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## PERE 2023 US Debt roundtable

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## US lenders tackle the 'higher for longer' puzzle

*Interest rate increases have raised credit spreads but reduced dealflow in the US. Real estate lenders say it is time for buyers and sellers to have a meeting of minds to reactivate the market. By **Alicia Villegas***

As six industry executives gathered in New York for PERE's US debt roundtable at the end of August, markets had further confirmation that interest rate hikes were here to stay. Four days before the roundtable, Jerome Powell, chair of the Federal Reserve, warned higher rates may be needed to cool still-too-high inflation, although he promised to proceed with care. Softer data from the US economy has bolstered expectations that the Fed will take a breather from rate hikes, but a rate cut is not yet in sight.

With rates in the US set to stay higher for longer, some real estate professionals, like Tim Podboy, managing director at Chicago-based manager Heitman, expect a challenging environment for lenders due to a decline in property transaction volumes.

According to Moody's Analytics, commercial real estate lending volumes are estimated to dip below \$500 billion in 2023, a drop of 38 percent compared to the \$816 billion originated last year. "Our view is that things are going to continue to be really choppy for the next six to 12 months, especially in light of the recent Fed signals," Podboy says.

He notes that many recent transactions have been out of necessity rather than choice, with real estate buyers and sellers not on the same page yet, although "that is starting to thaw just a little bit."

Craig Oram, managing director and head of debt originations at LaSalle Debt Investors, the US debt fund platform of manager LaSalle, says the market is currently in transition, yet the firm has managed to close some loans. "Since March this year we have closed eight transactions. We're still

quoting transactions that don't happen, and there are plenty of brokers out in the market who want to pursue a dual process for their clients, exploring refinance and sale options at the same time. But transactions are happening for the right buyers and sellers as well as for the right property owners who have to move on because their lenders aren't willing to extend."

In this vein, Matthew Rosenfeld, managing director and head of US debt at real estate equity and debt manager Cain International, sees "stratification" where deals are getting done. "It's either deals that have to get done because owners need financing or transactions need to take place. Or, at the other end of the spectrum, it's very high-quality deals with great sponsors that are getting done because there's still dry powder and people want to push through."

He adds: "I wouldn't say it's business as usual. It's everything in the



### Craig Oram

Managing director, head of debt originations, LaSalle Debt Investors

As head of debt originations, Oram's responsibilities include sourcing, pricing, structuring, underwriting and closing of debt investments at LaSalle Debt Investors. He also serves on the firm's US debt investment committee.

### Daniel Schapiro

Managing director and head of real estate credit, CIM Group

Schapiro oversees all investment activity for CIM's property credit platform, with \$10.5 billion of assets under management. His 17 years in the industry include extensive experience in real estate finance and investment management.

### Matthew Rosenfeld

Managing director, head of US debt, Cain International

Under Rosenfeld's leadership, the debt business of Cain International, a privately held investment firm with more than \$16 billion in assets under management, has committed over \$2 billion in new originations across the US since 2018.

### Eric Smith

Chief executive officer, Locust Point Capital

Smith is a founding member of Locust Point Capital, a specialized credit manager focused on the US senior housing industry with \$1.3 billion in assets under management. He has spent the past 25 years investing in the senior housing and care sector.

### Tim Podboy

Managing director, Heitman

Podboy leads an investment team focused on structured equity and senior debt at Heitman, a global real estate investment manager with \$53 billion of total assets under management, of which \$5.8 billion is in private debt. He is also an equity owner of the firm.

### John Lippmann

Head of structured debt, New York Life Real Estate Investors

Lippmann runs structured debt and manages the firm's Madison Square Structured Debt Fund. The investment management division of insurer New York Life manages \$684 billion of assets, around \$68 billion of which is in real estate.



*“Things are going to continue to be really choppy for the next six to 12 months”*

**TIM PODBOY**  
Heitman

middle that is definitely in a state of flux.”

John Lippmann, head of structured debt at New York Life Real Estate Investors, the real estate arm of New York Life Insurance Company, agrees: “On the origination front, we are seeing a tale of two worlds. For very high-quality transactions, there is a fair amount of competition, especially in the development space. And then there’s everything else, some of which has had a big fall in value.”

Daniel Schapiro, managing director and head of real estate credit at Los Angeles-based manager CIM Group, describes the market as “quiet” due to

the impact of the interest rate spike on mortgage REITs.

In the equity space, transaction volume has picked up over the past couple of months, he says, although most buyers are not yet willing to pay the prices that sellers are willing to transact at, with some exceptions seen in hospitality and multifamily.

Senior housing, however, has experienced the opposite trend, with more deals being done at the beginning of the year than today, says Eric Smith, chief executive officer at Locust Point Capital, a specialized credit manager focused on the US senior housing industry.

