# Frontier International

## US property debt: a challenging landscape

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# About Frontier

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on over $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.


## Andrew Kemp

Head of Defensive Assets
and Private Markets

Andrew Kemp joined Frontier Advisors in 2016 and is the Head of Defensive Assets and Private Markets. His team undertakes research and ratings on liquid fixed interest strategies, private asset classes including private debt and equity, and provides specialist advice in the currency and derivative overlay segments.

Andrew has more than twenty years of experience in the asset management industry both domestically and globally, having worked in Australia, Singapore and the UK.

Prior to joining Frontier, Andrew worked for a decade at Alliance Bernstein Australia as a fixed income portfolio manager, spent three years as Head of Fixed Income at DBS Asset Management in Singapore and then joined Chimera Capital as Director of Asset Management, primarily in Singapore. Andrew holds a Bachelor of Commerce (Finance) from Otago University (NZ) and a Graduate Diploma of Applied Finance and Investment from Finsia.


## Nam Tran

Senior Consultant

Nam Tran joined Frontier Advisors as a Consultant in 2017 and was promoted to Senior Consultant in January 2021. He is a senior member of the Defensive Assets and Private Markets Team with a focus on Private Markets.

Previously Nam worked with NAB in the institutional banking area, undertaking industry and credit analysis in the Resources, Energy and Utilities sectors for ten years.

Prior to this, he spent three years with KPMG and the Sarbanes Oxley team at NAB, undertaking financial and operational analysis of clients in the financial services industry, and three years with HSBC in Vietnam in corporate and institutional banking. Nam holds a Bachelor of Business from Monash University, a Master of Commerce from the University of Sydney, and is a CFA charterholder and CAIA charterholder.



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# Introduction

Our Private Markets Team recently embarked on a virtual research trip to better understand how US property debt managers are adapting to sharp changes in interest rates, demographics, and sentiment. This paper summarises the key observations from our research trip and highlights the risks and available opportunities investors should be aware of.



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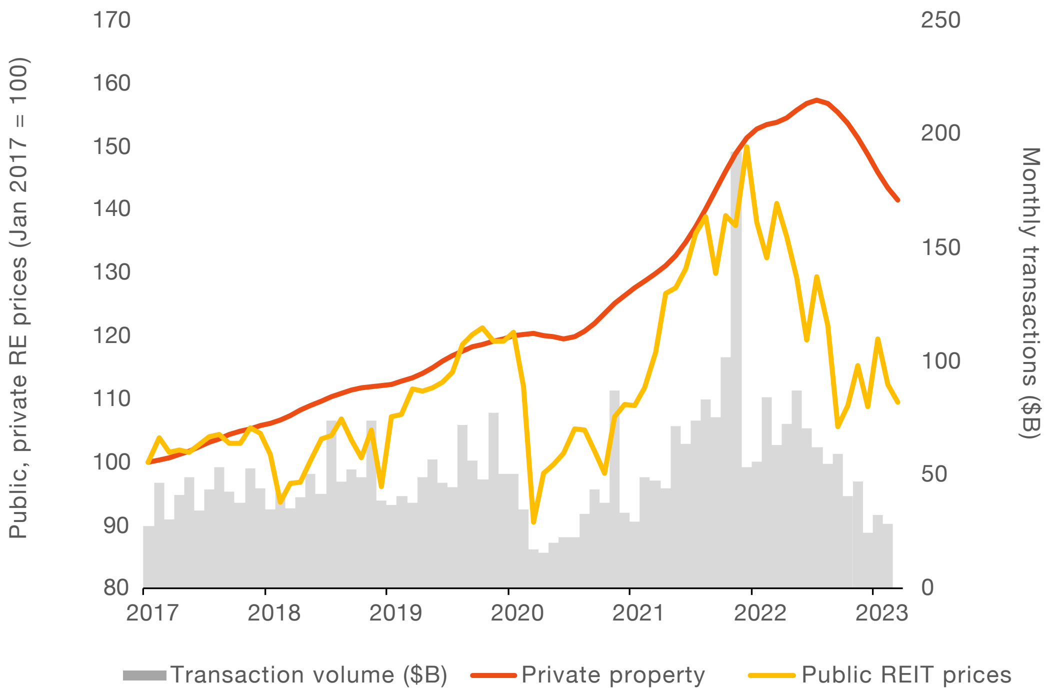
# US property market – a difficult backdrop

