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U.S. Real Estate Credit

A Safe Harbor in Tumultuous Times

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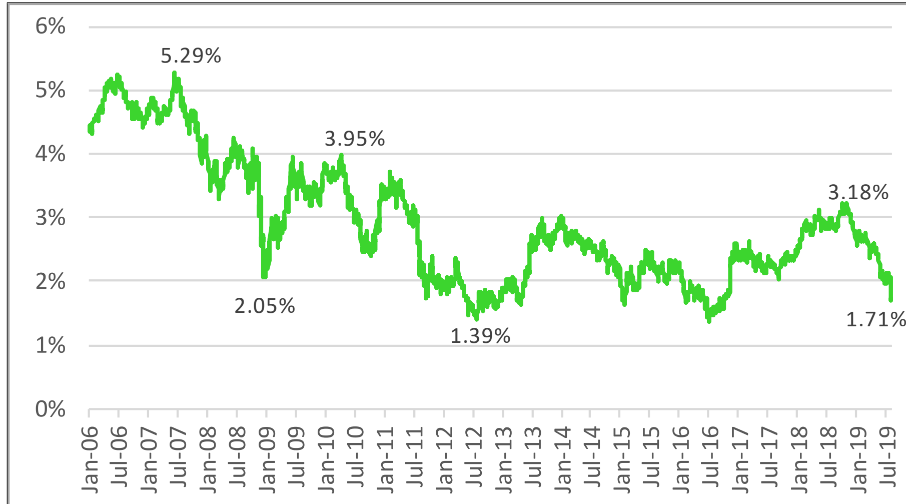
Executive Summary

Since the Global Financial Crisis ("GFC"), we have witnessed an active and ongoing rotation of capital from liquid fixed income strategies to higher returning illiquid credit strategies, as investors continue to search for yield in a persistently low rate environment. Alternative credit, defined here as real-estate backed fixed income[1] and corporate middle market direct lending[2], has been a particularly attractive investment opportunity given its ability to deliver strong current yield with medium term liquidity and moderate risk. However, over the past few years, we have witnessed a meaningful divergence between the risk-return profile of illiquid real estate credit and that of illiquid corporate credit, as underwriting standards and asset quality have remained robust in real estate, while noticeably atrophying within the corporate universe.

Fixed Income Markets

Capital markets have been experiencing change, as uncertain monetary policy coupled with ongoing geopolitical events and global trade dynamics continue to impact investment returns and investor appetite. The Fed has implemented the first rate cut in over a decade, as the 10-year Treasury moved below 2.0%, down from approximately 3.0% just one year prior, and we are now experiencing an inverted yield curve. Corporate spreads remain tight, the new issuance market remains active and fixed income flows continue to be strong.

Figure 1: Historical 10-Year U.S. Treasury Yields[3]



[1] Repayment driven by cash flows generated by rental contracts associated with underlying real estate / commercial properties, such as Multifamily, Office, Retail, Industrial assets

[2] Repayment driven by cash flows generated by an underlying operating company

[3] Bloomberg, July 16, 2019

Figure 2: U.S. Bond Market Issuance (*$ in bn*)[4]

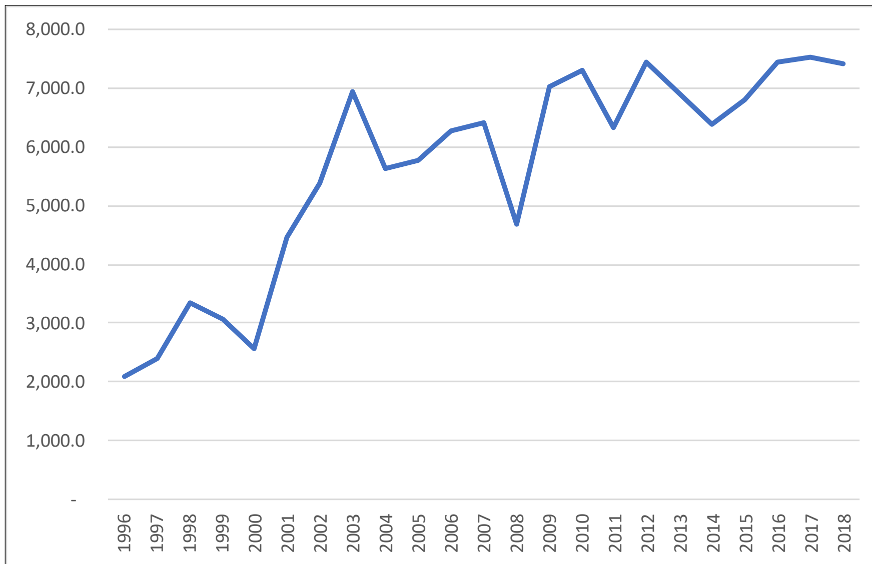
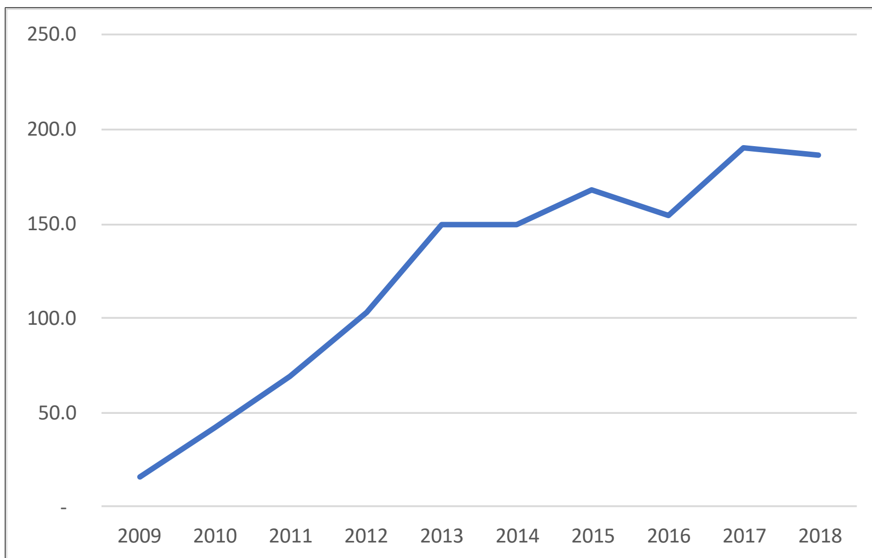


