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Lenders assemble

The implementation of Basel III regulations means the stage is set for private credit lenders to expand. A key question is how these platforms will solve the issue of capacity. By Henry Leonard

Private real estate credit providers are preparing for what they believe will be a generational opportunity to expand their platforms as the market prepares for the initial implementation of Basel III regulations on July 1, 2025.

The regulations, colloquially referred to as 'Basel Endgame,' are expected to significantly increase bank capital requirements – and subsequently decrease bank capacity to originate commercial real estate loans.

As a result, private credit funds, mortgage real estate investment trusts, investment management companies and other non-banks lenders are already seeing the impact of these pending changes, say panelists on *PERE Credit*'s inaugural alternative lender roundtable.

The April 25 discussion included Charlie Rose, Los Angeles-based global head for Invesco Real Estate; Richard Mack, co-founder and chief executive of New York-based Mack Real Estate Group; Anne Jablonski, executive managing director and head of real estate at SitusAMC; Scott Singer, principal and co-lead of Toronto-based Avison Young's Tri-State debt and equity finance team; Tiffany Theriault, managing director on the real estate credit team at New York-based Apollo; Jason Hernandez, head of US real estate debt at New York-based Nuveen Real Estate.

Similar to the period after the global financial crisis, the market has recently seen alternative lenders lean in as some traditional capital sources have pulled back, says Apollo's Theriault: "The alternative lending market really started in 2009, when the rest of the lending market was largely shut down because of the financial crisis.

"The implementation of Basel III and Dodd-Frank created more capital requirements for banks, which meant they had to hold, on average, 15 to 20 percent more capital for any given balance sheet position, and alternative lenders stepped into that void. Further implementation of these regulations will continue that trend."

But there is some tension around the need for an alternative source of capital and private credit providers' ability to fill that void. Capital raising – including dedicated funds, separate accounts and insurance capital – is a key component of this. "Part of the growth of alternative lenders has been building insurance platforms and deploying permanent capital on behalf of insurance companies," Theriault adds.

There is another important factor at play: the way in which private credit providers are using back leverage to finance their positions, Nuveen's Hernandez notes. Back leverage, which is typically provided by banks and can include warehouse lines and note-on-note financing, will be a critical component to any private credit expansion.

Hernandez – whose firm invests across the core-plus and value-add space and finances about 85 percent of its positions via structured, non-repo one-off leverage – believes back

PHOTOGRAPHY: **ROBERT A RIPPS**

Jason Hernandez

Head of US debt, Nuveen Real Estate

Hernandez leads the US debt business for Nuveen Real Estate and is responsible for all aspects of commercial real estate debt-based investments, including investment strategy, originations, asset management and oversight of Nuveen's third party credit-focused strategies. He is a seasoned lender, having led more than $30 billion in transactions over his 20-year career.

Richard Mack

Co-founder and chief executive officer, Mack Real Estate Group

Mack co-founded Mack Real Estate Group in 2013 and Mack Real Estate Credit Strategies, its credit business, in 2014. He serves as chief executive officer and is a member of the investment committee of both firms. Mack was also one of the initial employees of AREA Property Partners (founded in 1993 as Apollo Real Estate Advisors).

Charlie Rose

Global head of commercial real estate credit, Invesco Real Estate

In his role as head of global real estate credit, Rose primarily focuses on setting strategy, overseeing portfolio management, and leading the firm's credit investing initiatives in the US. Rose is a member of the North American Credit Investment Committee and the European Credit Investment Committee.

Anne Jablonski

Executive managing director, SitusAMC

As executive managing director and head of commercial real estate at SitusAMC, Jablonski is responsible for the strategic direction and operational oversight of the firm's real estate platform. She has also filled senior roles at Cushman & Wakefield and GenCom American Hospitality.

Tiffany Theriault

Managing director, Apollo

Theriault joined Apollo Global Management in 2021 and is a managing director on the real estate credit team. She is responsible for originating and structuring commercial real estate mortgage and mezzanine loans on behalf of Apollo's permanent capital balance sheets and managed funds.

Scott Singer

Principal and co-lead of the Tri-State Debt & Equity team, Avison Young

Singer is the principal and co-lead of Avison Young's tri-state debt and equity finance team. During his career, Singer has arranged more than $10 billion of construction and permanent debt and equity financing on behalf of New York City-based real estate family offices, developers, and institutional owners.

leverage is the "lifeblood" of the industry. He cautions, however, that not all back leverage is the same.

