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WEALTH SOLUTIONS

Seizing the Real Estate Debt Opportunity

In a recent memo to investors, Oaktree Capital Co-Founder and Co-Chairman Howard Marks outlined the attractive opportunity for real estate debt investing. Higher interest rates since the beginning of 2022 have dramatically impacted the investment landscape for real estate debt by causing:

- A decline in real estate values;
- Increased borrowing costs for asset owners;
- Reduced credit availability from traditional financing sources such as banks and the securitization market.

While this backdrop has created challenges for borrowers, we believe it has also generated tremendous opportunities for real estate debt investors with capital to deploy, as they can now earn higher yields while taking less risk.

HOWARD MARKS
CO-CHAIRMAN, CO-FOUNDER

"We've gone from the low-return world of 2009-21 to a full-return world, and it may become more so in the near term. Investors can now potentially get solid returns from credit instruments, meaning they no longer have to rely as heavily on riskier investments to achieve their overall return targets. Lenders and bargain hunters face much better prospects in this changed environment than they did in 2009-21."

— **HOWARD MARKS,**
SEA CHANGE, DECEMBER 2022

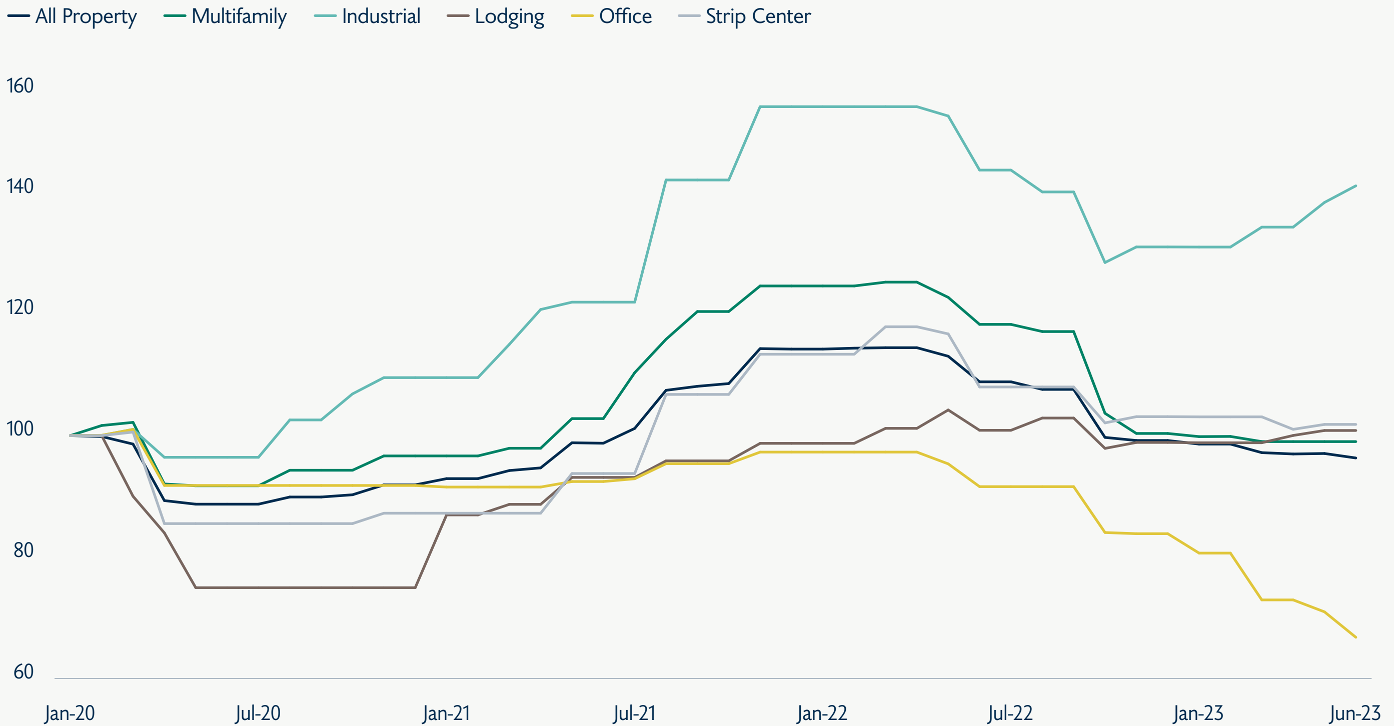
Commercial Real Estate Values Amid a Reset

The real estate market enjoyed a bull run from the end of the Global Financial Crisis until the beginning of the Covid-19 pandemic. Supply and demand in commercial real estate were relatively in balance during the 2010s, and low interest rates and the robust transaction volumes in the liquid debt markets created a goldilocks era for real estate in this period.

When Covid-19 upended the world, fundamentals in some property sectors, notably hospitality and office, faced severe headwinds. On the other hand, certain asset classes enjoyed improving fundamentals during the pandemic and thus enjoyed a surge of buyer interest. The industrial sector, multifamily and self-storage were among the "Covid winners."

In early 2022, average commercial real estate capitalization rates were at 5.1%, near their lowest level in the last 20 years, and consistent with low risk-free rates globally. But since January 2022 and amidst the surge in interest rates, cap rates have risen by more than 100 basis points to 6.3% in May, which, in turn, has depressed valuations, according to data from Green Street Advisors.