Figure 2 above illustrates the meaningful uptick in fixed income issuance, while Figure 3 below illustrates the rise in Commercial Mortgage-Backed Securities issuance over the past approximately ten years.

Figure 3: Commercial Mortgage-Backed Securities (CMBS) Issuance (*$ in bn*)[5]



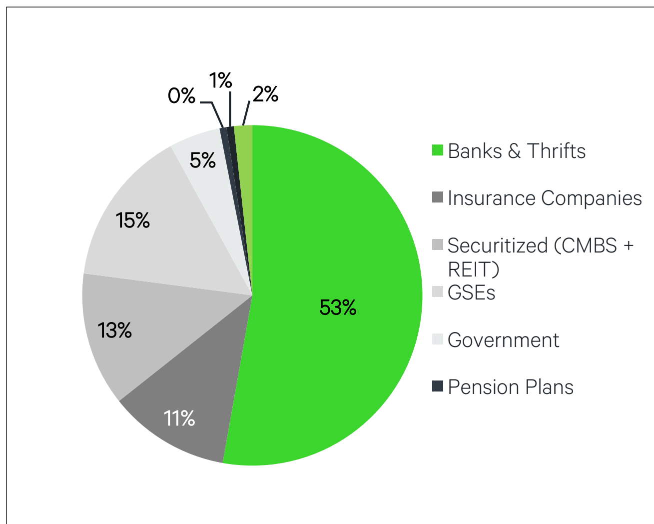
[4] Bloomberg, July 17, 2019

[5] Ibid

Market Opportunity within Illiquid Credit

Prior to the GFC, banks and insurance companies served as the primary liquidity providers both within real estate and corporate credit. However, as a result of more stringent capital and liquidity requirements, traditional providers became increasingly averse to lending. This shift in the broader landscape created significant opportunity for more nimble private lenders. Figure 4 below illustrates the composition of the lending universe post GFC. The lending market has been growing rapidly, as non-regulated lenders continue to capture increased market share.

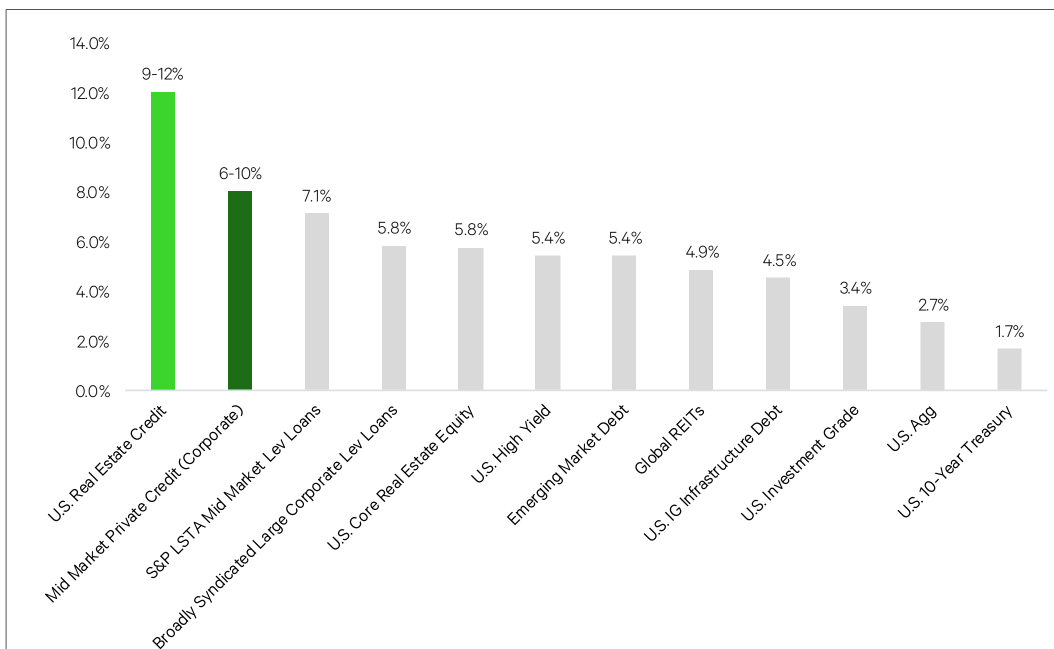
Figure 4: Landscape of Liquidity Providers Post GFC



As investors searched for yield and looked to take advantage of this new expanded opportunity set given the pullback in traditional lending, a large volume of capital actively rotated from more liquid fixed income instruments to illiquid corporate and real estate credit.

