best risk-adjusted returns in years. The US commercial real estate sector is one of the largest and most highly sought-after asset classes in the world, and despite some of the challenges it faces, parts of the sector, including high-yield real estate debt, offer compelling opportunities for institutional investors. ■

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