The Advantages of Allocating Capital to Private Real Estate Credit

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Through the years, the advantages of investing in private real estate credit (high-yield debt) have essentially remained the same: attractive relative value, equity cushion to absorb asset stress caused by unexpected events, real asset collateral to help hedge against inflation, floating rate/short duration to avoid major interest rate–driven markdowns, and returns composed primarily of income.

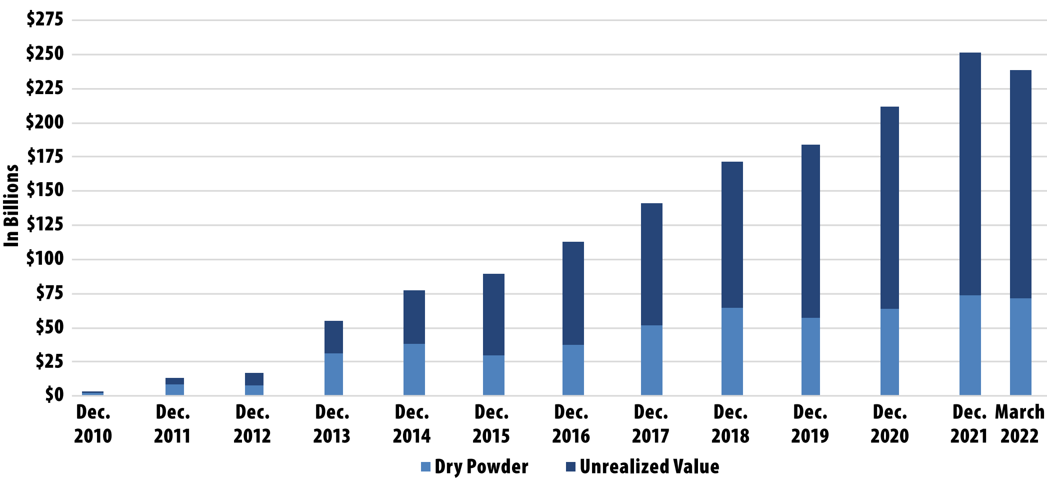
Exhibit 1 shows that private real estate debt funds have for the most part experienced steady growth—the advantages have spurred increased allocations. New debt investments made in the next couple of years should potentially benefit from underwriting post-inflation valuations, higher yields, and better visibility on the post-COVID-19 pandemic real estate landscape. In Principal Real Estate's opinion, the 2023 and 2024 vintage years could be two of the most positive over the next decade. Investors are gaining a renewed focus on the equity buffer/cushion and high current return during this period of uncertainty and market volatility. The opportunities today's market presents are outlined in this article, and I'll revisit some of the time-tested benefits of the private real estate credit space.

The Capital Gap Has Returned

The banking sector is under pressure on several fronts, including concern among bank management teams about how their books will perform going into the economic slowdown prompted by the Federal Reserve (Fed). Bank balance sheets are heavy from a flurry of activity in 2021. Banks are also under close scrutiny from regulators and face capital adequacy pressure from stress testing and other factors. In addition, existing loans are being repaid slower as borrowers exercise loan extensions that have below-market spreads and above-market proceeds (in many cases, capital infusion/paydown would likely be required if borrowers refinance). Banks are still lending but are being very selective and offering lower amounts of leverage. These circumstances are likely to persist until banks gain confidence that the slowdown has been successfully navigated, allowing for a renewed focus on earnings. There are several steps, including the Fed's reaching its terminal point and better visibility on the contour of the slowdown, before this conservative mindset begins to change.

When the banks tighten lending and offer lower loan-to-value (LTV) loans (i.e., 50%–55% LTV loans instead of 60%–65% LTV), borrowers will turn to subordinate debt

Exhibit 1: Private Real Estate Debt Fund AUM Growth



Source: Preqin, March 2022

Exhibit 2: Higher Cap Rates Provide for Lower Exposure Levels

Cap Rate Change Scenarios (bps)	Pre-Inflation Loan	50	75	100
Units (Multifamily)	175	175	175	175
Net Operating Income	2,000,000	2,000,000	2,000,000	2,000,000
Cap Rate	**4.25%**	**4.75%**	**5.00%**	**5.25%**
Value	47,058,824	42,105,263	40,000,000	38,095,238
Hypothetical Value Change	**NA**	**–11%**	**–15%**	**–19%**
LTV	70%	70%	70%	70%
Loan	32,941,176	29,473,684	28,000,000	26,666,667
Loan per Unit	**188,235**	**168,421**	**160,000**	**152,381**

Source: Principal Real Estate, Dec. 2022; for illustrative purposes only

capital sources to fill the capital gap. Loans that would have been all senior debt in late 2021 will now feature a conservative senior portion combined with subordinate debt. Alternatively, a borrower may take a stretch senior mortgage from a nonbank lender and pay a higher spread to gain the additional proceeds. The securitization markets will also look to use traditional subordinate debt to improve the certainty of the executions around the financing.