“Over the last six weeks we’ve seen tremendous liquidity being sucked out of the market, especially on senior housing from the banking sector. Traditional banks have really tightened credit tremendously.”

Although there is less debt available in the senior housing space, the credit quality of the transactions that are closing is better in this environment than at the beginning of the year, Smith notes.

“Leverage is down dramatically. At the beginning of the year, we were looking at deals that were on a total leverage basis – senior plus subordinate – probably around 75-80 percent.

We're now down on a market basis to about 70 percent on all-in debt."

### Dry powder on the sidelines

In this 'higher for longer' period, there is a large amount of dry powder waiting on the sidelines. But in order for this capital to be put to work, property valuations need to adapt to the elevated rate environment.

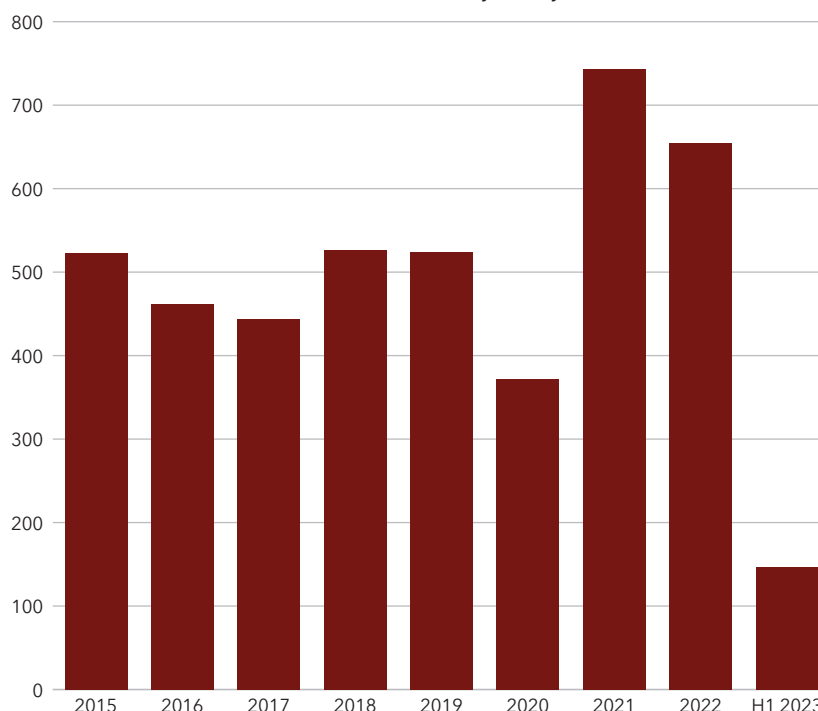
"We need sellers to come to the reality that we may be in this elevated rate market longer than they anticipated," Podboy says. Once they come to that realization – or are forced to through debt maturities and cap rates that may continue to elevate – private equity is going to come off the sidelines and underwrite capital stacks with less debt needed, he argues. "That, in our view, will facilitate a reawakening of the market, which will benefit us on the private credit side."

For Lippmann, the big impetus that would bring dry powder into the market would be a more active senior lending environment that could drive transaction volume and leveraged returns. "The banks will have to restart lending in the senior tranches to finance the returns required by that dry powder – to coax it into the market. Once we see senior lenders come back to the market, both real estate fund equity and subordinated debt will come in."

Rosenfeld agrees: "You think about the cost of capital of that dry powder, it needs that bank debt or that senior leverage in order to make it work. The question is when that senior leverage becomes available or whether investors reprice their own capital to start to fill the void. We've certainly started to see that. And senior lending has become a lot more attractive than it was 18-24 months ago."

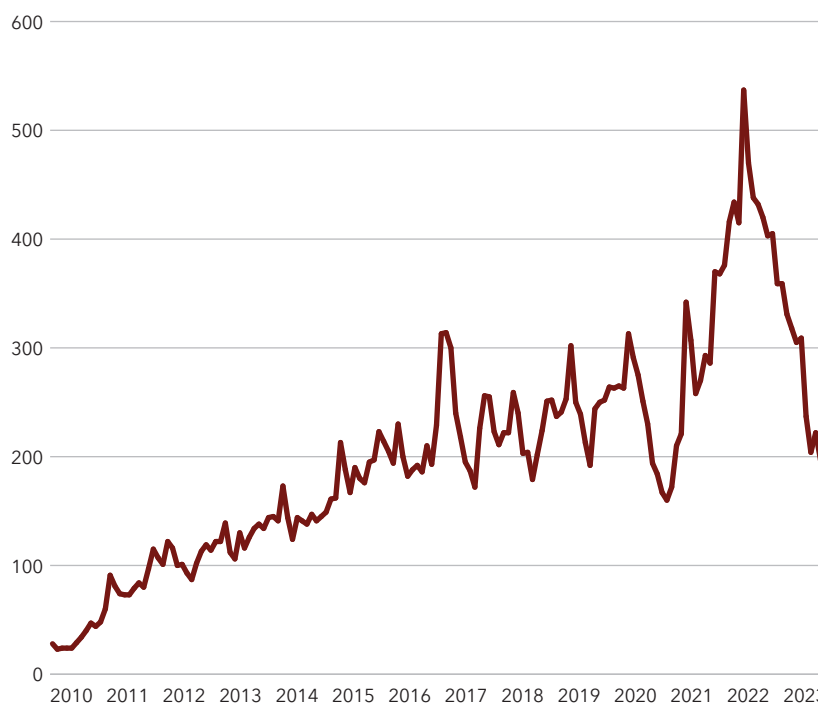
At the moment, equity and debt investors are deploying capital "patiently," which is partly driven by the banking world, Schapiro notes. Banks, however, are not going back to financing property on their balance sheets