There have been significant challenges and risks to real estate investing in the past 15 months with rising interest rates and inflation, as well as changes to investor demand and risk appetite. Against that backdrop, public property REIT prices fell materially in 2022. While this same trend has yet to be observed in private property, some prices have softened from their peak, and further declines are anticipated. As Chart 1 shows, transaction volumes in the US real estate market have fallen from the 2021 peak. In our discussions managers consistently noted lower property acquisition activity, which in turn has led to lower demand for credit to support such acquisitions. Lower transaction activity has also led to difficulty in determining the true market valuation of the property which is a key issue for investors. That said, some managers expected acquisitions activity would likely increase once rates have stabilised. Many managers emphasised the dry powder of private equity property funds is high (current dry powder is estimated at about US$300b[1]), and deployment will most likely need to occur in the next few years, driving up transaction activity.

**Chart 1:** US transaction activity has dropped




Source: Barings, Bloomberg, Federal Reserve, NAREIT, NCREIF. 31 March 2023

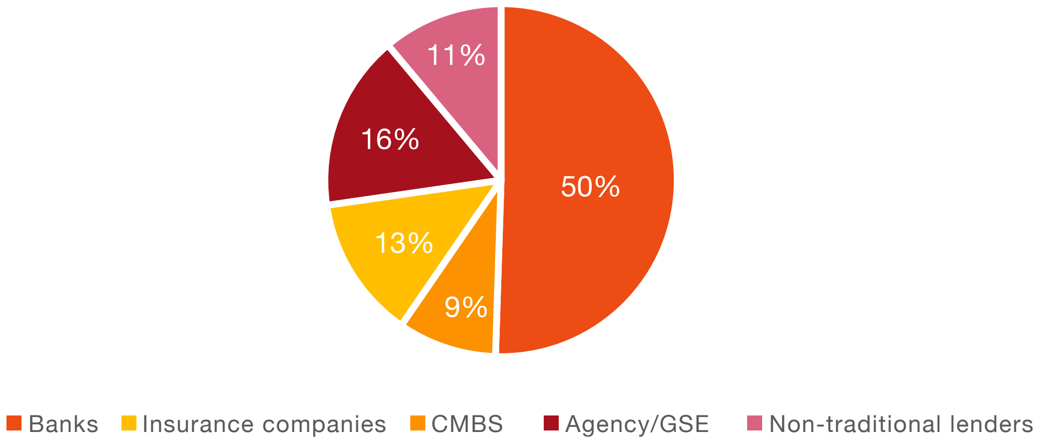
[1]Source: Deloitte 2023 commercial real estate M&A outlook

# US property debt – a large, diverse market

The size of the US property debt market is substantial with the commercial and multifamily mortgage market estimated to be ~US$5.5 trillion. The sources of funding are diverse (see Chart 2) with non-bank funding sources accounting for half of the market. Non-bank, non-traditional lenders (such as credit funds) account for an important portion of around $600 billion or ~11% of total market. As the banks tighten credit standards in a rising rate environment, managers believe non-traditional lenders will see more opportunities.

Managers have also highlighted that regional banks traditionally have been very active property lenders. As a result of the US regional bank crisis, and likely increased regulation on regional banks in the future, lending appetite from regional banks is expected to be greatly diminished. It is still unclear what the full impact of regional banks pulling back from the property debt market will be and how this may change the market dynamics. However, borrowers are expected to find financing and refinancing more difficult to achieve and more expensive, which may lead to stress and distress in some instances. For certain large, well-established and well-funded non-traditional lenders, this may create an opportunity to further displace the banks and capture more market share in the years ahead.

**Chart 2:** Composition of lenders in the US property debt market




Source: Nuveen, Federal Reserve, Bloomberg. 30 September 2022



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## Multiple property debt strategies to suit different needs

Well-established managers normally have different strategies with varying risk/return profiles to suit different investors' needs. From a portfolio perspective, managers indicated investors can use property debt as a replacement for corporate bond allocations (*low risk strategy*), a component of private debt allocations (*mid risk*), or an alternative to property equity (*high risk*). Table 1 shows a summary of different strategies.