"We all have to get a lot smarter on how we finance our positions and understand the benefits and risks of repo. It is a different risk profile to use repo financing versus structural leverage."

Hernandez has tracked an increase in structural leverage options from money center banks and larger regional banks as these institutions adjust to the coming regulatory changes.

"The banks, which have always been good at this, are also getting smarter with how and to whom they're providing back leverage. They're thinking more about what their share is of each alternative lender's wallet and asking if they are getting enough of that higher-fee, higher margin business," he says.

Invesco is expecting to see more bank lenders pivot away from direct lending and more towards backing real estate debt funds, Invesco's Rose says.

"In direct real estate lending, buying an A note from an alternative lender and holding a direct loan, or making a direct loan, is pretty inefficient business for them," Rose explains. "The capital charge today is 8 percent. If they provide debt on debt financing, it's just north of 1.5 percent. It's much more efficient for banks to finance alternative lenders than it is for them to be direct real estate lenders themselves."

Consolidation coming

There are roughly 180 private credit providers focused on the commercial real estate space, according to estimates from the panel. But there was a consensus that this high number of firms is at odds with the size these lenders will need to expand.

Having a large asset base allows firms to carry certain costs, whether it's using capital markets to finance positions, or having an asset management team being more rigorous now than two or three years ago, Hernandez says.

"Scale matters, and we will see more consolidation. There are 180 debt funds in the world today, but there probably should be 20 or 25, and five to eight that matter."

Scott Singer, principal and co-lead of Toronto-based Avison Young's Tri-State debt and equity finance team, concedes some consolidation is likely. But as an adviser, he believes this trend may not be positive from the borrower's perspective. A diversity of capital sources is beneficial for the entire market.

Jablonski observes an increasing trend at SitusAMC: a surge in inquiries from foreign investors seeking third-party support and expert opinions on their prospective investments in commercial real estate. These investors are keen on understanding the actual market conditions and property values before making any commitments.

"We're often brought in to bridge the gap between the current market reality and the credit standards set by foreign capital providers," Jablonski explains. "Foreign investors are adhering closely to their credit parameters, and if the deals don't align with what's presented to them, they simply won't proceed. We've witnessed numerous deals falling through for this reason. Today, for many buyers, the focus lies squarely on values and whether or not they've reached their lowest point."

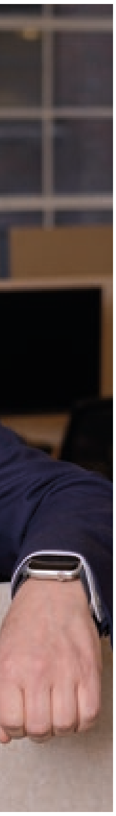
SitusAMC holds the belief that not all asset managers have accurately adjusted their asset values to reflect current market conditions. "The crucial question is whether they'll be able to maintain their current valuations or if adjustments will be necessary," Jablonski says.

Early movers

Panelists reported a growing urgency among investors that now is the time to capitalize on the depressed property valuations seen across sectors. As investors start to move, this will boost dealflow, provide transparency on pricing and create competition.

"Part of the growth of alternative lenders has been building insurance platforms and deploying permanent capital on behalf of insurance companies"

TIFFANY THERIAULT
Apollo



"We all have to get a lot smarter on how we finance our positions and understand the benefits and risks of repo"

JASON HERNANDEZ
Nuveen

"While transaction activity has been picking up, I believe it will remain muted through the end of the year. But I think there is a broad expectation that within real estate portfolios, values should reach a bottom at some point this year," Rose says. "Within the transaction market, there is a consensus that the trough has actually already been reached and there is also so much dry powder on the sidelines, mostly in closed-ended funds which needs to be deployed."

Singer says Avison Young has been fielding a spike in calls from global capital allocators, noting there is a rising perception that "New York is on sale."

"We've traditionally represented New York families, and several of the younger generations who have not been active acquirers for the last 20 years now see this type of environment as the one where their ancestors built and acquired their portfolios. They see this as a buying environment for the first time in their career essentially, and they want to know how they can take advantage of this market."

Yet with capital costs still at a 15-year high, pricing and valuations remain depressed.

"We can create competition around the better deals, but it's not led to a pushing of sizes," says Singer. "We may wind up with 10 lenders competing for a deal, but there's still a constraint that is mostly based on the cost of capital."

From where Mack Real Estate sits, Mack notes the firm has seen transaction activity pick up in recent weeks: "But volume is going to stay low because there doesn't seem to be the pressure to force sales. The sales that are happening are happening mostly at negative leverage. So, this market is going to be locked for a while.

