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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS

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The replacements

Value-add and opportunistic lenders have filled a void left by traditional banks and securitized products, and now have a firm grip on the private real estate marketplace, writes Thomas Duffell

Hands tied: traditional lenders are curtailed right now, leaving scope for alternative lenders to step up

Last year, just shy of $25 billion was corralled by private real estate investment managers to lend to property investors, according to *PERE* data. That total dwarfs the $9 billion raised for real estate credit funds in 2009.

The comparison with 2009 is significant, as that was the first full fundraising year following the global financial crisis and it was the year before the finalization of the banking reform measures that followed it. Chief among them Basel III, introduced in December 2010 and staggered into implementation in the years following, has been responsible for turning the property sector's lending universe on its head. Full implementation is expected in 2019.

With Basel III's rules slowly coming in to force, banks must now hold more cash reserves to account for anything that falls into the 'high volatility commercial real estate category,' or HVCRE in shorthand. Having to keep this extra risk-retention capital has limited the real estate lending capacity of some of the property sector's most historically ensconced lenders and given opportunity to a new order of loan issuers. As *PERE*'s fundraising data suggest, private real estate investment managers have been quick to plug this gap.

"If you are an opportunity fund targeting returns of 15-plus percent [internal rate of return], then you usually require higher leverage. They need to borrow 65-75 percent [loan to value] to generate the IRR. That's where we come in. Banks can only typically make 50-60 percent LTV loans now. Our focus puts us in that space the banks have made available," says Boyd Fellows, founder and managing partner at San Francisco-based real estate lender Acore Capital.

According to Fellows, Acore made around $4.9 billion of loans across approximately 70 deals in 2016 and he says the expectation is for a similar volume this year. He adds that being able to lend billions is critical in taking advantage of the opportunity to replace the banks in real estate lending.

"Basel III affects most of the bank lenders who could address $100 million loans, so that is the space being targeted," says Fellows.

Perhaps predictably, New York-based property sector powerhouse Blackstone is another firm that has been able to raise a series of multi-billion-dollar debt funds. Its latest, Blackstone Real Estate Debt Strategies III, corralled $4.5 billion for a final close last year.

Yet, an executive at one of real estate's biggest non-bank lenders, who declined to be named, says it is not banking regulation creating this lending opportunity. "Basel III has certainly hurt construction lending as the concept of HVCRE, which is focused on high LTV or LTC development loans, and so you are hard pressed to find a traditional bank loan for development today," he says.

"But, the other thing that has changed, and when I say changed that would be calling the period 2005 to 2007 a normal period, and it wasn't, is the end of a period of time when the securitized markets could digest just about anything. That was really the market that disappeared that opened up this opportunity."

After the collateralized debt obligation model blew up and banks became more conservative, the early real estate debt funds in 2009 were targeting global financial crisis assets, and buying loans from banks, says the non-bank lender. Then, as real estate markets started to recover by 2011, distressed property buyers needing a loan to finance business plans were left with limited options.

"It was natural for businesses like ours to say, 'We are not buying as many loans as we were, but we can make loans with a similar risk profile to people rehabilitating these properties.' That was the first step in the process of these businesses becoming direct lenders," he says.

Further opening up the space for non-bank lenders was the declining appetite among banks following the aftermath of the crisis.

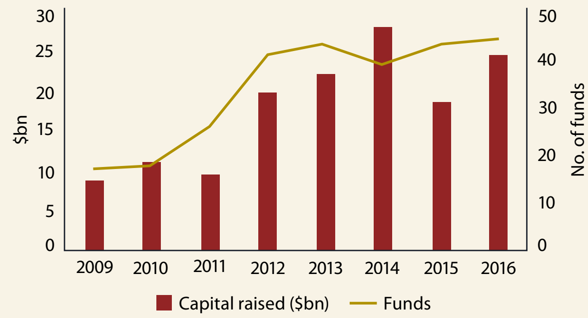
"There are really two major issues that are affecting the volume of opportunities in the non-bank market; the regulatory issues but also regulated banks' risk appetite for real estate at the point of the cycle. Big banks are going to do everything they can to not fail or take big losses again on their real estate portfolios. As such, their risk appetite has definitely moderated in addition to changes being caused by regulatory scrutiny. Those two things together create opportunities for us," says Mark Cagley, chief credit officer of Starwood Property Trust, the US's largest commercial mortgage REIT, with a market capitalization of more than $5 billion.