**Table 1:** Types of property debt strategies

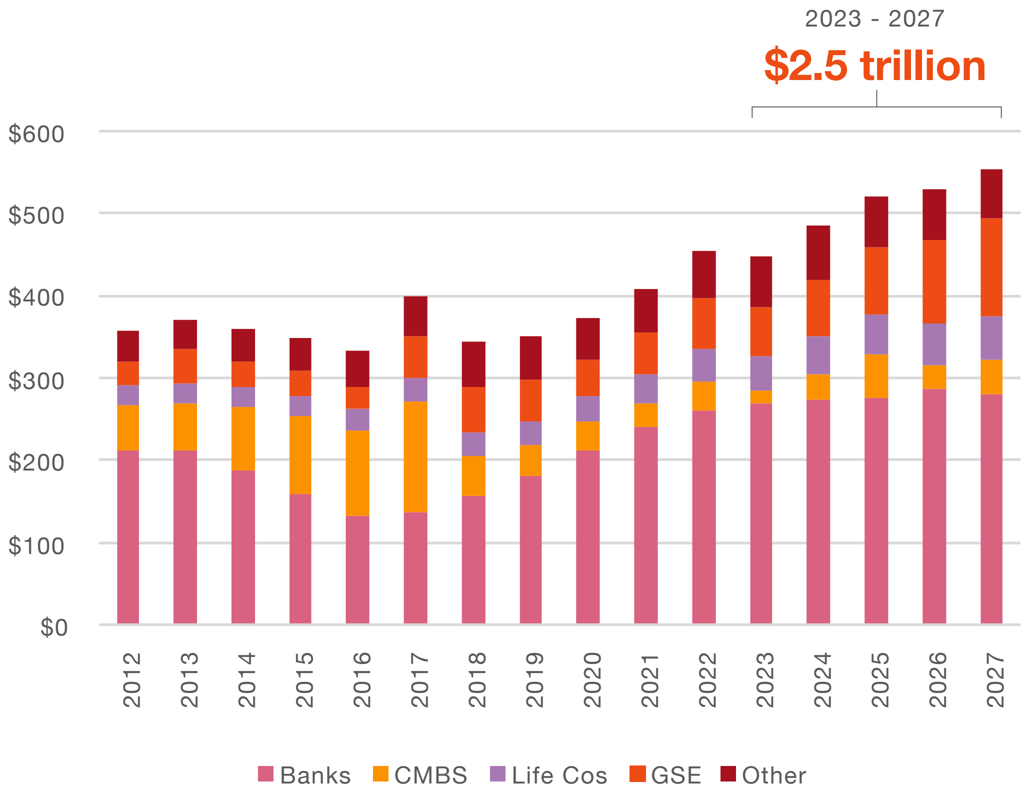
| Risk profile | Low risk | Mid risk | High risk |
|---|---|---|---|
| **Description** | Senior debt, IG, Low Loan to Value (LTV) | Mainly senior debt, medium-high LTV | Short term, high yield lending. Can include mezzanine debt |
| **Property** | Core assets | Transitional assets (core plus/value-add assets) | Construction, value-add, opportunistic, special situations |
| **Duration risk** | Yes, fixed rate and floating rate loans | No, floating rate loans | Minimal |
| **Benchmark** | IG corporate bond index | Total return | Total return |
| **Fund leverage** | No | Yes | May include some leverage |
| **Product format** | Open-ended | Open-ended/closed-ended | Closed-ended |
| **Return target** | Lowest return. Seek to outperform benchmark by 100-120bps gross of fees | Medium return. High single digit (7-9%) net of fees | Highest return. 10%+/low double-digit net of fees |

Source: Managers, Frontier Advisors

# Maturity wall – higher demand for property debt in the future

Given the sheer size of the total market, it is not a surprise there is a meaningful volume of loans maturing in each year. Volumes of maturing loans are projected to increase steadily in the next five years (see Chart 3) with a total of ~ US$2.5 trillion of loans maturing between 2023 and 2027. It is believed that as the maturity wall approaches in coming years, demand for credit for property refinancing should stay high even if US property acquisition activity stays low.

**Chart 3:** Maturity wall - US property debt market ($billion)




Source: Nuveen, Trepp. 30 September 2022

# Diversified property sector exposure

Managers typically invest in a diversified portfolio with exposures to varying underlying property sectors. The most common sectors include residential/multifamily, industrial, specialty/life science, office and hotel. Some managers also focus primarily on residential/multifamily, which is considered the largest and most liquid property sector in the US.

