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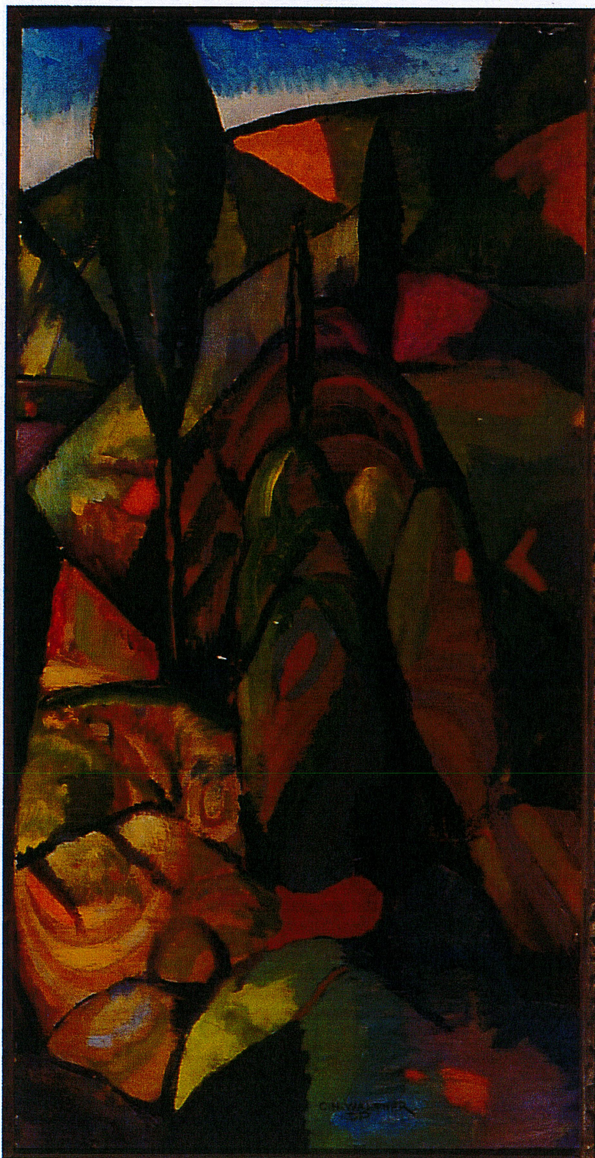

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A new debt frontier

The appeal of private direct lending to commercial real estate

by Stuart Boesky and William Dowling

Under current market conditions, private commercial real estate lenders can deliver value-added-level returns to their investors, at lower risk than equity vehicles, because private lenders command premium pricing for certain types of loans that banks effectively have been regulated out of making. Even with a considerably higher cost of capital than banks had precrisis, private lending funds have great potential for this strong risk-adjusted performance.

Emergence of private direct lending to commercial real estate

Private direct lending to commercial real estate emerged after the financial crisis of 2008. As understood today, this sector is distinct from hard-money lending or distressed lending. Rather, commercial real estate private direct lending came into existence to fill the vacuum created when traditional banks curtailed their lending activities due to cyclical and structural factors. The cyclical factors are largely in the past, but the bank-lending vacuum for certain loan types continues today because of structural factors — primarily the reregulation and consolidation of banks.

The Dodd-Frank Wall Street Reform and Consumer Protection Act and Basel III international capital accord imposed significant disincentives for banks to provide higher-risk commercial real estate loans — effectively restrictions on commercial real estate lending. The new rules imposed higher capital requirements for commercial real estate loans and punitive capital requirements for high-volatility commercial real estate loans. The new regulatory regime also demonstrated a strong bias toward highly liquid investment-grade assets and away from illiquid unrated assets, such as commercial real estate loans. At the same time, industry consolidation led to 8 percent of banks controlling 90 percent of all deposits, as can be seen in the Federal Deposit Insurance Corp.'s Statistics on Depository Institutions database. Since 2000, the number of separate banking institutions has dropped by 40 percent, according to the FDIC.

