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The Rise of Debt Funds

The number of debt funds and non-traditional lending sources has grown throughout this cycle. Is that a reflection of temporary market forces or have they become a permanently larger part of the commercial mortgage landscape?

Debt funds originated about $67 billion in mortgages in 2018, up from $52 billion in 2017 and $32 billion in 2016, according to Jamie Woodwell, vice president of Commercial-Multifamily Research at the Mortgage Bankers Association. The MBA estimates that debt funds originated roughly 10 percent of all commercial mortgages in 2018.

Debt funds have been around for a long time. In the cycle leading up to the global financial crisis, vehicles that financed highly leveraged tranches of mezzanine debt proliferated, though many were wiped out by the downturn. In recent years, debt funds have filled a void left by commercial banks in the construction and transitional loan space. Reforms passed in the wake of the banking crisis required banks to put up more capital for construction and redevelopment loans, making those products less profitable. Not every bank has cut back, but large banks in particular are facing increased scrutiny from regulators on the amount of commercial mortgage holdings on their books.

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The hole left by banks has enabled the sector to proliferate, though the exact number of funds is hard to pin down because most are raised privately. Preqin, a London-based research firm that tracks private equity, found 125 private equity funds raised $61 billion of capital to invest in closed-end debt funds over the past two years, roughly the same amount of money that was raised for the sector in the eight years combined between 2005 and 2012. Fundraising peaked in 2017 at $33.3 billion before declining to $27.7 billion in 2018, in part because some funds are still deploying capital.

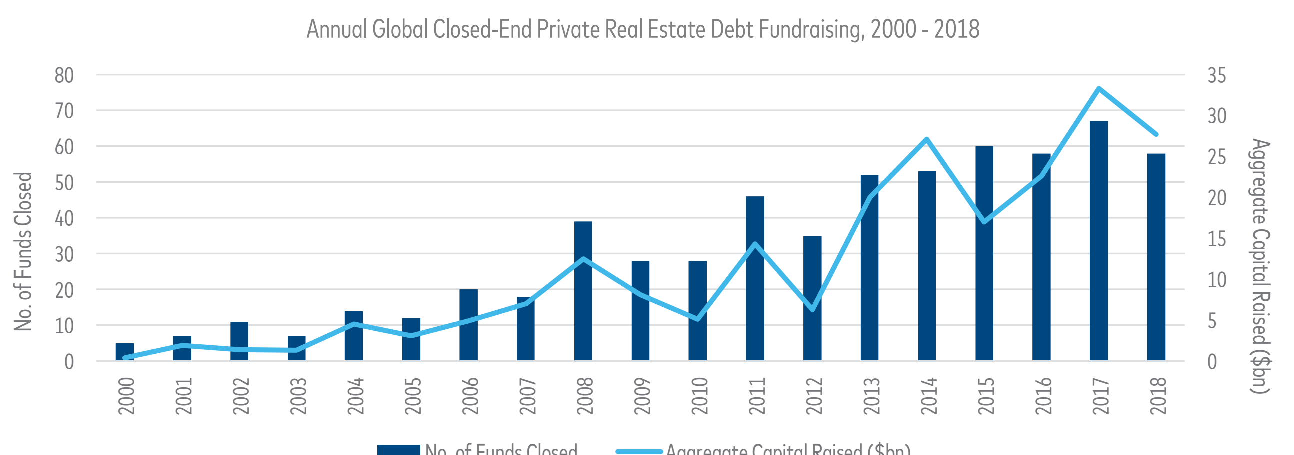
Hoboken, N.J.-based newsletter "Real Estate Alert," which also tracks the segment, found 70 vehicles actively investing or raising capital in 2018, up from 49 in 2014. The REA survey only covers closed-end funds with a minimum raise of $50 million.

Historically, most debt funds have been structured as closed-end vehicles (those with a finite, typically two- to three-year investment period, after which capital from loan repayments must be returned to investors), but that is starting to change, as well. CBRE, for example, is launching a multibillion-dollar open-ended vehicle called CBRE US Credit Partners that will originate loans that include senior and core-plus. Open-ended funds (those that can go on indefinitely) are a challenge because it can be tricky to replace maturing mortgages with new loans that have the same credit quality and yield.

Cyclical and secular growth

The growth in non-traditional lenders is due to both cyclical and secular forces. Some investors believe debt is a good late-cycle play because it is higher in the capital stack than equity. As the market inevitably gets closer to the next downturn, the thinking is that debt can produce almost the same yield as equity with less risk. While that is theoretically true, the problematic experience of mezzanine debt funds in the last cycle is a counterbalancing argument. The safer-part-of-the-capital-stack argument is a false comfort if collateral is poorly underwritten.

Another contributor to the growth of debt funds is the amount of capital flowing into all commercial real estate. Investors of all stripes, including sovereign wealth funds and other foreign sources, want to allocate capital to U.S. real estate because of its stability and the prospects for growth, even this late in the economic cycle. However, competition to buy suitable properties is stiff, and setting up a lending operation is an arduous process. An alternative for institutions is to provide capital to an experienced mortgage team. Most debt funds are managed by executives that have a record of success running a CMBS or portfolio lending operation. Debt funds are a way to get capital invested quickly in the sector and meet return expectations.



Sources: Prequin

Debt funds are largely seeded by institutions. Individual investors have access to a growing number of mortgage REITs run by large managers that include Blackstone, KKR, Starwood Capital, TPG Real Estate Finance, Pine River Capital Management and Ladder Capital. There are only a handful of debt funds, such as Terra Capital Partners, that still raise money from the retail broker-dealer network. That market has shrunk in the wake of regulations that require more transparency and hold brokers to a fiduciary standard.