In particular, the ongoing rotation to real estate credit has largely been due to its strong yields and predictable, stable cash flow that is secured by tangible underlying assets. On both a relative and an absolute basis, real estate credit delivers higher yields than does illiquid corporate credit. Further, as illustrated in Figure 5, yields associated with real estate-backed fixed income have been and continue to be significantly higher than nearly all other forms of liquid and illiquid credit.

Figure 5: Yield Comparison Across Fixed Income[6][7]



The Evolution of Underwriting Standards

Post GFC, investors witnessed a material shift in the underwriting standards governing both real estate and corporate lending. Given the role that the U.S. subprime single-family mortgage market played in the banking crisis and ultimate market downturn, real estate lending standards came under intense scrutiny and have been closely monitored ever since.

In the real estate lending market, Loan-to-Value (LTV) ranges tightened while required Debt Service Coverage Ratios (DSCRs) increased. Structural protections, including interest reserves and carveout guarantees, became increasingly rigid and assumed new roles as key risk management tools. Borrower creditworthiness became more critical with in-depth analysis conducted around sponsor track record, net worth, borrowing history and even underlying motivations and anticipated behaviors in a default scenario.

[6] Source: U.S. Real Estate Credit: Bridge Debt Strategies proxy with target current yield of 80-90% of total gross returns of 11-13% (net returns of 9-11%); Corporate Middle Market Direct Lending Proxy, Bridge Investment Group Research: Typically 200-300 bps premium to syndicated loan market (Reuters 'US Middle Market Loan Yields Fall Amid Low Deal flow' article as of 5.3.19); S&P LSTA Middle Market Leveraged Loans: Reflects syndicated middle market loans to companies with EBITDA of $50 million or less in the S&P LSTA Leveraged Loan Index; Broadly Syndicated Large Corporate Leveraged Loans: Represents loans to companies with EBITDA greater than $50 million in the S&P LSTA Leveraged Loan Index; U.S. Core Real Estate Equity: JPMorgan core real estate equity 2019 estimations, JPMorgan Long Term Capital Markets Assumptions; U.S. High Yield: iShares iBoxx High Yield Corporate Bond ETF as of 8.9.19; Emerging Market Debt: JPMorgan EMBI Global Core Index as of 8.9.19; Global REITs: iShares Global REIT ETF as of 8.9.19; U.S. IG Infrastructure Debt: Blackrock Infrastructure Debt estimations; U.S. Investment Grade: LQD Investment Grade Corporate Bond ETF as of 8.12.19; U.S. 10-Year Treasury: US 10-Year as of 8.12.19; U.S. Agg: AGG Barclays Agg as of 8.12.19 (includes: US Treasuries, Federal National Mortgage Association, Govt National Mortgage Association; Federal Home Loan Mortgage Corporation)

[7] No assurance can be given that Bridge Debt Strategies will achieve it return or yield targets

Figure 6: Real Estate Lending Standards Pre and Post GFC

	Pre-GFC	Post-GFC
Loan to Value (LTV)	70 - 90% on aggressive valuations	60 - 80% on reasonable valuations
Stabilized Debt Service Coverage Ratio (DSCR)	1.15 – 1.25x	1.25 – 1.50x
Interest Reserves for Transitional Deals	Minimal interest reserves often waived	Fully funded interest reserves with replenishment requirements or debt service guarantees
Amortization on Stabilized Loans	Not required	Required
Carveout Guarantees	Not required	Required
Cash Management Structure	Not required	Required

Similarly, within corporate middle market direct lending,[8] underwriting standards initially strengthened post GFC. Lenders imposed lower leverage ratios, more restrictive financial and maintenance covenants and higher interest coverage ratios. Additionally, many corporate lenders shied away from lending to sponsor-backed companies given the historical preference of private equity managers for higher leverage and less restrictive covenants.

A Meaningful Divergence: Real Estate Credit versus Corporate Credit

Despite the initial convergence in lending standards and the heightened underwriting discipline in both real estate and corporate credit, we are now witnessing a meaningful divergence between the two universes with respect to not only the stringency of lending requirements, but also the underlying deal structures employed.

Real Estate Credit

Very significant levels of capital have flowed to real estate-backed fixed income, as investors have sought yield-oriented investments secured by hard, income-producing assets. Real estate underwriting standards have held steady in the post-GFC era, and lenders largely have maintained a consistent level of discipline in sourcing, underwriting and structuring loans. Structural protections, including covenants have remained restrictive, Loan-to-Value and Debt Service Coverage ratios have remained conservative and borrower creditworthiness continues to be critical.

