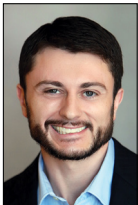


Private Credit to the Rescue! (Or Too Little, Too Late?)



Rob Kochis
The Townsend Group

Will commercial real estate survive the looming “wall of debt maturities” over the next few years? As real estate markets remain significantly frozen, while many traditional lenders sit on the sidelines, and as capital formation crawls along, the availability of financing is an issue of concern in many headlines. Private credit funds targeting real estate may provide a helpful relief valve. But will these funds offer enough capital to dent the problem?



Nick Moné
The Townsend Group

In this column, we track capital raising for real estate funds. We strive to identify a variety of data and trends as investment managers offer private market commingled funds for investment

by mostly institutional investors. This article focuses on capital raising for real estate debt funds. Rather than buying equity, this subset of real estate funds focuses on offering credit: mezzanine loans, bridge loans, and senior-secured, as well as more-opportunistic strategies focused on the acquisition of troubled loans for workout or foreclosure.

Tracking Fundraising in Institutional Real Estate

As a consultant advisor to numerous public and private pensions, foundations, endowments, and other capital sources, The Townsend Group reviews approximately 300 new real estate fund offerings per year on a global basis. These include both closed-end and open-end funds targeting real estate equity and debt strategies. Although The Townsend Group also reviews products targeting other real assets (such as infrastructure, timber, agriculture, and other natural resources), this article focuses on real estate funds only.

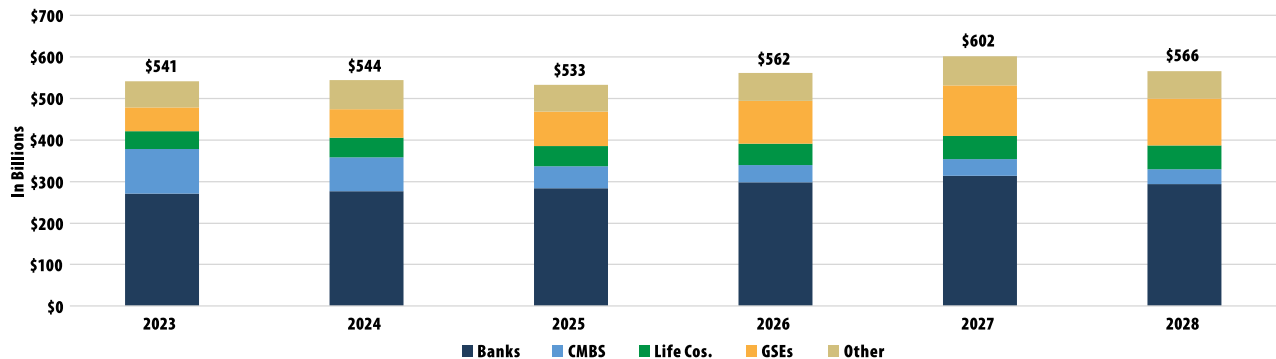
When a sponsor approaches The Townsend Group with a new fund, the product is entered into a database. The sponsor is asked to identify essential terms and characteristics, which are logged. Logged items include a description of strategy or target sector, geographic focus, forecast returns, fee structures, intended use of leverage, target fund size, and more. This database is updated as the sponsor proceeds through its fundraising. The fund sponsor is asked to provide closing dates (and the amount raised). Having done this for more than 30 years, The Townsend Group has a rich database for tracking fundraising trends in real estate.

How Bad Could the Problem Be?

The industry faces an unprecedented collection of events, and these events are material and significant. As a result of central banks’ aggressive tightening of monetary

policies around the world, borrowing rates for real estate have essentially doubled. In the US, real estate valuations have been in decline for two years. Real estate is a capital-intensive asset class, and borrowed capital is often a