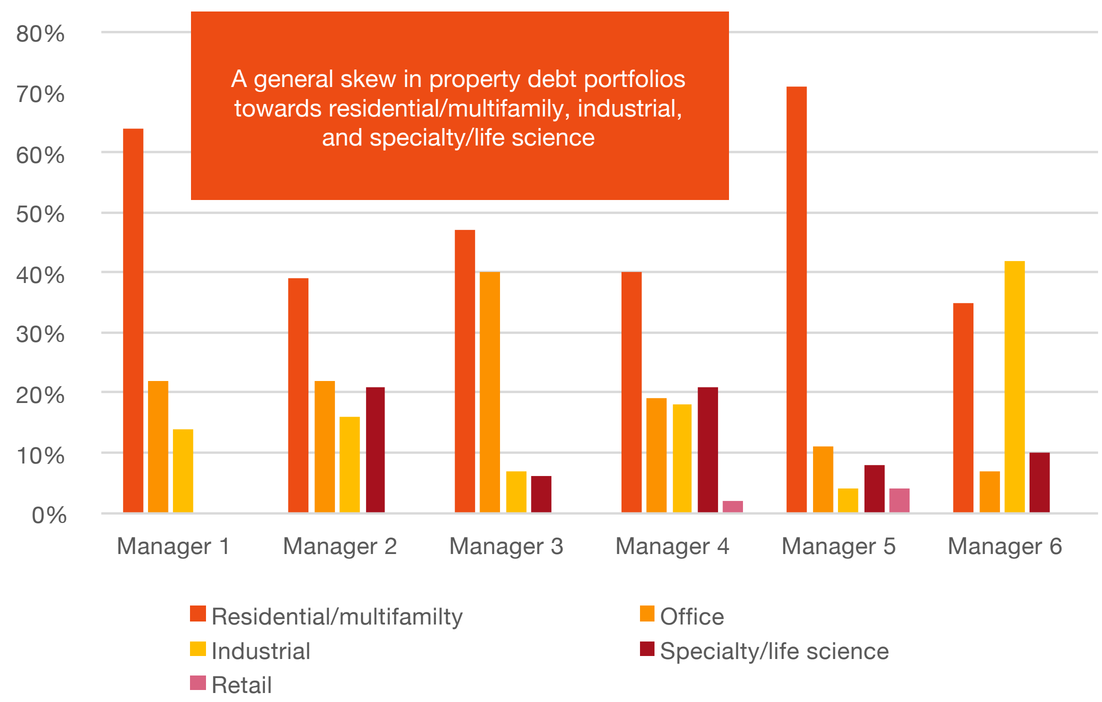
Feedback from managers on different sectors is summarised below:

- Healthy sectors include industrial and residential/multifamily. Industrial demand is driven by tenants' desire to get closer to cities and to ensure supply chain integrity. Multifamily continues to benefit from structural undersupply of residential assets.
- Life science fundamentals remain strong with annual rent growth observed across most geographical markets, growing by double digits in many. Investment continues to flow into this sector, although has slowed from 2021 levels.
- Hotel fundamentals have improved with higher demand and occupancy. Revenue per available room is significantly up in the past two years, and now above pre-COVID levels.
- Retail sector performance continues to be uneven. There is demand around high traffic, high quality assets or redevelopment of poorly performing projects.
- The office sector remains under stress. Vacancy rates are high despite back-to-office initiatives, particularly among tech companies and government entities. There is, however, a strong bifurcation across assets by quality and location, with high-quality assets observed to have better occupancy rates, and these are expected to outperform.

## Stress in the office sector

Exposure to the office sector varies quite considerably among managers with exposure as little as 5-10% at the lower end, and up to 40% at the other extreme. Almost all managers noted challenges in managing their office sector exposures. Office vacancy rates vary depending on the office location, building characteristics and tenant profile, but vacancy rates of 40-50% are not uncommon. High vacancies, as tenant employees failed to return to work as expected, higher interest costs and falling property valuations have caused some office property owners to either default on loans or require loan amendments. The unwillingness of some tenants to pay their rents was also cited as another reason for the office sector stress. Managers noted examples of companies in the technology sector not paying rent for offices located in San Francisco and New York. The final impact and actual losses within the office exposure across funds remains to be seen and is an area of continued monitoring for Frontier in future research.