"In the past, when we have been through recessions, whether you were calling the bottom right or wrong, you were paid to wait. Today, if you're buying assets, you're paying to wait, and you must have a lot more conviction around investing."

A key metric market participants are pointing to is replacement costs, which are now estimated at about 50 percent. "I do think there will be people who say, 'Buy signs are here because of replacement costs. But it is expensive to get it wrong in this real estate market," Mack adds.

The growing sense of urgency seen, along with an acceptance that rates will be higher for longer and an estimated $930 billion near-term maturity wall, means that more sellers are capitulating.

"The belief that we are going back to lower rates is disappearing," Singer says. "We went through a process where it was practically impossible to do deals as rates were rising and it was unknown as to how high they would go. That moved everyone away from transactions. Now it feels different. Conversations have moved from 'It's not time to act yet' to 'Let's lock in the rate while we can.'"

Underpinning this urgency is the considerable dry powder – much of it in closed-end vehicles – sat on the sidelines waiting to be deployed. "If you're a closed-ended vehicle, you have an incentive because eventually your investment period ends," Hernandez says.

Asset and market selection

Against the backdrop of the discussion about the availability and cost of capital is a greater focus on asset selection, with investment decisions increasingly hinging on regions and specific asset classes. This reinforces the notion of a fragmented marketplace, panelists say.

"Every asset class, every sub-market, is its own story right now," says Mack. "We're in a very disjointed environment."

In the office market, where lenders and borrowers are grappling with depressed valuations and continued remote and hybrid working practices post-pandemic, Singer notes there is an area of activity for office loans, albeit on a limited basis: the commercial mortgage-backed securities market. The yields on these loans are being used to increase the overall yield on CMBS pools, Singer adds.

"We closed four office building loans last year, all of which had extraordinarily low leverage – it was $25 million on a 450,000-square-foot building," Singer explains. "It was very challenging, and it was a tiny subset of the market. It's going to be different this year, and it's already different in a meaningful way."

Hernandez notes that the traditional life company fixed-rate structure is not always the best execution for an office asset. "A highly capital-intensive asset class [like office] is not a good fit for a long duration, fixed rate loan. One of the biggest thing that scares me, in my book, is not a transitional loan, it's a legacy fixed rate loan with a 3.5 percent fixed coupon with sponsors taking cash out. You're creating misalignment every month, every quarter. That's going to be a challenge with offices."

Outside of office, Jablonski says the advisory company is observing robust performance across various sectors.

"We're noticing strong performance not only in major food group asset classes but also in other sectors like healthcare, self-storage, and R&D facilities. These 'hot properties' are generating impressive returns."

Jablonski notes there is a heightened emphasis on deal sponsorship. "There's a notable shift towards scrutinizing deal sponsors more closely," she explains.

"Lenders are delving deeper into the borrower's background, track record, and commitment to the project. They want assurance that the borrower has the right team, sufficient experience, and the capital needed to see the project through, thus avoiding scenarios where they relinquish control. The key questions revolve around the competency of the team and their commitment to resolving challenges rather than walking away."

The next layer to that question is around the sponsor's access to capital and operational expertise, Theriault says. We are not in an environment where if you build it, they will come. Not all sponsors are equal, and even for any individual sponsor, by sector they are not equal."

Changing landscape

Alternative lenders are looking at a vast space for investment, with Invesco's Rose noting real estate credit is the fourth-largest fixed-income asset class in the US. This asset class has also, historically, been less accessible to a significant number of investors.

"We are seeing the bank pullback create a void in the market. But at the same time, we are also seeing an increased understanding among a wide array of investors who see that real estate credit is secured by hard assets and, historically, has had a lower default and loss rate than corporate lending," Rose says.

"[Real estate credit] has been more stable than many other fixed income alternatives and offers a premium income return in this environment. We are now seeing increased inflows from a wide array of institutional and retail investors into the space."

Another part of the changing landscape can be seen around the size of loans private credit providers are doing – and a growing understanding that sponsors are as different as the properties in which they are investing.

"I do think the dynamic of private owner, local operator, sharpshooter versus the larger institution is changing," Hernandez says.

Hernandez notes Nuveen – having completed around $7 billion in the core-plus/value-add space over the past four years – averaged around $100 million per position around that time. But the firm anticipates increasing its origination of smaller positions in the coming months and years.