Figure 1: Commercial Property Values Have Diverged Since the Pandemic



Note: Data indexed to 100 as of January 2020. Chart reflects values for sectors within the Green Street Commercial Property Price Index (CPPI). Green Street's CPPI is a time series of unleveraged U.S. commercial property values that captures the prices at which commercial real estate transactions are currently being negotiated and contracted.

Source: Oaktree Capital, Green Street, data as of June 30, 2023.

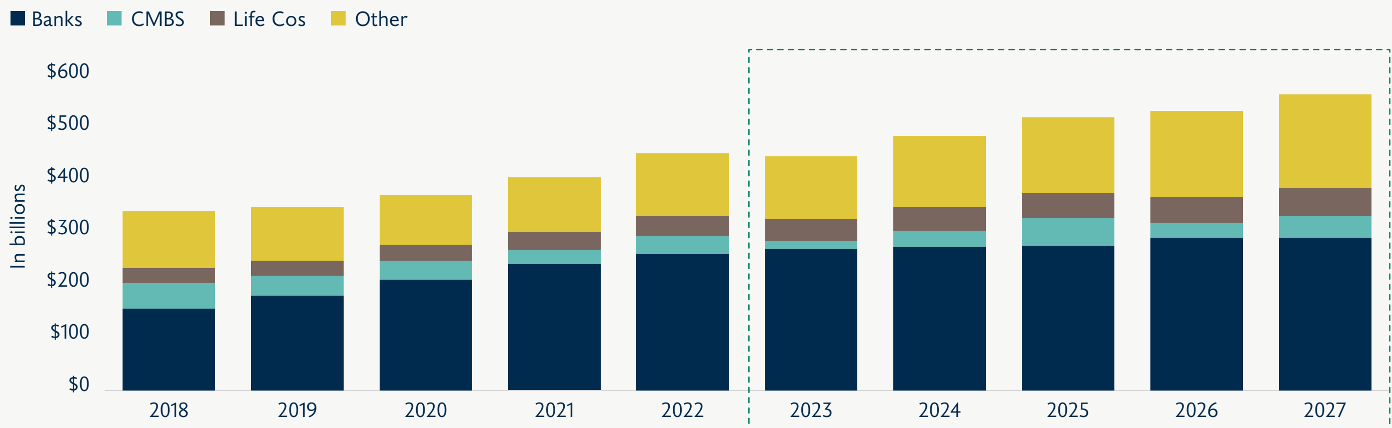
Values have fallen by 16% since property prices peaked in April 2022, according to the Green Street Commercial Property Price Index for the second quarter of 2023. However, as shown in Figure 1, values have diverged significantly by sector, with office values lower and indutrial values higher. As a result, real estate debt investors can now lend based on deflated valuations, which aims to provide greater risk mitigation and more room for value appreciation over time.

Resiliency in Residential Real Estate

Larger banks limited commercial real estate lending in the second half of 2022, due to changing regulatory capital requirements, balance sheet losses on long duration investments and other challenges. In early 2023 lending was further constrained by the failure of several regional banks, Silicon Valley Bank, Signature Bank and First Republic Bank. The fear triggered by bank failures caused many depositors to move money from regional banks to the largest money-center banks, depriving the former of liquidity and further straining their ability to lend.

The recent banking sector turmoil is likely to further suppress lending for commercial real estate, as regional banks have historically been a steady and reliable source of financing and a major buyer of investment-grade mortgage-backed securities. U.S. banks have historically supplied roughly 40% of total commercial real estate debt (regional banks contributed about 70% of these funds).

Figure 2: More Than $2.5 Trillion of Commercial Real Estate Will Mature by 2027



Note: CMBS refers to commercial mortgage-backed securities, Life Cos refers to life insurance companies that extend commercial real estate loans.
Source: Trepp, as of March 31, 2023.

This confluence of factors has created a vicious cycle in commercial real estate investment, as a reduced supply of capital from traditional sources has driven financing costs higher and increasing asset price volatility has further widened bid-ask spreads between buyers and sellers, making traditional capital providers *less likely* to lend. Meanwhile, the need for commecial real estate financing is enormous. As Figure 2 shows, more than $2.5 trillion in commercial real estate debt is scheduled to mature by 2027.

We expect these traditional sources of real estate debt financing to remain on the sidelines for some time, given the lack of liquidity in markets and heightened regulatory scrutiny. However, real estate markets still need debt capital, and this is creating an extremely attractive environment for non-traditional lenders, such as real estate debt funds.

A Tremendous Opportunity for Real Estate Debt Investors

We believe these once-in-a-generation challenges are creating compelling opportunities for real estate debt investors. These circumstances present an opportunity for non-banks to lend to borrowers with high-quality assets at attractive yields with moderate risk assets. Non-banks can likely extend loans with attractive loan-to-value ratios based on reduced valuations. This has the potential to provide lenders with additional downside protection and more room for future appreciation.

Current yields for publicly traded debt are roughly double 2021 levels. According to data from Oaktree Capital, all-in yields across a range of real estate debt securities are now around 10-12%, as yields of high-yield debt have increased by 500-700 basis points.

Conclusion

Even though some real estate sectors are beset by challenges, we believe there are reasons for investors to be very optimistic about the outlook for real estate investing for several reasons:

- The battle against inflation is likely far closer to its end than its beginning.
- The reduced supply of capital available to finance real estate will likely improve future risk-adjusted returns.
- Declining property values will likely improve downside protection for investors.

We believe these factors have created the most attractive investment environment for real estate debt investors since the dislocation caused by the 2007-2009 Global Financial Crisis.

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