The underlying integrity and rigor of the underwriting process within real estate credit generally has remained as strong as it was immediately post-GFC, as lessons learned and a desire to avoid past mistakes has been a motivating factor. Further, real estate lending standards have not exhibited any indication of weakening, largely due to the increased scrutiny on the industry's role in the GFC and the resulting credit controls imposed by banks since 2008.

[8] "Middle Market" defined as loans to companies generating $15-75 million in Earnings Before Income Taxes Depreciation and Amortization (EBITDA), frequently used proxy for cash flow of a company

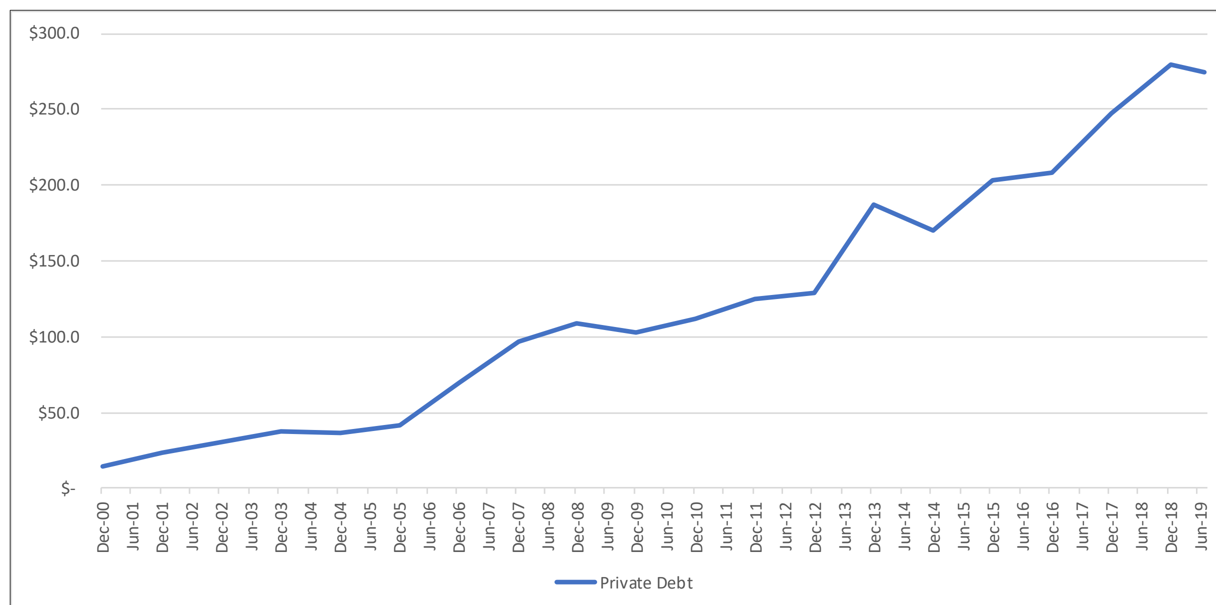
Corporate Credit

Over the past decade, as investors proactively searched for yield given the low rate environment in which traditional assets exhibited a high degree of correlation and a general inability to deliver desired returns, many re-allocated capital from more liquid fixed income strategies to illiquid credit strategies at an accelerated pace.

The influx of capital to illiquid corporate credit coupled with the lack of regulation in a space historically served by highly-regulated banks led to unusually high levels of dry powder chasing a limited number of deals. Specifically, within corporate private debt, direct lending funds continue to hold a majority of the dry powder totaling $103 billion.[9] High levels of dry powder have resulted in spreads succumbing to downward pressure and private credit managers struggling to deploy capital.

This oversupply of capital and increased difficulty putting dollars to work has had two very significant outcomes: (i) increased sourcing and competitive pressures faced by corporate lenders and (ii) an erosion of the underwriting standards employed post-GFC and consequent willingness to accept less rigid terms and structures.

Figure 7: Increase in Dry Powder in Corporate Private Debt



The need to maintain a sourcing edge in order to outperform competitors in a highly saturated market coupled with the need to achieve a strong pace of deployment has driven the shift in underwriting standards for corporate lenders. Leverage levels have increased, loan terms have deteriorated, covenant-lite structures have returned and spreads have compressed. In addition, many private lenders are seeking to syndicate deals in an effort to put larger amounts of capital to work while collecting syndication fees. These developments have dramatically eroded the historical resilience of the middle market credit space.

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[9] Preqin Quarterly Update: Private Debt Q2 2019

Previously, private credit investors expected to receive a premium for investments in middle market direct lending given the illiquid nature of the loans and the fact that the underlying companies tend to be more vulnerable to a market downturn. However, average middle market spreads have tightened such that the premium investors once expected and received relative to large syndicated deals has evaporated. This has led many investors, both individual as well as institutional, to question whether the lower return and higher risk now associated with illiquid corporate credit is truly worth the illiquidity or whether they would be better served to allocate to other Alternative credit strategies, such as real estate-backed fixed income, in which loans are secured by tangible, underlying assets and the path to control in the event of default is much clearer.

Figures 8 and 9 below provide a comparison across both real estate and corporate credit underwriting standards post-GFC relative to today.