Exhibit 1: Commercial Mortgage Maturities by Lender Type



Sources: Trepp, Inc., Federal Reserve Flow of Funds; as of Sept. 30, 2023

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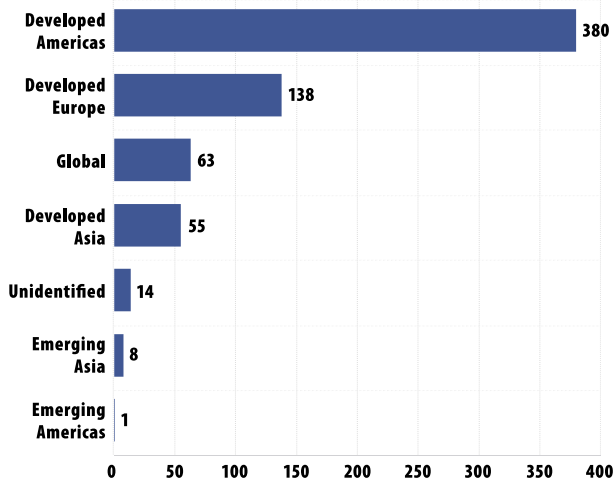
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¹Source: Institutional Real Estate Inc., Global Investment Managers 2023 Special Report

Exhibit 2: Closed-End Private Debt and Real Estate Funds Currently Available in the Market



Source: The Townsend Group; all data as of March 31, 2024

substantial part of a real estate investment structure. The availability and cost of that borrowed capital often drives real estate market cycles, so it is particularly concerning that debt is less available and significantly more expensive today, during a material market correction.

As has been widely reported, the volume of commercial real estate debt maturities is increasing in the US. Putting stress on the industry, an estimated \$2.8 trillion of existing real estate debt will mature over the next five years (Exhibit 1). That debt must be addressed during this period when valuations are down and debt is less available and significantly more expensive.

With many lenders sitting on the sidelines, can private market fundraising fill the gap? An easy answer is “not completely.” However, the trend in fundraising over the past two years is not encouraging.

Real Estate Funds Currently Available for Investment

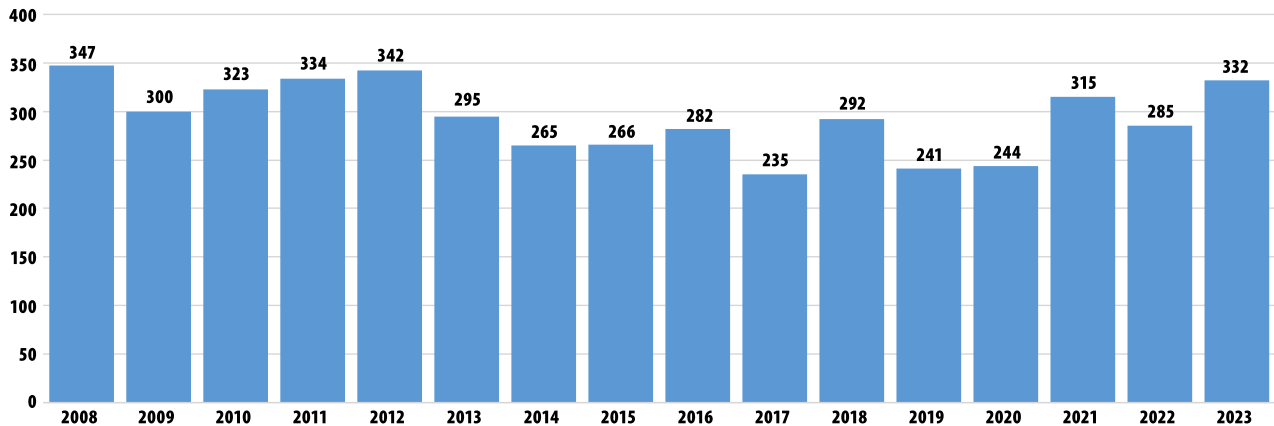
Generally, the number of institutional fund offerings is rising. The Townsend Group is currently tracking more than 650 real estate funds offered for investment. The sponsors of these funds collectively are estimated to be seeking to raise more than \$300 billion for both equity- and debt-related investments. As shown in Exhibit 2, more than 440 funds are actively fundraising for strategies targeting North America or “global,” strategies that will likely invest meaningfully in the US.

