

KEYNOTE INTERVIEW

Capital markets illiquidity spurs refinancing challenges



*Rising interest rates are creating challenges for commercial real estate sponsors, complicating the refinancing of existing debt amid a shrinking lender pool, says **Eric Smith**, chief executive and managing partner of Locust Point Capital*

Commercial real estate borrowers in the senior housing sector and beyond continue to grapple with higher interest rates and illiquidity which is making it harder to refinance existing loans or obtain new financing. As a result, more borrowers are looking at short-term options to bridge through today's higher rate environment, explains Eric Smith, chief executive and managing partner of Locust Point Capital.

The firm is a credit-focused alternative asset manager that invests in the US senior housing sector, focusing on providing tailored capital solutions to owner-operators.

These solutions serve as bridge financing, assisting borrowers until they can refinance out to permanent capital

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such as Fannie Mae, Freddie Mac, or HUD loans, Smith notes. "Throughout this year, we have seen a notable increase in the demand for bridge financing, specifically refinancings, primarily due to capital market illiquidity leaving borrowers unable to extend or refinance their existing debt," he says.

This illiquidity is occurring across many sectors as the majority of banks have significantly scaled back their lending activities. "But it is especially pronounced in the commercial real estate sector, and borrowers have increasingly sought alternative non-bank

financing to address this growing financing illiquidity gap," he adds.

As lenders and borrowers seek to work through legacy issues, Smith has observed several changes.

"I believe the primary focus in the current interest rate environment is centered around cashflow and ability to service higher interest rate debt. To attain the desired debt service coverage ratios, there has been a significant reduction in leverage. Nowadays, capital is only flowing to the strongest deals with the highest DSCRs. This shift has left marginal deals, which might have been feasible in a lower interest rate environment, unable to secure financing," Smith says.

Furthermore, Smith has observed

Bridge Lending

that obtaining financing, especially for larger transactions in secondary and tertiary markets, has become increasingly difficult.

“This difficulty is further compounded by the limited number of banks that remain actively lending within these markets. Additionally, specific real estate asset classes, such as offices, are extremely difficult to finance, whereas asset classes displaying robust demand growth and minimal correlation with the broader economy, such as senior housing, are easier,” he adds.

Q Locust Point focuses on senior housing and care properties – why this focus?

Locust Point’s focus on senior housing and care properties is driven by what we believe are the compelling attributes of this market segment.

One standout feature of this asset class is the demographic outlook. The 85-plus age group is projected to nearly triple in size, surging from 6.7 million in 2020 to an estimated 19 million by 2060. A significant proportion, approximately 70 percent, of this demographic is expected to require some form of long-term care.

This demographic shift creates a growing demand for senior housing and care properties, offering a promising avenue for investment opportunities.

Furthermore, senior housing has proven to be a resilient asset class during tough economic times due to its needs-based nature, which makes it largely independent of broader market fluctuations. That is why I believe senior housing may be an attractive option for institutional investors to consider.

Q Are you seeing an increase in demand in bridge lending? What are borrowers hoping to achieve with short-term loans?

I think that borrowers are actively seeking capital from any available



Q How are you structuring these loans? And are borrowers having trouble getting rate caps?

In the current lending landscape, being adaptable is crucial. We’re actively working alongside our borrowers, using various approaches to provide the financial support they need during these challenging times.

For example, in some of our transactions, we’re helping our borrowers manage their increased interest rate costs by arranging financing for in-the-money interest rate caps at SOFR strike prices of 3 percent or less. Additionally, we’re tweaking the ratio between the current coupon and payment-in-kind on a temporary basis to offer extra assistance to our borrowers.

This ability to creatively problem solve alongside borrowers is where non-bank institutions often have an edge, as they can be more flexible in designing loan structures compared to traditional banks.