This conservative senior debt dynamic will improve the leverage levels of the debt investments made and help offset the reduced flow of slower acquisition activity. Existing loans will come due that need to be paid off, and the borrowers will be required to refinance/recapitalize these assets. As observed during prior periods of stress, the capital gap has once again emerged as an opportunity.

Reset Values Lead to Better Entry Points and Lower Exposure Levels

As interest rates—short and long end of the curve—increased in 2022, the higher debt costs put pressure on property valuations. This adjustment to a new rate environment will take some time to settle, and the ultimate range of the ten-year Treasury will be a significant driver (as opposed to the projected next 12 months of the Secured Overnight Financing Rate [SOFR], which is temporary in nature). The classic bid-ask quasi stalemate will most likely exist for non-forced sales until investors feel valuations have reset to a reasonable level.

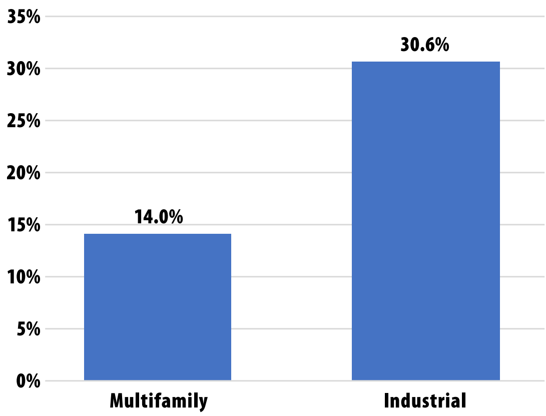
One way to gauge the magnitude of the in-process valuation adjustment is to analyze several capitalization rate (value = income/cap rate) scenarios relative to pre-inflation (fall 2021). Exhibit 2 shows how the values of a hypothetical multifamily asset could change depending upon where cap rates settle. The table also provides insight into how a newly underwritten loan, made on an asset with a value that has been reset, will result in a lower exposure level. All else being equal, the lower exposure is a credit positive. In reality, the underwritten LTV for new loans will also be lower until the market stabilizes, helping to further drive exposure levels down.

Whether the post-inflation valuation decline is 5% or 20%, new debt investment/loans will be sized to reset values, generating a fresh equity buffer and lower exposure levels. This is one of the reasons the 2023 and 2024 vintages should more than likely be in a favorable credit position versus legacy loans.

Private Real Estate Credit Remains a Solid Complement And Hedge to Core Equity Holdings

As highlighted, property values are in the process of adjusting to higher debt costs. Even the preferred property types are not immune to this dynamic. Although Principal Real Estate is still constructive on industrial and multifamily over the long term, coming off years of very strong appreciation, an allocation to credit with a current income focus is a logical complement to core equity.

Exhibit 3: One-Year Value Appreciation for Multifamily and Industrial—3Q2022



Source: NCREIF Property Index, July 2022

Real estate credit investments are typically less sensitive to rental growth. Lease trade-out numbers remain impressive, although they moderated in late 2022 for many projects. However, the pending economic slowdown makes rental growth in years two to five harder to predict. Again, the fundamentals in the preferred property types are healthy, but the upside is less clear in comparison to a few years ago. Exhibit 3 shows the trailing four-quarter appreciation for multifamily and industrial assets ending in the second quarter of 2022.

Relative Value Continues As in Years Past

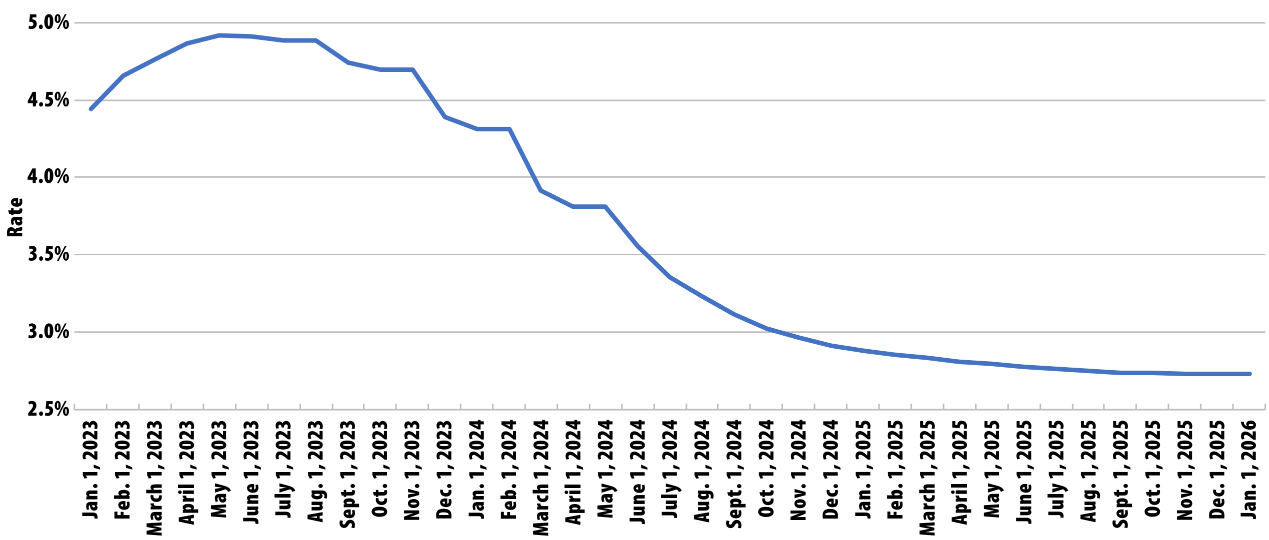
For BB to BB+ type of risk in today's market, yields of around one-month term SOFR + spreads of 450–550 (8.5% to 10% depending upon tenor) are available for subordinate debt investments. Most of this return is in the form of current income, providing cash flow to investors as well as good relative value compared to corporate alternatives. BB corporate spreads as of early December 2022 were in the 280 basis point range (ICE BofA BB US High Yield Index).