US commercial real estate transaction volumes fell 60% year-on-year in H1 2023 (\$bn)



Source: JLL Research, Real Capital Analytics

The CBRE Lending Momentum Index, which tracks the pace of CBRE-originated or brokered commercial loan closings in the US, declined by 53.5% when compared with the loan volume of a year earlier



Source: CBRE Capital Markets and CBRE Research, Q2 2023

as actively as they have historically. Instead, they are planning to use their balance sheets for a much smaller subset of borrowers, he argues.

“Instead of doing direct loans, banks are allocating more balance sheet capital to warehouse and repurchase facilities. We believe that’s where the banks are going to be more focused going forward. Private debt funds that are well capitalized will be active, because there is access to capital on the senior side to leverage their positions.”

Smith agrees: “Over the next five to 10 years, I believe there’s going to be a fundamental shift in the banking industry, especially in real estate, where banks are going to do less direct real estate transactions and their exposure is going to be through funds.

“We’ve been approached by several banks offering to provide credit facilities as opposed to doing direct lending.

What we believe will happen over the next decade is that banks will reduce their direct loan exposure, focusing on loans that have the strongest cashflow and highest debt service coverage ratio. New construction and heavy value-add transactions – or anything that has some hair to it – will be financed by private credit funds and finance companies that provide this type of credit.”

As banks retreat, private debt lenders are set to gain market share – and capitalize on better loan pricing in a volatile market.

“When we look at the overall floating rate of loans we have closed over the last 18 years, for the majority of this time we were in a band of 5-7 percent,” Oram says. “As we went into covid, overall loan rates started to go lower, and for much of 2021 and 2022 we were lending for less than 4 percent. But now lenders are achieving spreads

of 300 basis points and more – with today’s one-month term SOFR, you’re earning 8.5 percent current pay before origination or exit fees are included. These are the highest loan rates we have ever originated.”

As real estate credit spreads widen, the asset class attracts more capital. “We’re seeing really positive momentum to add incremental dollars to debt or debt-like strategies because the nominal returns are now approaching what used to be core-plus equity or even joint-venture equity, depending on where you’re playing in the debt space. And then if you are able to leverage your position, the returns may frankly outpace anything that you’re doing today as equity,” Podboy says.

“It’s a great time to be a lender,” Lippmann says. “We are seeing the ability to get outsized spreads for the risks that we’re taking. There’s a lot of

*“Transactions are happening for the right buyers and sellers as well as for the right property owners who have to move on”*

**CRAIG ORAM**  
LaSalle Debt Investors





*“Senior lending has become a lot more attractive than it was 18-24 months ago”*

**MATTHEW ROSENFELD**  
Cain International

## The valuation challenge

### Reduced deal activity is also creating difficulties for lenders when it comes to valuing property

“It’s incredibly challenging if you don’t know what the cap rate is today – there’s no trades, no comps,” says Cain International’s Matthew Rosenfeld. “When you’re in the private credit or the debt space, you have a lot more room to maneuver because, in your underwriting, you can add 100 basis points to your exit cap – so you’re still okay, we can live with it.”

“If you’re the equity you don’t have that luxury, it’s a whole lot more challenging. You’ve got to put yourself in their shoes sometimes and just be a bit more flexible, provide some leeway.”

For Daniel Schapiro at CIM Group, the key to understanding valuations in today’s challenging market is “to look at long-term interest rates and where the 10-year [Treasury] is going to settle and then what a generic spread is in whatever market you’re targeting between the 10-year Treasury and what the cap rate is over a 20- or 30-year basis. You can triangulate – it’s, depending on what sector, somewhere between 150 and 400 basis points over the 10-year [Treasury].”

LaSalle Debt Investors’ Craig Oram adds: “A mortgage broker said to me 18 months ago: ‘When are we going to get back to the situation when you can buy a stabilized, multifamily property, take out agency debt and have a high single-digit return on your equity?’ And when you look at the difference between interest rates and current cap rates, they haven’t diverged enough for that to happen.”