The number of new real estate funds offered each year has generally been increasing since 2017. As might be expected, over the past three years, since the COVID-19 pandemic interrupted the economy, new fund launches averaged more than 310 funds each year—the highest level of new funds The Townsend Group has tracked since periods associated with the global financial crisis (Exhibit 3).¹

Unfortunately, fund offerings do not always equate to capital raised. The Townsend Group data suggest that the spigot of private market capital mostly closed

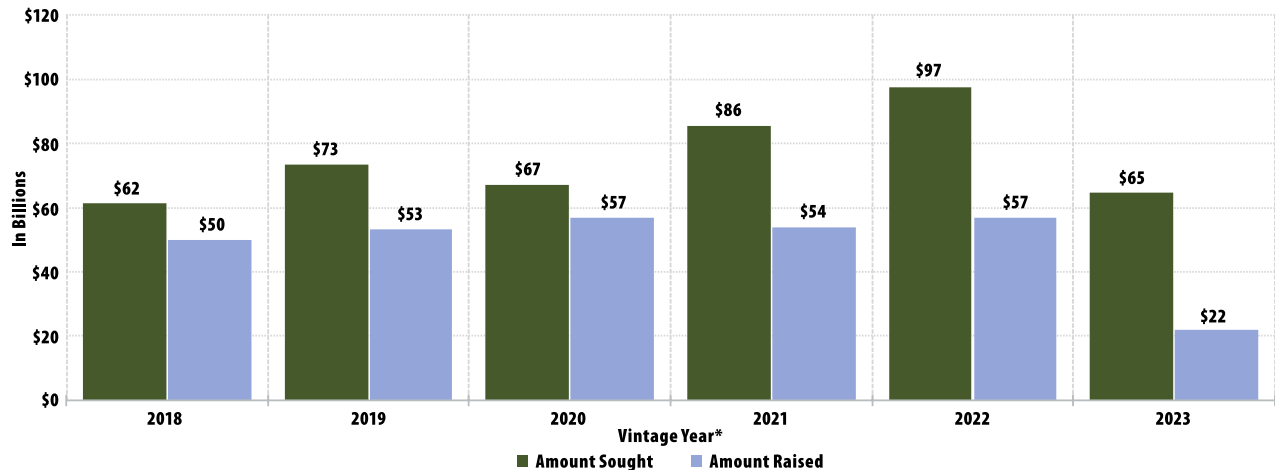
1. We associate the global financial crisis with the period extending from mid-2007 through early 2009. The number of new funds offered increased during the financial crisis as well as during the years that immediately followed.

Exhibit 3: Number of New Closed-End Real Estate Funds Launched



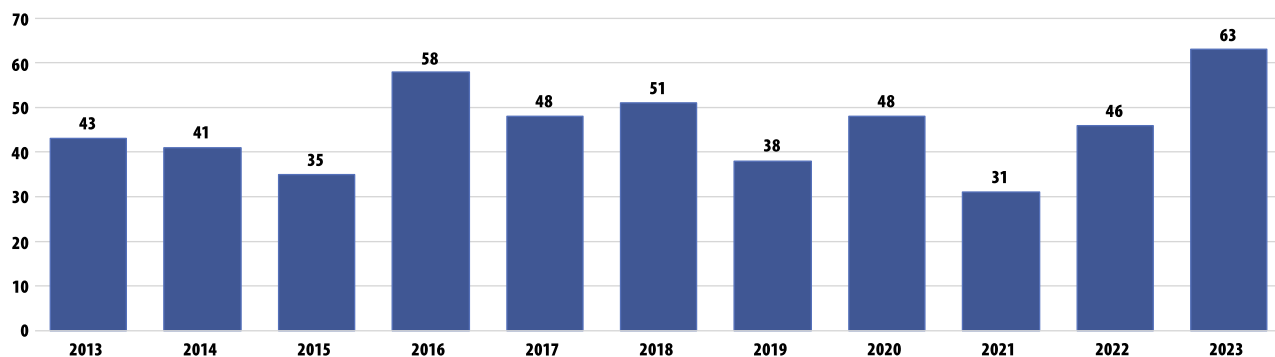
Source: The Townsend Group; all data as of March 31, 2024

Exhibit 4: Capital Raised for Closed-End Debt and Real Estate Funds



Source: The Townsend Group; all data as of March 31, 2024
 *Vintage year is based on actual or targeted initial closing.

Exhibit 5: Closed-End Private Real Estate Debt Funds Launched



Source: The Townsend Group; all data as of March 31, 2024

as markets froze in 2022. At that time, the US Federal Reserve began an unprecedented series of interest rate hikes. Institutional investors largely stopped investing. Capital raised dramatically dried up (Exhibit 4).