Private Real Estate Credit in the World of Elevated Inflation

Short Duration

The majority of loans in the subject space are structured as floating-rate debt. The accompanying low-duration profile has been a positive for investors as interest rates have risen, resulting in losses of 10% to 20% in some fixed-income portfolios in 2022. The Fed will likely start to cut rates (expected in 2023), lowering the floating-rate yields; however, the market anticipates short-term rates to stay above 2.5% in the future, as shown in Exhibit 4. Lenders use the forward curve in modeling yields knowing it isn't an effective predictor of rates beyond 12 months. However, it is hard to envision that the Fed will cut rates too aggressively with the inflation

Exhibit 4: One-Month Term SOFR Forward Curve



Source: Chatham Financial; Jan. 2023

Exhibit 5: Commercial Real Estate Correlation With Inflation (4Q1977–3Q2022)

	CPI	Commercial Real Estate (Total Return)	Commercial Real Estate (Income Return)	Commercial Real Estate (Appreciation Return)	US Investment-Grade Bonds (Total Return)	US Equities (Total Return)
CPI	1.0000	0.4048	0.2143	0.3703	−0.1122	−0.0150
Commercial Real Estate (Total Return)	0.4048	1.0000	0.1541	0.9835	−0.1316	0.0608
Commercial Real Estate (Income Return)	0.2143	0.1541	1.0000	−0.0270	0.2004	0.0723
Commercial Real Estate (Appreciation Return)	0.3703	0.9835	−0.0270	1.0000	−0.1697	0.0484
US Investment-Grade Bonds (Total Return)	−0.1122	−0.1316	0.2004	−0.1697	1.0000	0.1490
US Equities (Total Return)	−0.0150	0.0608	0.0723	0.0484	0.1490	1.0000

Sources: NCREIF, Bloomberg, Principal Real Estate; Dec. 2022
Notes: Private real estate returns reflect the NCREIF National Property Index. Investment-grade bonds reflect the Bloomberg US Aggregate Index, and US equities reflect the S&P index. Indices are unmanaged, and individuals cannot invest directly in an index. Color coding denotes similar correlation ranges.

fight fresh in their minds. This means that short-term yields will likely have a fairly solid floor at or near the Fed's inflation targets and that the Fed will be reluctant to cut rates too far.

Real Assets

The Fed is taking very aggressive measures to control inflation and will eventually succeed. However, Principal Real Estate's house view is that inflation, once in the system, takes time to diminish, and 2022 won't be the last year with inflation points above the Fed's target. The loan collateral for credit investments consists of real assets composed of land and improvements. Historically, commercial real estate has had a positive correlation with inflation, as shown in Exhibit 5. When inflation occurs, such as in the current environment, the resulting higher construction costs (labor and materials) should slow the new supply, benefiting existing properties. Interestingly, inflation is indirectly slowing supply by increasing debt costs and making it difficult to project returns on new developments.

Summary

With the tailwinds of reset valuations, higher yields, and improved property-type information, 2023 and 2024 are well positioned to outperform most years. New investments should be underwritten to reset valuations, and improved property-type information is available for sectors such as office. In addition, banks' conservative posture should allow for opportunities to enter the capitalization stack that did not exist previously and at LTV levels (first and last dollars) that weren't available pre-inflation. Private real estate credit investments have a margin of safety via the equity buffer, which is worth more during periods of volatility. Finally, the high current income typically generated by credit investments should help stabilize portfolio returns in a period in which there is uncertainty about the economy and future rental growth. ■

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