“We recently went back and looked at some of our old investment committee memos and what we were underwriting for a takeout rate in, say, 2012. For example, the takeout interest rate was 5.5 percent, and we were stress-testing our cap rates back then on a Class B multifamily property with a 6.75 or 7 percent cap rate. When you look at the historical premium, it’s a little bit scary from the equity perspective.”

“If interest rates end up being higher for longer, then that’s where they’re going to have to be because sponsors have to make a cash-on-cash return on a stabilized property. You can’t always guarantee there’s a value-add component where you can grow the NOI.”



*“Banks are going to do less direct real estate transactions and their exposure is going to be through funds”*

**ERIC SMITH**  
Locust Point Capital

relative value in the real estate space for active lenders.”

### Unlocking value

Despite the decline in real estate deal volumes, US lenders are finding value in alternative asset classes with positive demographic fundamentals that provide more certainty in this volatile market.

“Of the sectors that we’re seeing perform very well, I put the alternatives at the top of the list,” Podboy says. “Student housing, at a national level, experienced 8-9 percent rent growth year over year and the expectation is that we’re going to continue to see a

very strong year coming up. We’re still very bullish on things like self-storage; although those markets, due to some supply increases, have started to soften a little bit, we still think the long-term trajectory with self-storage is very positive.”

In the alternatives space, senior housing has maintained valuations and experienced strong rent growth, Smith notes. “Occupancy lows as a result of covid occurred in the first quarter of 2021 and have been building quarter after quarter. We’ve had eight consecutive quarters of occupancy increases on a national basis. We’ve had two consecutive years of rental

rate increases on a national basis of anywhere between 6 and 12 percent. From our operators, we are hearing that rental rate increases for 2024 are going to be slightly lower, between 5 and maybe 10 percent.”

Lenders also favor multifamily and industrial, but say there is still value to be found in the traditional, struggling asset classes of office and retail – albeit selectively.

“In terms of office, I think we’re all being very careful, but we all appreciate the utility of office in the world of the future. It will be interesting to see how users decrease their footprint over time and what the optimal amount of time in

the office is. We're watching that on a user-by-user basis in terms of tenants in our portfolios, both in our lending and direct equity books," Lippmann says.

Oram cuts in to ask: "Would you lend on an office today?"

"Sure," Lippmann says. "There are certain markets today where there are fundamental improvements, increases in usage. We're not opposed to office, but we are very selective. The reality is that on a new deal, the advance rate is going to be impacted. The cost is also going to be high because the risk is high."

"We believe in office," Rosenfeld says. "We have 830 Brickell in Miami, which was a fully spec office building. It's now close to 100 percent pre-leased, and that's a testament to the right market, the right location and the right product where there was none. It was the first office building built in the Miami CBD in a decade. We are financing offices as well. New build, both pre-leased and speculative, in very selective markets with very selective sponsors. You're getting paid for the risk, but we still believe in the use."

Podboy, however, observes that the negative sentiment around office is probably the worst he has seen for any sector in his entire career. Retail, meanwhile, seems to be gaining positive momentum within the lending community, he notes.

"We don't have much retail, but we like it at this point," Schapiro says. "The retail story has played out in terms of the winners and the losers. It's not many of the losers that are really left at this point. In [recent] loans on retail properties, [I've seen] strong



*"We're not opposed to office, but we are very selective"*

**JOHN LIPPMANN**  
New York Life Real Estate Investors

sales, increasing year over year, and good tenant demand.”

“We don’t have a huge amount of retail, but I would expect in the next 12 months we’ll add to our retail exposure,” Rosenfeld says. “We’re seeing opportunities on the fixed-rate side, taking over from where the banks are not able to lend.”

### What is to come

Just as lenders have renewed their interest in retail, which could result in more opportunities, activity across the property market is expected to improve in 2024. Nearly \$1.5 trillion in commercial real estate debt is maturing by the end of 2025, according to Morgan Stanley.

Oram says: “Borrowers are going to have to pay these higher interest rates,

or these assets are going to have to transact at a discount. Transaction volume is going to have to increase with these refinances coming up.”

Smith believes interest rates will stay higher for much longer than expected, which will impact liquidity until 2025. “Origination volumes are going to be muted in 2024, similar to 2023, as opposed to prior to the rate cycle.”

For Podboy, it could be at least until the middle of next year before activity really picks up. “We’re seeking to raise even more capital to supercharge [our strategies] because we do think it’s very hard to predict when things will wake up, but they will eventually. And we want to be ready with even more dry powder because we’re pretty enthused by the relative risk-adjusted return when that does happen.” ■

*“Banks are allocating more balance sheet capital to warehouse and repurchase facilities”*

**DANIEL SCHAPIRO**  
CIM Group