Jeff DiModica, president and managing director at Starwood Property Trust, adds: "In 2012-15, banks were competing with us on 65-70 percent LTV loans, but new capital rules in 2016 made it more efficient for them to lend aggressively to us at 50 percent LTV instead, which has allowed us to engineer higher returns for the same risk."

"The interesting thing is that while Basel III constrains the banks from making 65-75 percent LTV loans, we come in, fill the void, and then sell the embedded 50 percent LTV loan to the banks"
Boyd Fellows

Accumulating debt

Real estate debt fundraising last year was more than double 2009 levels



Source: *PERE*

Yet, while the real estate giants initially replaced bank lending, other market sources say that smaller players are trying to find ways into the space.

"It started with the marquee names replacing the banks, but what is happening now, and will continue, is that the same structures are now going down market with respect to sizing. You are now starting to see smaller platforms doing loans. Before it might have started at $100 million and up in origination, whereas now there are groups willing to look at $50 million and others even willing to do $25 million," says David Blatt, chief executive of investment bank CapStack Partners.

According to Blatt, smaller banks have been far more impacted by regulation than their larger counterparts, so they are even more conscious in putting capital out. This is particularly the case for the type of asset classes where the non-bank lenders are operating: value-add, opportunistic, transitional and even development plays.

"You're dealing with groups who are coming from an equity background. They're looking at projects with the perspective of, 'If this deal goes sideways, am I comfortable stepping in? Yes, because of my equity background.' They're financing at very reasonable leverage rates, compared with the last cycle," Blatt says.

However, other market sources question the longevity of these smaller debt fund managers.

One investment banking source, who also spoke on condition of anonymity, says that funds under $500 million

Wall street: banks are less dominant a lending force in private real estate markets these days

will not make the manager any money. He says that the number of employees on the payroll, leases, travel and entertaining budgets, and other operating costs will make it hard for the smaller groups to break even.

Sustainable strategy

There is a larger proliferation of this non-bank lender profile that market sources predict will continue. The near-$9 billion committed to real estate debt strategies in 2009 was raised across just 17 funds, whereas last year, 44 funds attracted $24.5 billion in capital support, according to *PERE* research.

In spite of an increasingly crowded marketplace the opportunity for these non-bank real estate lenders is expected to endure for the foreseeable future. And, as it does, these investor-lenders are able to match the double-digit returns they would expect from straight equity outlays by selling off the senior participation of their loan – often to the very lenders that are today prohibited from issuing the same original loan.

"The interesting thing is that while Basel III constrains the banks from making 65-75 percent LTV loans, we come in fill the void and then sell the embedded 50 percent LTV loan to the banks," says Acore's Fellows.

CapStack's Blatt adds: "For the banks, they are able to come in at a much lower leverage point with a subordinated lender of an institutional calibre behind them, charging the same rate they would have charged directly to a borrower at a much higher leverage point.

"From simply an administrative standpoint, it is a wholesale opportunity. The banks love this because they don't have to go out and spend the resources to bring an end borrower into the bank in order to originate that loan. It is being brought to them at a wholesale level, so there is a cost-saving, better credit, and they are still earning the same yield. That is going to ultimately sustain this profile."

While the value-add and opportunistic real estate markets need financing and banks continue to take on less risk in property lending, the rise of the non-bank lender profile will continue.

That is not to say that investors backing this proliferating array of debt funds are always onto a winner. Starwood's DiModica warns: "For every deal we do we pass on 20, but someone does those 20.

"Just because there is available capital doesn't mean they are always good deals. There is a risk that non-bank lenders without credit expertise enter the space and people will make mistakes."

And, as if the market needed another reminder of who is ultimately in charge of US regulation, he concludes: "We are also closely monitoring potential regulatory changes under the Trump administration that could alter the competitive landscape." □