CLO comeback

Debt funds have been boosted by the resurrection of the collateralized loan obligation (CLO) market, which for some provides a source of financing. Some 19 firms issued $14.3 billion of CLOs in 2018, an 86 percent increase from the prior year and the highest since $41.8 billion was floated in 2007, according to "Commercial Mortgage Alert." Securitizing loans provides a financing tool for funds and allows them to recycle their capital to originate more loans. TPG Capital, Benefit Street Partners, Silverpeak Argentic, LoanCore Capital and KKR all securitized at least $1 billion in loans in 2018.

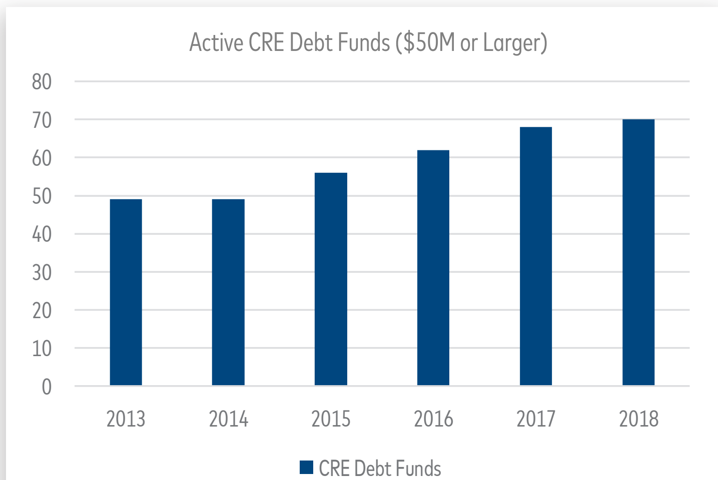
CLO issuance is off to a slow start in 2019, though, as volatility in the capital markets caused bond spreads to widen in the fourth quarter. Higher spreads make it less economical to securitize loans that were originated with lower coupons before spreads increased. It also forces securitization programs to increase spreads on loan quotes, which makes them less competitive to other types of lenders.

Another reason spread volatility is a problem is that the growth in debt fund competitors has pushed loan spreads down in recent years. Loans on transitional properties were routinely quoted at L+450 to 500 basis points a few years ago. Today spreads on similar loans are closer to L+225 to 325 basis points.

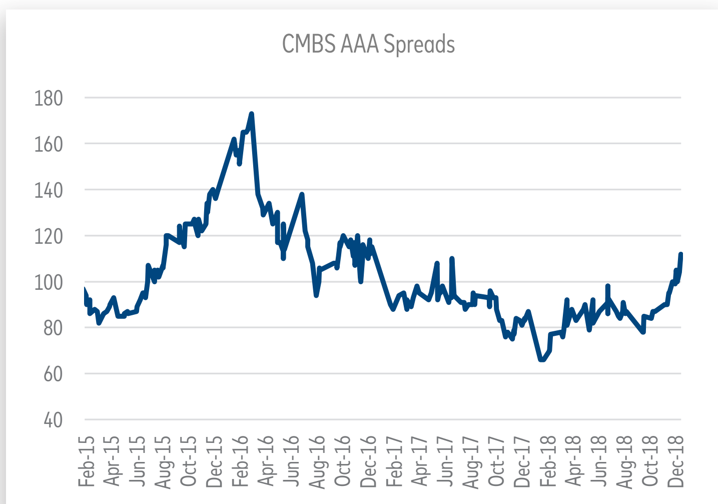
Although lenders have generally not originated loans with excessive leverage and overly optimistic future underwriting projections, as they did at the height of the last cycle, there is fierce competition on pricing. That creates worries that lenders will start cutting corners or chasing riskier deals to meet yields promised to investors. Some funds are originating loans with higher leverage or on properties with higher vacancies, little to no cash flow in place and even construction loans.

Cycle play or permanent tool?

The aftermath of the financial crisis has ceded the field for lending on non-stable assets to non-traditional lenders. Their future relies to some extent



Sources: Real Estate Alert



on whether banks return to the segment. Banks have a cheaper cost of capital, giving them a natural advantage over debt funds if they are competing for the same product.

While smaller banks remain competitive in the middle-market segment for construction and redevelopment loans, large banks don't seem inclined to go back into lending on risky real estate on a wholesale basis. Large banks ($250 billion in assets and up) still maintain significant commercial mortgage operations, but they increasingly focus on stabilized properties and longer-term loans. Larger banks are cutting back construction lending, which has historically had higher default rates than other loan products.

"We don't see banks returning to (the transitional lending) space anytime soon," said Todd Sammann, executive managing director & head of credit strategies at CBRE Global Investors. "Banks are focused on balance-sheet management, and the last thing they want is the potential for volatility. Funds are better positioned to finance risky assets."

If the retreat by banks is long term, debt funds are better positioned than other types of lenders to win loans on non-stable properties. Life companies and government-sponsored enterprises (GSEs) concentrate lending on stabilized properties. CMBS lenders were once active in floating-rate loans, but demand for bonds backed by transitional assets dried up after the financial crisis. While that can change, CMBS programs will be less competitive as long as bond investors keep a tight watch on collateral quality.

One thing for sure is that the increase of capital into all segments of commercial real estate has opened more avenues for managers to create vehicles aimed at niches to serve both borrowers and investors. "There are far more players and pockets of capital than there ever has been, and that's a good thing," said Lisa Pendergast, executive director of the CRE Finance Council, a Washington, D.C.-based trade group representing the commercial real estate capital markets.

—Paul Fiorilla, Director of Research

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