**Chart 4:** Sector exposure of a select group of US property debt managers




Source: Managers

# Fund leverage is common

It is noticeable that leverage at the fund level is commonly used in US focused strategies. This is a difference compared to Australian and European focused strategies, where fund leverage is not widely used. Leverage, while enhancing returns, brings an additional level of risk and complexity. Table 2 highlights common types of fund financing used by managers. A key observation is that the terms of financing vary considerably. Managers note they have extensive experience in accessing fund leverage and believe if the terms of financing are appropriate, it can be value enhancing for investors. Managers commented the historical asset-liability spread (spread between lending rates and cost of financing) is typically in the range of 75-200 bps. Depending on the quality of the underlying assets, the asset-liability spread today remains positive at around 100+ bps and financing continues to be open to managers despite a challenging environment of rising rates and lower capital availability. Understanding the use of leverage is a key focal point for Frontier and should be a key point of due diligence for investors.

**Table 2:** Common types of financing

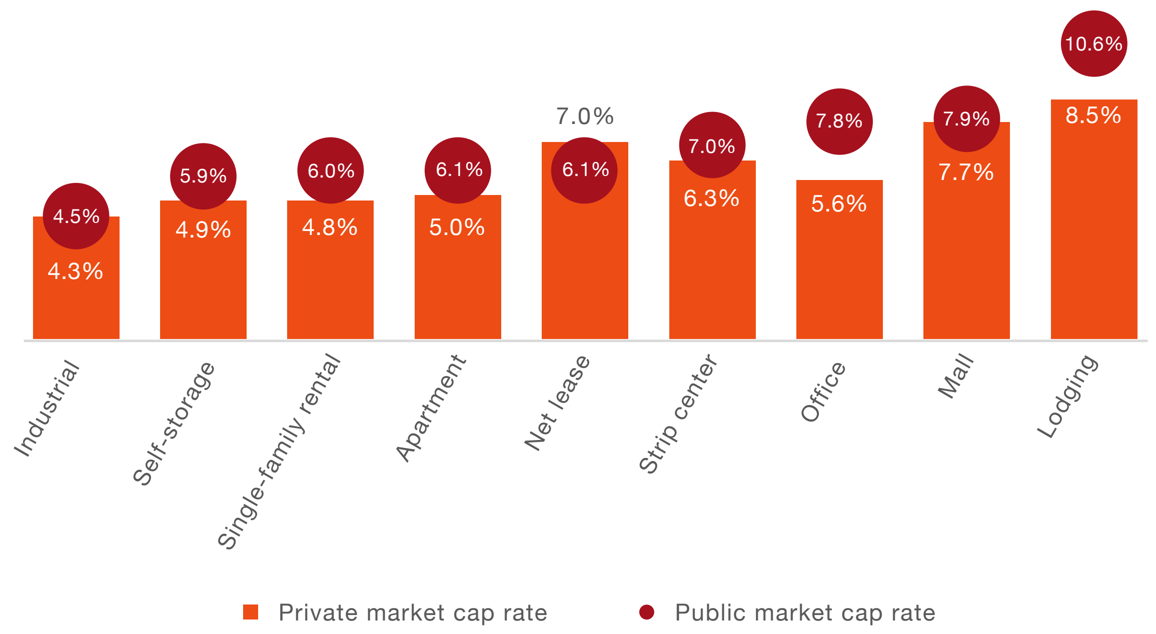
| Type of financing | Warehouse | Loan-on-loan | Securitisation (CRE CLO) |
|---|---|---|---|
| **Description** | Line of credit, multiple asset financing<br>Assets cross-collateralised | Single asset financing<br>Customised, deal specific | Multiple asset financing<br>Asset cross-collateralised |
| **Financing subject to mark-to-market** | Mark-to-market (MtM) and non-MtM option | Non-MtM | Non-MtM |
| **Recourse** | Partial or non-recourse | Partial or non-recourse | Non-recourse |
| **Term of financing and term of lending** | Not matched | Matched | Matched |

Source: Managers

# Valuations – private markets lag, further risk to the downside

Given the challenging operating environment, property valuations have been under pressure, particularly in the office sector. This has been clearly felt in public markets, where listed property REITs were down 20%-30% in 2022. Valuations in private markets have lagged. Managers advised there was evidence external valuers are hesitant to reduce valuations considering minimal market transactions to support a new valuation.

**Chart 5:** Pricing gap between public and private markets




Source: Oaktree, Green Street, NCREIF, December 2022 U.S. Commercial Property Outlook Report

Managers commented that in late 2022 and early 2023, write-downs had occurred to some office loans, although these were minimal to date (indicated in some cases from par to 90 cents/dollar). In instances of loans requiring amendments (such as maturity extension and waiver of covenant), mark downs are higher, although this varies by loan.

