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Special Report

CREDIT: INVESTORS' APPETITE GROWING; MANAGERS' JOB GETTING HARDER

Managers boosting credit offerings

BY ARLEEN JACOBIUS | APRIL 17, 2017 12:01 AM

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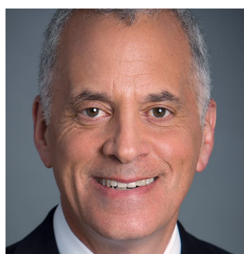
Money managers are betting investors will continue to shift a portion of their real estate allocations to credit and that the new money pouring in won't swamp the investment opportunity.



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Barry Blattman, senior managing partner at Brookfield Asset Management, says real estate debt's ability to provide steady cash flow appeals to investors.

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Pacific Investment Management Co., Oaktree Capital Management (OAK) LP (OAK), Brookfield Asset Management, Hermes Investment Management, Blackstone Group LP, AXA Investment Managers, Colony NorthStar Inc., Kildaire Partners and Cerberus Real Estate Capital Management LLC are among the private equity and real asset firms offering real estate credit strategies.

"In the commercial real estate world there's been a number of folks raising money for so-called debt funds," said Jim Costello, senior vice president of New York-based real estate research firm Real Capital Analytics Inc. "Folks formerly investing in equity are raising money for debt."

Managers are hoping to capitalize on the prevailing investor sentiment that at the mature stage of the real estate cycle, credit is a little safer than equity. What's more, there is a view that the commercial mortgage-backed securities originated in 2006 and 2007 are coming due and will need to be refinanced, Mr. Costello said.

In 2016, 43 real estate debt funds closed with $22.5 billion, up from a combined $16.7 billion raised by 44 funds in 2015, according to London-based alternative investment research firm Preqin.

But a few recent developments "have thrown cold water" on the strategy, Mr. Costello said.

President Donald Trump's view on repealing the Dodd-Frank Wall Street Reform and Consumer Protection Act is encouraging banks to re-enter the real estate lending business, Mr. Costello said.

In 2016, local and regional banks accounted for 20% of the real estate loans, up from 9% in 2012.

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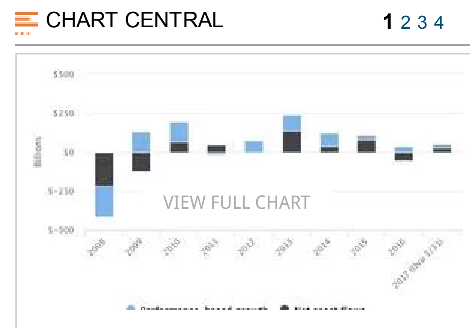

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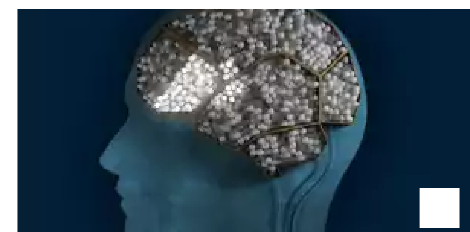

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Banks are stiff competition for real estate credit managers because they have a lower cost of capital.

"Banks are very competitive," Mr. Costello said. "They are better situated for the needs of local borrowers."

Instead of competing with banks on safer first-mortgage positions, some real estate credit managers are lending to riskier properties such construction deals in need of additional financing, and projects that other lenders, including banks, wouldn't touch, Mr. Costello said.

Still, there is a lot of demand for debt capital, he said. Banks tend to provide the safer, first-lien debt, leaving demand for mortgages on riskier properties and borrowers than the banks would accept, Mr. Costello said.

Barry Blattman, vice chairman and a senior managing partner at real asset manager Brookfield Asset Management, New York, said real estate debt is attractive to investors in a low-interest-rate environment because it can provide steady cash flow.

In response, the field of managers vying to invest in real estate debt is growing, especially on the direct lending side, Mr. Blattman said.

"We are seeing tremendous interest amongst global sources of capital in direct lending," he said. "Sometimes when the markets get flush with capital from sources around the world … overall pricing is affected by lenders that want to lend on more and more deals."

The successful lenders will be the ones that are disciplined, understand the properties and do not add leverage on leverage, Mr. Blattman said.

"I think we are in a good spot right now in terms of opportunities," he said.

Real estate buyers have remained disciplined in that they will leverage properties to 80% or 85% of loan-to-value at the top end, rather than the 90% or 95% loan-to-value that was popular before the global financial crisis, Mr. Blattman said.

Bruce Batkin, CEO of commercial real estate debt manager Terra Capital Partners, New York, said it is uncertain how much of the capital raised will be deployed in credit. But the amount of capital looking to invest in real estate credit is not having an impact on Terra's lending business.

"Our pipeline of transactions is as robust right now as it has ever been," Mr. Batkin said. "I'm not seeing the effect of the new money into the space."

Indeed, the environment is the opposite of what one would have predicted at this point in the real estate cycle, said Mr. Batkin.

For example, there is less leverage on construction loans: 70% to 75% loan-to-value on ƒ financing, he said.

"This is helping to mitigate any potential bubble," Mr. Batkin said. "You're in a conservative credit environment. I don't think the major banks want to increase the leverage point on senior loans."

At the same time, commercial mortgage-backed securities issuers are "feeling their way" around the securitization risk-retention rules requiring CMBS (as well as collateralized loan obligation and non-residential asset-backed loan) issuers to retain 5% of the value of the new securities they originate, he said.

"They are all trying to figure out the formula to maximize their profitability" in light of the new rules requiring managers to have more capital, Mr. Batkin said.

At the same time, construction is picking up after being latent for most of the current real estate cycle, providing lending opportunities, he said.

"Overall, since 2009 we are in a very sensible part of the credit cycle for new development," Mr. Batkin said. However, there are some sectors that Terra executives are staying away from, including hotels.

"We think the hotel cycle is in a very mature stage. We are concerned about the changes in currency valuations and we are concerned that international travelers will not come (to the U.S.) in the same volumes as in the past."

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Terra executives also are concerned with what Mr. Batkin called the "Airbnb effect" — technology changes that are cutting into hotels' business.

Terra executives do like senior housing and the redevelopment of old warehouses into new, high-end quality industrial for construction loans, Mr. Batkin said.

Overall, there is a need for real estate credit, especially with new CMBS issuers holding back, fewer banks lending for real estate than before the crisis and $300 billion to $400 billion a year of CMBS maturing that will need to be refinanced, he said.

While the CMBS maturation expected for 2017 is expected to fall short of the annual average of $300 billion to $350 billion since the financial crisis, there is "still a lot to choose from a lender's perspective," Mr. Batkin said.

Indeed, some industry insiders think that heretofore unpopular pockets of the U.S. securitized mortgage markets, such as non-agency mortgage-backed securities, could provide a better illiquidity risk premium.

"We believe non-agency conduits are re-emerging … the spreads are at attractive levels," said Thierry Adant, investment consultant credit research in the New York office of consulting firm Willis Towers Watson.

It's one of the sectors that are less liquid but in which investors could be compensated for the illiquidity by getting in while prices are low, he said.

In 2006, non-agency RMBS was more than 56% of new issuance or $1.17 trillion. By 2008, non-agency RMBS had shrunk to $52.6 billion, or a mere 4.3% of new issuance. At the end of 2015, non-agency RMBS issuance had increased only marginally to a very modest $75.9 billion or just 5.4% of all new issuance in 2015.

Even so, Mr. Adant says that many in the industry expect the non-agency market to grow to around $500 billion in the next five-to-seven years, which is roughly 5% of the U.S. mortgage market.

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