Borrowers had fewer places to go, and under Dodd-Frank and Basel III, those lenders were less likely to lend. Banks had less money available for

commercial real estate loans, and the loans offered were far more conservative in terms and advance rates. Middle-market real estate — with deal sizes of $10 million to $50 million — was hit the hardest. Under the new regulatory regime, large banks need large loans and borrowers who represent cross-selling opportunities, such as investment banking, capital markets and private client services, which middle-market borrowers typically do not provide.

Private real estate investment managers understood the disconnect in the market and began raising institutional capital to fill the void left by banks. At the start, institutional fundraising for commercial real estate private direct lending strategies was a major challenge. Before the financial crisis, commercial real estate debt was not a familiar investment class for the great majority of institutional investors. They found the sector difficult to categorize. Within the real estate class, commercial real estate private direct lending returns did not fare well when compared with those promised by opportunistic equity strategies and, within the traditional fixed-income class, commercial real estate private direct lending was considered too illiquid. In addition, it is difficult for many institutional investors to allot capital to strategies that appear to be "out of the box," even if they make a compelling investment case.

Over time, however, institutions have begun to understand and embrace commercial real estate private direct lending. Both the number of investment vehicles and dollars raised have expanded considerably. Between 2000 and 2008, debt managers raised less than one-third of the total amount of equity raised from 2009 to 2017 year-to-date — $127 billion has been raised for debt funds since 2008, versus only $36.3 billion from 2000 to 2008, according to Preqin. Institutional Real Estate, Inc.'s FundTracker database reports similar figures — 109 debt funds had final closings from 2000 to 2008, raising $50.53 billion, while 156 debt funds had final closings from 2009 to 2017 year-to-date, raising $131.45 billion. And commercial real estate private direct lending still has room to grow — even though debt represents approximately half of commercial real estate value nationally, debt funds still represent only 20 percent of all real estate funds.

What is the appeal for institutions and investment managers?

Despite its somewhat slow adoption, commercial real estate private direct lending investment is expanding for good reasons. The reregulation of banks following the financial crisis resulted from their mispricing of risk and use of inexpensive FDIC-insured deposits to build market share. In the precrisis lending environment, commercial real estate private direct lending had a much higher cost of capital than banks and could not compete for the majority of transactions. Today, the tables have turned.

Despite a cost of capital higher than that of banks (pre- or post-crisis), commercial real estate private direct lending can command premium pricing for (1) providing advance rates higher than 60 percent loan-to-value, (2) capitalizing transitional properties, and (3) offering speed and certainty of execution. Continued borrower demand for loans with these attributes, and near-zero supply of them from banks, has kept pricing higher — and more reflective of risk than the products offered by banks precrisis. With banks now having limited ability to lend on commercial real estate, their balance sheet loans for commercial real estate have been repriced, and advance rates and terms have become less favorable to the borrower, leaving a natural play for commercial real estate private direct lending to fill the gaps that have resulted.

Moreover, many see cap rate expansion as a big risk as we enter what they believe to be a rising interest-rate environment. If cap rates do expand, it will reduce returns on equity investments, making it harder for those investments to outperform private direct loans. Cap rates tend to correlate with 10-year Treasury yields — and if yields spike, the equity investor's interest in a property can quickly be wiped out. In this context, the equity becomes "top loss protection" for commercial real estate private direct lending.

Assume a property is acquired under a value-added equity strategy, for example, using a mortgage with a 75 percent loan-to-value. If cap rates increase by 20 percent, the value of the investor's equity position would erode by 70 percent. Assuming reasonable rent and expense increases of 3 percent per year, it would take the equity holder an estimated six years to earn back his original investment, leaving him far short of the targeted return.

Conversely, on the lending side, a commercial real estate private direct lender holding the mortgage in this scenario should still be "money good" throughout the investment period, regardless of cap rate changes, with the remaining 30 percent of the borrower's equity still acting as top loss. At the same time, because of premium pricing for value-added loans, the private direct lender is providing roughly equivalent investment performance to the equity value-added investor. So, in today's market, commercial real estate private direct lending is an investment that can provide excellent risk-adjusted performance with low-teens returns. ❖

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