At this juncture, managers are not expecting widespread defaults to occur within their office loan exposures. Rather, defaults will be dependent on specific assets. Defaults will also be dependent on the financial strength of property sponsors and their willingness to work with lenders to resolve any problem loans.

We expect challenges in the office sector to remain in the foreseeable future until the path of future interest rate movement and pattern of work from home is better known. More office loans will require restructuring and more loan default/loss and write-downs will likely occur. Therefore, high caution is required for investors contemplating an investment to an existing portfolio. Due diligence on the health of existing loans and current exposure to the office sector in the portfolio should be a top priority. We believe a more sensible approach for investors is to consider allocating to a new fund where managers are better placed to drive lending terms based on more realistic valuation assumptions.

# Downside protection for property lenders

Notwithstanding the risks of deteriorating property performance and falling property valuations, managers demonstrated there are important levers available to mitigate risks. A key risk mitigant is to ensure there is a sizable equity cushion beneath the lenders in the capital stack. Managers commonly write loans with a substantial equity cushion of 25-35%, i.e. loan-to-value in the range of 65-75%, lowering the risk of loss for lenders if default occurs and at the same time property value falls.

The structuring of a loan facility using terms and conditions such as loan covenant and loan amortisation is also an effective risk mitigant. In such instances, the lending exposure is lowered over time as the loan amortises and the lender also has the ability to step in early when performance of the underlying asset deteriorates. Most managers also impose a requirement on borrowers to hedge 100% of variable interest rate exposures (via the use of interest rate derivatives) over the life of the loan, which helps to lock in the cost of interest expense and mitigate the risk of any future interest rate rises.

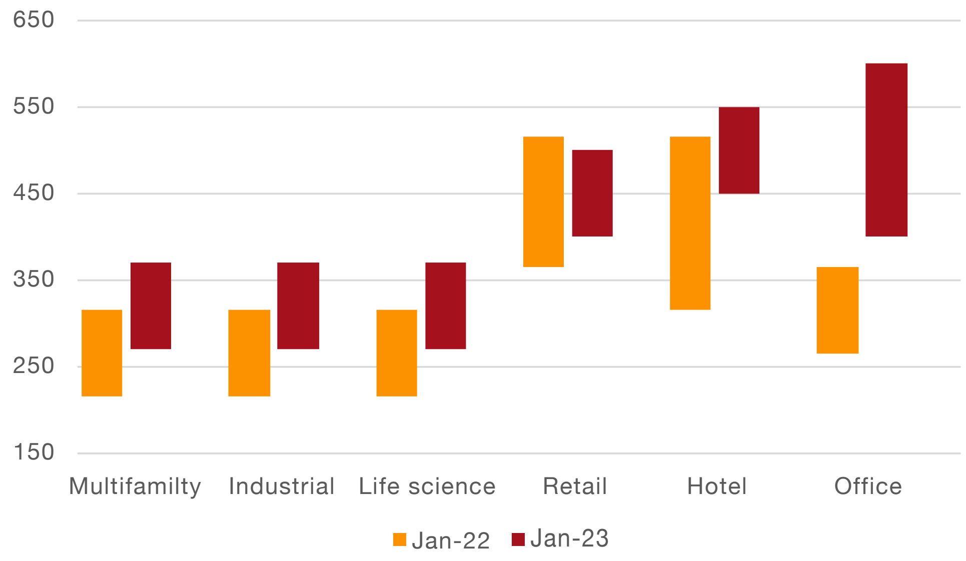
Portfolio diversification also plays a key part in protecting the downside risk for lenders. Portfolios are commonly diversified by geography, sector, sponsors, and a number of investments.

# Opportunity for new loans in current markets

### Better returns ahead?

While the current market is clouded with uncertainty and heightened risks, it also represents an attractive opportunity for patient investors with an illiquidity appetite. Property debt investors can currently earn higher potential returns compared to the past few years, driven by both higher base rates and increased credit spreads. Credit spread increases vary by sector and assets, but in general, managers reported credit spreads being 50-200bps wider compared to 12 months ago.