“In the current lending landscape, being adaptable is crucial”

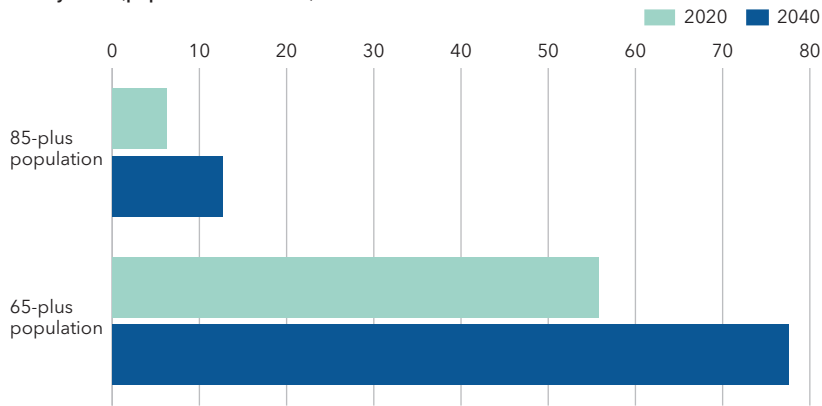
ERIC SMITH

source. Due to the limited liquidity within the banking sector, they are increasingly turning to non-bank financial institutions to secure financing. Considering the prevailing interest rate environment, borrowers are inclined to opt for short-term financing with the intention of waiting for a potential drop in interest rates before committing to permanent financing or executing on a sale.

Q What are the different types of loans you can provide?

Locust Point Capital is a direct lender, specializing in a wide range of financing options, including senior mortgages, subordinate debt, A/B, unitranche and preferred equity structures. Our strength lies in our ability to tailor

The demographic outlook of the US indicates the 85-plus age group is on track to nearly triple in size by 2060 (population in millions)



Sources: Census Bureau, CBO

capital solutions that align with the unique financing requirements of our borrowers.

Q How important is flexible financing to these sponsors today? What kinds of problems are you working with sponsors to solve?

In today's market, adaptability as a lender takes precedence. Borrowers are confronting an array of challenges, including maturity issues, working capital shortages, heightened operating expenses, valuation uncertainties and various covenant-related issues. So having adaptable capital structures that can address these diverse challenges is crucial to sponsors.

And commercial banks' lending less is compounding many of these issues. In fact, there are significant differences across the range of capital providers in the sector: banks, insurance companies, private funds and fincos. Banks and insurance companies can be less flexible because of regulatory requirements. And certain private funds and fincos also can be less flexible depending on the way, and the terms on which, they source capital.

Even within the private credit funds context that I am most familiar with, not all senior sector lenders are created equal. For example, private funds that employ greater leverage inherently possess less flexibility compared to

credit funds that derive their returns from the inherent strength of their underlying assets.

So, borrowers need to carefully evaluate any constraints on a particular lender's flexibility, and ask whether those constraints will limit that lender's agility in today's complex financial landscape.

Q Generally speaking, market participants agree rates will be higher for longer. What does this mean for you as a lender?

I agree that interest rates are likely to remain higher for an extended period. Looking back over the past 15 years, the Federal Funds rate has consistently remained below 2 percent, contributing to historically low mortgage rates. Recently, the 10-year Treasury yield has been bouncing around the 5 percent range for several weeks, and it seems reasonable to anticipate that it may stabilize at this level if not go higher.

In general, investors tend to seek higher returns when they perceive greater risks. Considering the ever-expanding size of the US deficit, investors may indeed demand higher returns for Treasuries, driven by a subtle apprehension regarding the government's ability to meet future debt obligations.

If the 10-year Treasury yield settles

around 5 percent, it's likely that commercial mortgage rates will remain elevated, a development that carries both positive and negative implications. It's important to distinguish between legacy loans and newly originated loans in this scenario.

Most lenders are encountering challenges within their commercial loan portfolios with those loans originated during a period of near-zero interest rates, especially those featuring floating rates without interest rate caps.

However, when it comes to newly originated loans, lenders can anticipate a more favorable environment, characterized by robust collateral, higher interest rates and lower leverage compared to the past decade.

Collectively, these factors suggest that we may be on the brink of entering one of the most promising lending markets we've seen in quite some time.

Q What is your outlook?

I believe the next decade could see institutional investors leaning more toward debt allocations over equities. This shift is influenced by the concept of a sea change introduced by Howard Marks, emphasizing the need to adapt to evolving market conditions and investor behaviors.

Ongoing economic uncertainty, driven by factors like geopolitical tensions and fluctuating interest rates, is a key driver of this trend.

In such an environment, institutional investors are likely to favor assets offering stability and predictability. Additionally, a growing aversion to risk may lead to a preference for debt investments over equities, potentially extending to specialized asset classes like senior housing, which are known for their stability and lower market correlation. I believe this sea change concept highlights the importance of diversification and capital preservation, suggesting that the upcoming decade may be termed the decade of debt. ■