Based on other data sources, The Townsend Group’s figures on actual capital raised are likely understated.² However, the trend is undeniable (as many fund sponsors are no doubt keenly aware). Calendar year 2023 in particular was a very difficult year to raise capital for institutional real estate investment.

Spotlight on Real Estate Debt Funds

Not surprisingly, an increasing number of real estate debt funds have been offered in response to current market conditions. Indeed, fund offering materials often refer to

the “wall of debt maturities” as the opportunity upon which such funds will capitalize. As shown in Exhibit 5, The Townsend Group tracked 63 new real estate debt funds offered in 2023—the highest in a single year for which data are available, even higher than during the aftermath of the financial crisis.

Despite the growing number of debt fund offerings, such funds are not faring much better on the fundraising front. Indeed, the amount of capital raised by debt funds appears to be significantly below expectations over the past two years. We estimate more than 100 debt funds offered in 2022 and 2023 sought to raise more than \$80

2. Fund sponsors do not always provide timely updates on actual commitments made. Because of underreporting or lagged reporting, actual capital raised is likely greater than reported here.



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billion; however, the amount raised so far is less than one-third of that target. This is based upon actual fundraising results reported by the fund sponsors.

Adding to manager frustrations, not only has the amount of capital raised apparently declined but also the pace of fundraising has been much slower. The Townsend Group tracks the time a manager is “in the market” raising capital, as well as the timing of reported fund closings. Based upon manager reports, 50% to 60% of debt fund offerings since 2021 did not have a first closing within six months of launching the fundraising. Historically, nearly two-thirds of new real estate funds offered held a closing during the first six months of fundraising. A similar phenomenon occurred during and after the financial crisis, when the pace of fundraising also appeared to slow considerably. Based on the above, investors have been particularly stingy with capital for real estate debt funds since the US Federal Reserve took action in 2022 (even more stingy than funds committed to traditional real estate equity funds).

Will Private Market Debt Funds Fill the Lending Void?

Real estate debt funds are not likely to change the dynamics of anticipated loan maturities in the coming years. The sheer volume of commercial real estate debt dwarfs the capacity of the universe of private market real estate debt funds. Although sponsors are offering more products (clearly in recognition of reduced lending by traditional sources), the amount of capital raised has been too slow and too little to fill the lending gap materially.

No doubt other sources of private capital will help alleviate the stress associated with illiquid markets. Looking at the broader (and larger) universe of real estate funds raising capital (not just the debt funds), many traditional real estate funds have flexible mandates and can structure creatively on a deal-by-deal basis to fill a lending gap. It would not be a surprise to see higher equity commitments or preferred equity structures become more prevalent across many real estate funds in the years to come.

Private fund capital might create a “multiplier” effect for lending generally. Traditional sources (such as banks) may increase availability of financing in connection with private fund investment. For example, a mezzanine loan may reduce the loan-to-value ratio for a first mortgage

lender, thereby reducing the lender’s risk. A preferred equity investment may increase the creditworthiness perceived by a first mortgage lender that would otherwise not make a loan. Real estate funds may contribute to opening the lending spigot from traditional sources.

Finally, The Townsend Group’s fundraising data capture real estate funds specifically. A larger universe of private credit funds invests across a diverse spectrum of opportunities, of which real estate is only one sector. The Townsend Group data do not capture many diversified private credit offerings that also target corporate credit, syndicated loans, or asset-backed lending outside of real estate. Anecdotally, it appears that the number of diverse private credit funds is growing in a manner consistent with the real estate debt funds that populate Townsend’s database. This broader pool of lending for special situations will likely help alleviate stress within the universe of real estate borrowers.

Conclusion

The real estate debt market is enormous and diverse. It will require a multitude of capital sources to ease the pain of the looming wall of debt maturities. We believe real estate debt funds will play a role by providing needed capital, but they cannot solve the potential problem alone. Although managers of real estate debt funds are likely frustrated with the pace of fundraising, they are most likely eager to invest what capital they raise. Given the sheer size of the real estate lending market, debt managers with capital to invest probably appreciate the opportunity to pick and choose to find the highest-quality buildings and strongest credit borrowers. ■

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