**Chart 6:** Senior property debt deals – higher credit spread (bps)



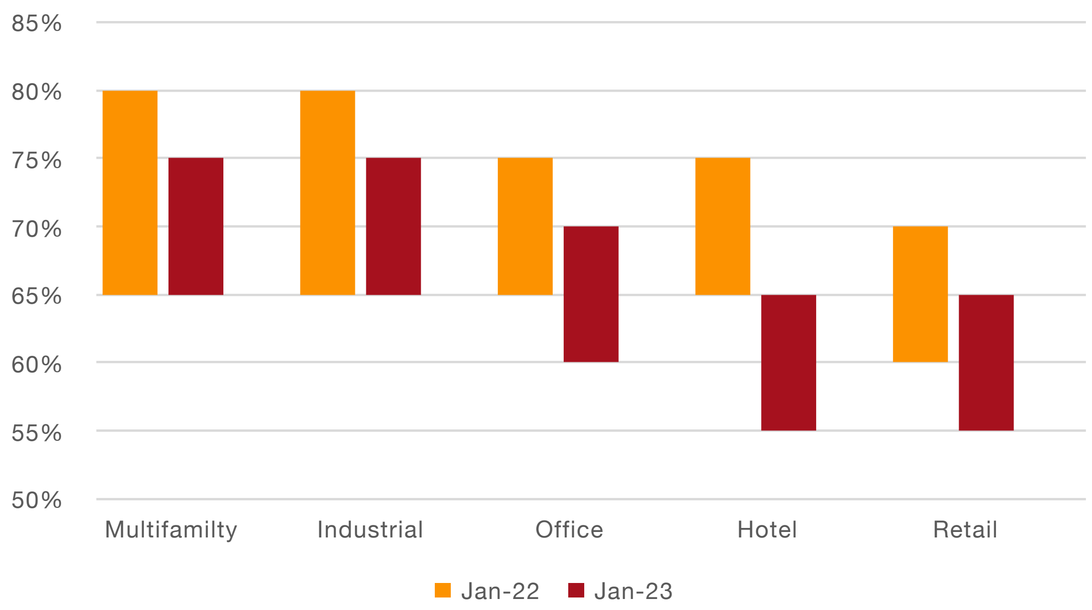

Source: Managers, Frontier Advisors.

## Lower risk amid less competition

In addition to higher returns, the risk taken by investors for new transactions is arguably lower. Managers stated that for new deals, there is a stronger equity cushion, i.e. lower loan-to-value (LTV) ratio compared to LTV levels transacted in late 2021/early 2022. Terms and conditions of any new lending has also tilted in favour of lenders, which can be partly attributed to lower availability of capital from banks (driven by tightening credit standards and the regional bank crisis), and low CMBS issuance in public markets.

Furthermore, property values have moderated across the board. At a more reasonable initial starting value, the risk of the underlying property value suffering a steep fall is lower, resulting in reduced risk for the lender suffering loss if a borrower defaults.

**Chart 7:** Lower LTV ratio across all sectors for new loans




Source: PIMCO, as of January 2023

# The final word

**The US property debt market is large, diversified and well established. There are a multitude of strategies with different risk/return profiles to meet the different needs of investors.**

The current investing environment is challenging with an uncertain economic outlook; falling property valuations; higher vacancy rates in some segments; and rising interest rates and costs. We have observed certain property owners, in particular in the office sector, being pressured, with instances of loan restructuring and loan default having occurred. The level of write-down and loss in the office sector for property lenders to date has been limited but we expect more to follow. Overall, the impact on existing portfolios appears manageable at this juncture given office loans are typically not a large component of a diversified property debt portfolio.

In contrast to the existing loans where valuations have been slow to fall and there is further risk to the downside, new loans are more appealing. New lending opportunities should offer better relative value with higher return potential (higher credit spread and base rates) and lower risks (lower LTV and more favourable terms for lenders). New investments can represent an attractive opportunity for investors with an illiquidity budget and patient capital to deploy in the coming years where competition from banks is expected to be reduced. For investors contemplating an allocation, investing into a new vintage is our preference as investors can avoid exposure to the stressed property sector, benefit from sectors with strong fundamentals, and minimise valuation write-down risk. Investors, however, should carefully consider the risks and partner with managers with proven experience and expertise to successfully navigate the complex and evolving market conditions.

### Want to learn more?

Frontier will be looking to conduct further research to verify our initial assessment from this trip. We will also seek to identify appropriate investment options for our clients. If you are interested in learning more about this topic, please reach out to your consultant or a member of the Defensive Assets and Private Markets Team.

**Frontier Advisors**

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

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