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5 Reasons for Real Estate Opportunistic Credit

ZENZIC CAPITAL

Overview

SPEED READ

- The interest rate hike cycle has drastically re-priced credit in favour of lenders on both an absolute and relative basis
- The transaction set for real estate opportunistic credit is expanding significantly. Thematic opportunities - liquidity based financings and (di) stressed scenarios - that have largely been absent for the past 15 years are potentially vast in size
- Despite talk of price discovery, the basis of real estate valuation is, in our view, far less precarious than in the zero-rate era
- An allocation towards real estate opportunistic credit can increase diversification, deliver high absolute and relative returns while reducing market correlation. In particular, the UK and European lower mid-market offers a wealth of attractive opportunities yet vastly reduced competition

The current tightening cycle heralds a generational opportunity for opportunistic credit, and particularly so within the real estate sector

The current tightening cycle, after nearly 15 years of near-zero rates, heralds a generational opportunity for credit providers, particularly those in the real estate opportunistic credit space. Why do we believe this is the case?

1. Real estate credit is now better value than real estate equity in both absolute and relative terms

The 500-basis point increase by central banks in US and UK, reprices most forms of credit in lenders' favour by the same or nearly equivalent amount. This opens up the possibility of high single-digit IRRs on vanilla credit for "Grade A" real estate. For instance, a UK commercial real estate (CRE) facility priced at 200bps above the five year swap rate, with a 1% transaction fee on commencement and expiry of the facility, could generate an 8-9% IRR, without employing leverage. This exceeds the equity yield on many real estate assets (average 4%-6% at the end of 2022). It illustrates the relative value of credit; equity returns will ultimately pay for the higher debt return and suffer lower cash-on-cash yields as a result. Opportunistic real estate credit - which provides borrowers with greater flexibility, responsiveness and/or liquidity - can expect a significant premium over such returns.

2. €150bn of CRE maturity will offer attractive liquidity plays for opportunistic lenders

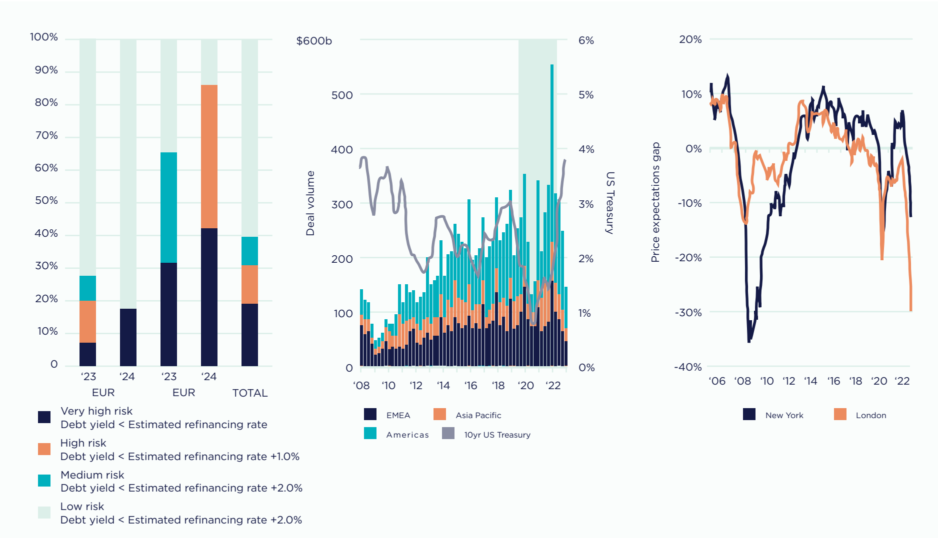
The commercial real estate debt requirement over the next 3 years is estimated at €150bn[1] in respect of refinancings alone, but in the context of higher debt costs and lower market values. A study by Scope Ratings[2] found that almost 20% of the loans in European CMBS maturing in 2023 and 2024 face high refinancing risk as their expected cash flows are too low to meet higher expected requirements from lenders, and another 14% face high risk if swap rates rose another 100bps (see Figure 1). Since their analysis, six loans securing four European CMBS have been forced to seek maturity extensions to prevent refinancing failures[2]. This is a direct consequence of interest rate rises which affects both asset values (via expanding capitalisation rates) and interest cover (via higher interest costs). The worked example Scope provide is stark: a 60% LTV CRE facility with a 2.0% coupon and 2.0x ICR in 2020 would require a mere 30bps increase in capitalisation rate,

[1] Evercore report quoted by React News in "€150bn of debt across European property firms to mature by 2025"
[2] Scope Ratings GmbH: A third of commercial real estate loans in European CMBS face significant refinancing risk 30 January 2023

For opportunistic credit providers, there will be value in providing liquidity to borrowers who want to play offence (borrowers that can buy well but need capital to do so) and defence (structures struggling to obtain vanilla refinancings). Traditional capital - by which we include both banks and more mainstream real estate private credit offerings - will be reluctant to participate in such scenarios. Opportunistic credit providers should face lower competition while benefiting from a better risk-return lending profile because they will be financing assets at revised market values with lower leverage and more robust structures at higher spreads.