Figure 8: Real Estate Underwriting Standards Post GFC / Today[10] [11]

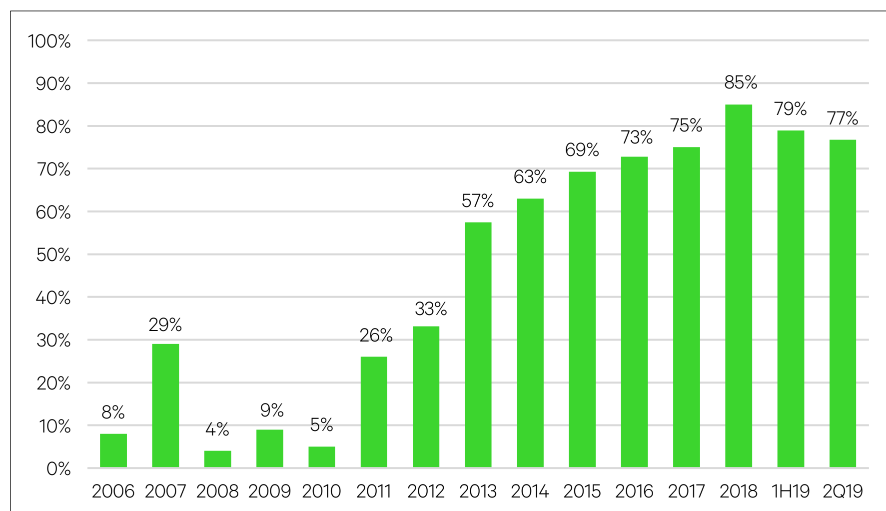
	Post GFC / Today
Loan to Value (LTV)	60 - 80% on reasonable valuations
Stabilized Debt Service Coverage Ratio (DSCR)	1.25 – 1.50x
Interest Reserves for Transitional Deals	Fully funded interest reserves with replenishment requirements or debt service guarantees
Amortization on Stabilized Loans	Required
Carveout Guarantees	Required

Figure 9: Corporate Credit Underwriting Standards Post GFC / Today[12]

	Corporate Credit	
	Post GFC	**Today**
Leverage (Total Debt / EBITDA)	3.0 – 4.0x	5.6 – 5.7x
Purchase Multiple	6.5 – 8.5x	10.6 – 12.6x
Equity Contribution	45%	40 – 50%
% of Institutional Loans that are Covenant-Lite	5%	~ 80%
Credit Terms:	**Post GFC**	**Today**
Covenant Cushion (Leverage)[13]	20 – 30%	40%
Add-backs to EBIDTA	10 – 15%	Up to 25%

[10] Bridge Debt Strategies
[11] Post GFC defined as the one to two years following the 2007-2008 period
[12] LCD Quarterly 2019Q2
[13] Covenants that set a maximum level for a financial ratio; leverage ratio covenant includes the concept of a cushion identifying the range above the opening total leverage ratio to which borrowers may go; https://www.pehub.com/2007/11/dusting-off-financial-covenants/ "Dusting Off Financial Covenants" November 29, 2007

Figure 10: Covenant-Lite Loans as a Percent of New-Issue U.S. Institutional Loans



It is evident that standards within real estate have held steady with no material change between the period immediately following the GFC and today. However, corporate lending standards have shifted quite markedly during this same time period. It is worth noting that the sponsor equity contribution has remained relatively consistent largely because sponsors must now inject more cash into deals in order to be competitive as purchase prices continue to soar. Additionally, the change in the proportion of institutional loans that are covenant-lite has increased quite dramatically, as illustrated in Figure 10 above.

Modification and loss rates are yet another factor to be considered, as they have been particularly significant within the corporate middle market direct lending space. Ratings agencies typically focus on default only and have a very narrow definition based on whether a company either misses an interest or principal payment or files for bankruptcy. However, as Cambridge Associates points out, this definition fails to accurately capture the fundamental and widespread credit stress that many private corporate credit funds have been encountering.[14]

Before missing a payment or filing for bankruptcy, a middle market borrower who is unable to fulfill its loan obligations is highly likely to contact the lender and request an amendment to the existing agreement. One such example is a request to convert to a Payment In Kind (PIK) structure in which interest payments are added to the principal balance of the loan in lieu of the borrower making cash payments. These modifications and amendments may be evidence of material credit stress and while often not captured by standard metrics, this stress has the potential to be quite detrimental to underlying investors. Further, within the corporate space, modification and loss rate ranges tend to be very wide, with modification rates ranging from 6% to over 20% and loss rates ranging from 2% to over 17%[15], another factor investors must take into account when assessing the true risk/return profile of an illiquid corporate credit investment.

[14] Cambridge Associates, “Stress and Losses Among Middle-Market and Senior and Unitranche Loans” July 2019

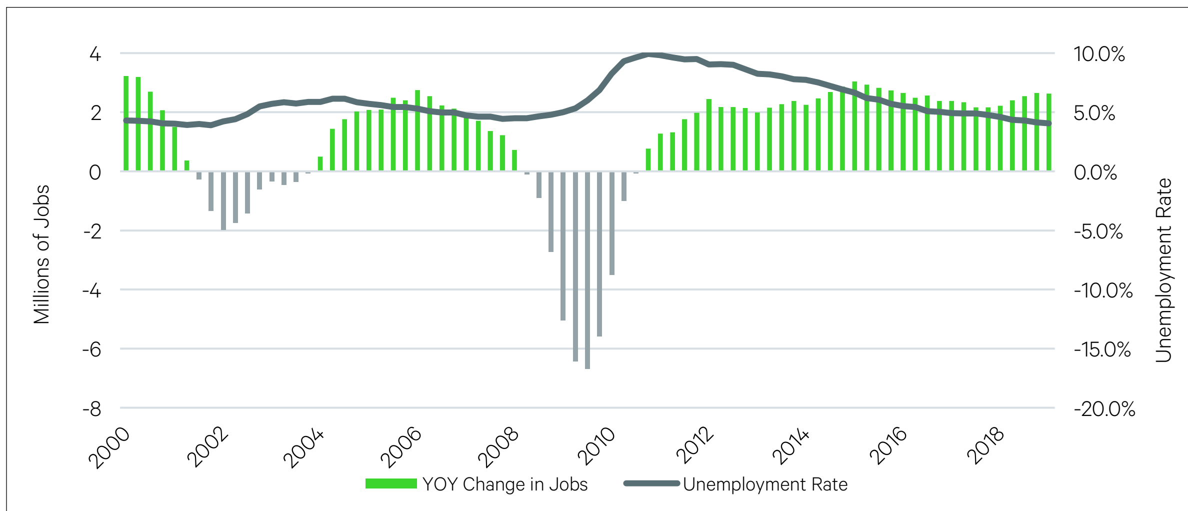
[15] Ibid

Healthy Real Estate Fundamentals

Prudent execution within real estate credit is expected to continue, as managers take a conservative approach to underwriting and structuring in order to avoid the mistakes of the past. Just as important is the fact that real estate fundamentals remain healthy and are driving the strength and stability of real estate capital markets.

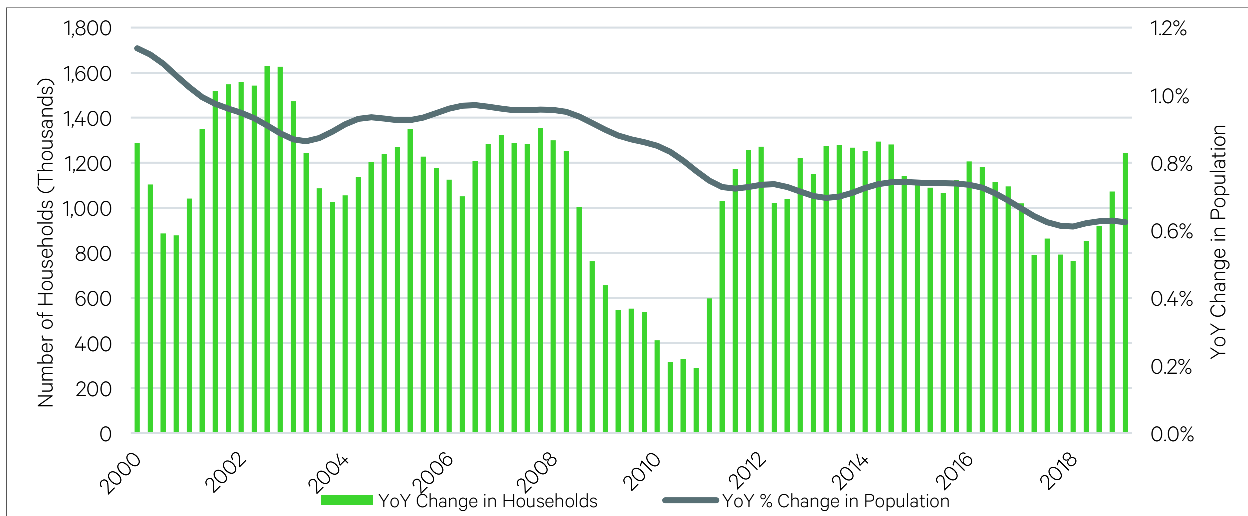
U.S. employment continues to be robust, as during the most recent expansion, an average of 600,000 new jobs were added each quarter. The unemployment rate declined 62% since the 2010 peak and currently stands around 4%. Employment growth and wage growth coupled with strong population growth and household formation have and will continue to drive strong demand for real estate across the United States. Further, inflation has remained under control throughout the current expansion, which supports continued growth amidst tight labor market conditions.

Figure 11: U.S. Job Creation and Unemployment Rate[16]