A specific liquidity based transaction set may be emerging, catering to the maturity wall in CRE, which is expected to hit €150bn by 2025

FIGURE 1: REFINANCING DEMAND & MORIBUND SALES MARKET IS CAUSING LIQUIDITY CONSTRAINT[3]



3. Distressed opportunities are rising

There have been a series of false dawns for distressed investors but it feels inevitable that the combination of rising interest costs, high debt burden, softening valuations, reduced liquidity and, for some sectors, retreating fundamentals, will lead to an increase in distressed opportunities. The office sector is the most obvious example of this, with an increase in both loan extensions and movements to special servicers in European and US CMBS structures (including some high profile sponsors such as Blackstone's Sponda portfolio and Brookfield's DTLA Fund Office Trust Investors) and WeWork's recent announcement that its future as a going concern is in question. In the private credit sphere the office sector has already seen high-profile defaults / value slides, including 5 Churchill Place Canary Wharf (acquired for £270m in 2017 but with concerns that the £175m senior facility will not be fully recovered), Assembly London, an office campus in Hammersmith built in 2017, for around £70m – reflecting a yield of around 13%, substantially below the £120m asking price[4]. These are not necessarily anomalies; they reflect a secular change in usage that has led to considerable asset re-pricing and with it distress. The opportunity set arising from distress is relatively well known but the scale of the returns are considerable if a pricing hit of this magnitude to the largest CRE sector continues.

In addition, we believe that there is a potentially significant NPL opportunity in the short-term / bridging sector of UK credit market (which is largely non-bank) where pre-development land has been financed at leverage levels up to 70% LTV. Bare land valuations derive from the developed land value. As the simplified example in Figure 2 shows a 75bps movement in capitalisation rates (even if all other costs are held constant) can eradicate the 30% value buffer most bridging transactions are predicated upon.

[3] Scope Ratings & MSCI: 2023 Trends to Watch in Real Assets. A potential counterpoint is the July Blackstone sponsored Last Mile Logistics 2023-1 deal. It was oversubscribed in every tranche and at least 2x covered at the mezzanine level. However, this has to be viewed in the light of the robust rental growth in that sector, the quality of the sponsor and the lower than typical leverage for CMBS (57% LTV). Even then, it placed at spreads over Euribor of 235/350/450/580 (AAA/AA/A/BBB respectively), providing a weighted average coupon on the pool of 3.33%. In comparison, Vita Scientia, priced in April 2023, and sponsored by TPG, had a weighted average coupon of 1.75%, implying a near doubling of the funding cost in little over 12 months
[4] React News: The Good, the bad and the ugly of office pricing

FIGURE 2: IMPACT ON BRIDGE LENDING OF CAPITALISATION RATE SHIFT

	2022 (£m)	2023 (£m)
a. GDV (projected NOI / capitalisation rate)	50	43.5
NOI:	2.5	2.5
Capitalisation Rate:	5.00%	5.75%
b. Construction Costs	20	20
c. Developer Profit	10	10
d. Land Value (a-(b+c)	20	13.5
e. Bridge Facility	14	14
f. Bridge Facility LTV	70%	104%

Shift in captalisation rates has left the bridge facility underwater and unfinanceable

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4. An end to 'fragile' value assumptions

Despite much having been written about the difficulties of lending in an era of price discovery, we believe today's valuation framework is actually preferable for creditors (or at least new credit providers), than the environment during the zero-rate era. Previous 'price certainty' was based on an assumption of continuing zero rates underpinning low capitalisation rates; price was certain (in that you could point to a body of comparable transactions supporting the yield analysis) but entirely fragile. Credit underwriting did not price in yield expansion if it wanted to be competitive and so there was only downside - and potential large downside - to asset price valuations via changes in capitalisation rates. In short, values could only move against lenders. Now a good part of that value correction has either occurred or is very much in train. And while capitalisation rates could trend higher, a crude mean reversion analysis would suggest the risk of a further 500bps upward movement is more remote than the same movement when rates were zero. New creditors can price on the basis of a more solid foundation than at any point in the preceding 15 years.

5. Emerging real estate sectors have strong fundamentals but are capital constrained

CRE markets are far broader and deeper than most observers realise and the capital requirements for both growth capital and refinancings are vast. More nascent sectors (self/open storage; data centres; PBSA; UK multi-family among them) that have been under-appreciated by capital markets for many years, have shown impressive NOI performance and growth in the face of both COVID and the ability to re-price rents to pass on inflation driven cost pressures. The idiosyncracies of UK and European funding markets means many worthy real estate businesses in these emerging sectors are deprived of capital in their growth stage; opportunistic credit is perfectly placed to fill that void.

Conclusion

For investors we believe an allocation towards private real estate opportunistic credit can increase diversification, provide enhanced absolute and relative returns and reduce market correlation. Over the next few years, we believe the median returns for opportunistic credit investors will be similar to those in traditional real estate private equity but with lower volatility and improved risk profile. As ever, but particularly in times of liquidity shortfalls, underserved markets are likely to offer better risk-adjusted returns for investors. That's why we favour private, European and lower-middle market arenas, which have no access to capital markets funding and at transaction sizes of below £50m are often ignored by many private credit funds seeking larger lot sizes. At transaction sizes of between £20-40m there is intrinsically less competition, yet the investable universe offers a wealth of attractive potential investment opportunities.

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