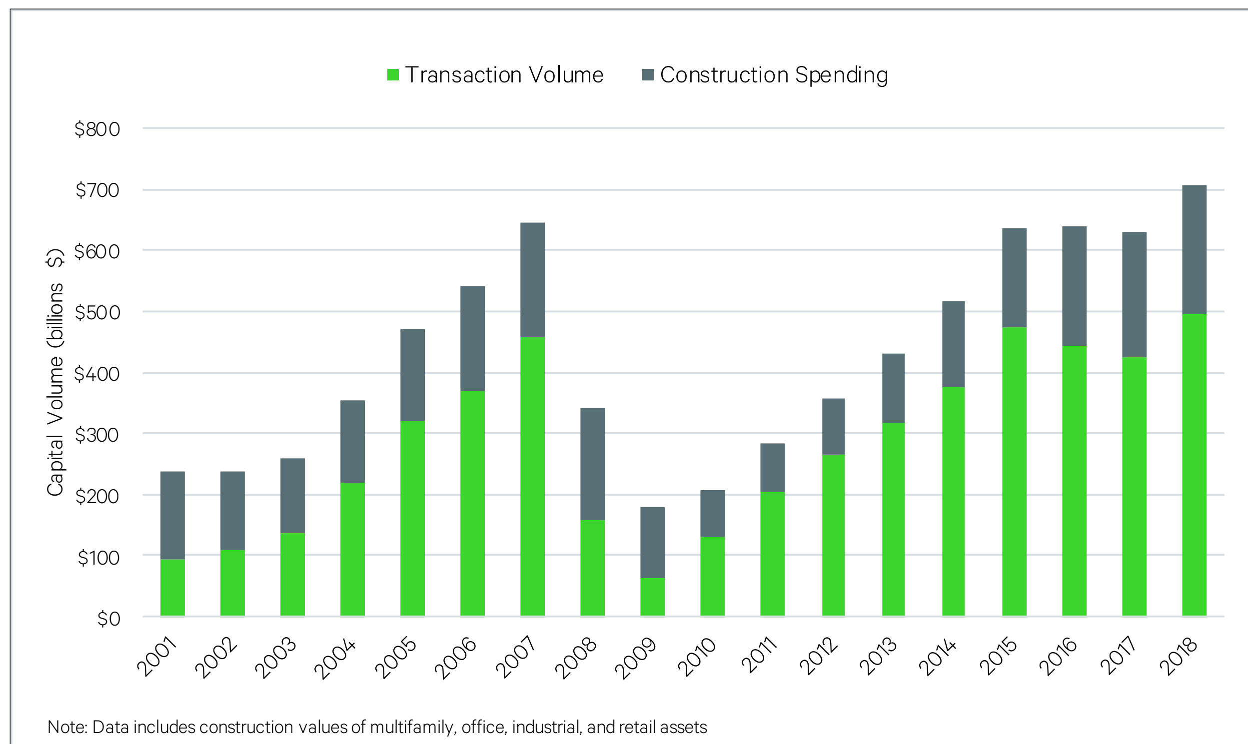
[16] Moody's Analytics, July 9, 2019

Figure 12: Household Formation and Population Growth Levels[17]



Healthy real estate markets and strong transaction volume, as illustrated in Figure 13 below, are expected to continue to drive robust real estate credit markets given the ongoing need for reliable debt.

Figure 13: Total Real Estate Transaction Volume and Construction Spending[18]

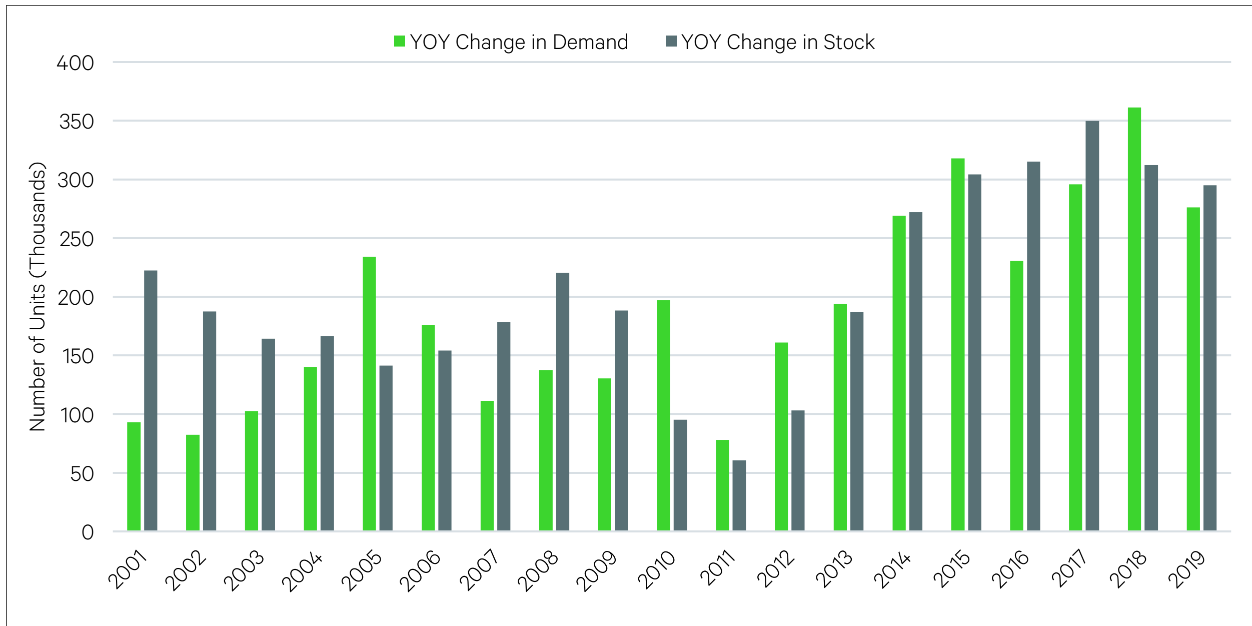


[17] Moody's Analytics, July 9, 2019

[18] Real Capital Analytics, Moody's Analytics, July 9, 2019, Bridge Investment Group Real Estate Research

The Multifamily sector, in particular, has been supported by both cyclical and secular demand drivers and continues to exhibit strength. A favorable supply/demand dynamic exists, as demand has kept pace, and even outpaced in some years, changes in supply. As demand and supply remain in balance, rent growth has outpaced inflation throughout the current expansion. The consistent and steady rise in both supply and demand has bolstered the U.S. apartment market and is a positive driver for the continued strength of real estate markets.

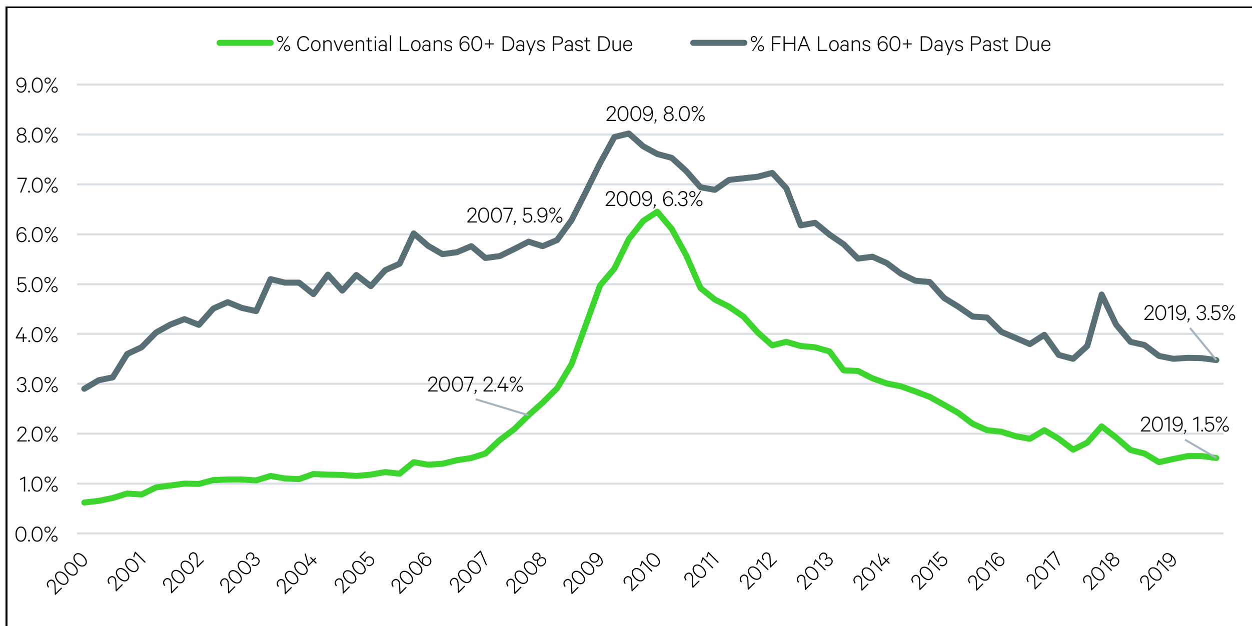
Figure 14: Multifamily Supply / Demand[19]



[19] CoStar Analytics, July 8, 2019

Further, real estate delinquency rates have been favorable, as both Federal Housing Administration (FHA) and Conventional 60+ day delinquency rates have steadily trended downward since their 2009 peak. FHA 60+ day delinquency rates are currently 41% lower than the year prior to the GFC and are approaching their 20-year low.

Figure 15: Real Estate Delinquency Rates[20]



Path to Control

In addition to a divergence in underwriting standards between real estate credit and illiquid corporate credit, perhaps one of the most distinct differences between the two is the path to control in a downside scenario. In the case of real estate, a unique opportunity exists for a well-positioned manager with a robust operating platform to take control of the underlying asset, optimally operate the property and effectively extract value for debt investors. This differs markedly from a typical corporate credit default process in which intercreditor agreements govern, negotiating leverage is limited, the bankruptcy process tends to be long and recovery values are low.

[20] Moody's Analytics, July 8, 2019

Conclusion

Since the Global Financial Crisis, we have witnessed a material rotation of capital from traditional assets to Alternative assets and more specifically, from liquid credit to illiquid Alternative credit. Immediately post GFC, both real estate credit and corporate private credit provided valuable investment outcomes to portfolios.

However, now nearly a decade later, a more nuanced rotation of capital has been taking place, as investors continue to search for yield, but are also seeking investments secured by tangible underlying assets, markets that provide attractive opportunities on a risk-adjusted basis and credit underwriting that has maintained a high degree of integrity. Corporate private credit is "undeniably in a slump"[21] and fundraising has fallen to its lowest level since 2016, as capital has moved at an accelerated pace to more reliable forms of fixed income, such as real estate credit.

The strength of the real estate credit market continues to be driven by disciplined execution, stringent underwriting standards and healthy real estate fundamentals. These factors will continue to support the ongoing rotation of capital from illiquid corporate credit to real estate-backed fixed income, as relative value investors seek greater opportunity and better value.

[21] Preqin Quarterly Update: Private Debt Q2 2019

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