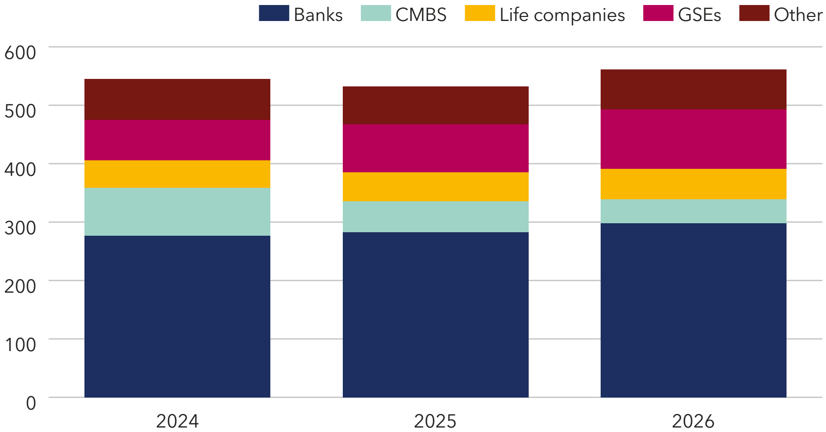
"Today, for many buyers, the focus lies squarely on values and whether or not they've reached their lowest point"

ANNE JABLONSKI
SitusAMC

"The belief that we are going back to lower rates is disappearing"

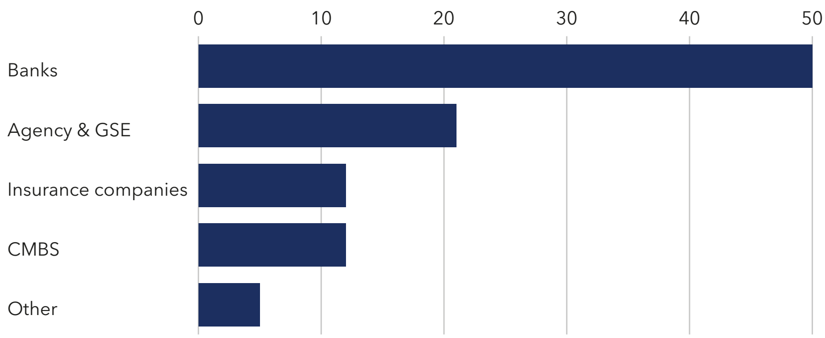
SCOTT SINGER
Avison Young

Banks hold the bulk of loans with maturities through 2026 ($bn)



Source: Trepp/Federal Reserve

Outstanding commercial real estate debt by lender type ($bn)



Source: Mortgage Bankers Association, Trepp, MSCI

"We are all fiduciaries of our respective capital sources. We all want to back institutional sponsors that are well-capitalized, that are vertically integrated and have real expertise. But generally, there's less liquidity so transaction sizes are getting smaller," Hernandez says.

Alternative lenders are looking at a vast space for investment.

Jablonski observes that although lending levels remain lower compared with previous years, SitusAMC has witnessed a significant uptick in the number of firms vying for the limited number of high-quality deals available in the market. "Despite the substantial amount of dry powder available, we initially expected competition to ease up, but it seems to have intensified due to the abundance of available capital from alternative providers.

"There's persistent heightened competition as numerous players vie for a limited pool of 'good' opportunities. We're noticing that deals are attracting multiple bidders, which underscores the critical importance of deal structure in securing execution.

How a deal is structured ultimately determines its success or failure."

Refinancing versus new loans

Panelists continue to see a mix of refinancings and new acquisition opportunities. Deal pipelines today across Nuveen's entire credit spectrum of fixed-rate core, core-plus, and value add, comprise around two-thirds acquisitions and one-third refinancings, Hernandez says.

Invesco, by comparison, is seeing far fewer acquisitions, according to Rose, with originations down on historical levels: "The refinancings getting done are generally the better deals; if someone's having issues, they're generally working with their existing lender and not finding a new lender to bail them out."

Mack Real Estate Group – as an integrated developer, operator, investor and lender – is taking a portfolio-wide view, says Mack. "On assets that have a long-term hold as part of the business plan, we'll go long with them from a financing perspective and that's going to be our long, fixed-rate exposure. We'll also take assets that have a slightly more immediate upside, and go shorter with our financing, understanding that we're not as hedged on that asset."

Apollo, which operates as a lender and a borrower, has been focused more on refinancing when it operates in the latter sphere, Theriault says: "As a lender, we're staying away from the value-add space, or the stabilized space, because we just can't compete, and instead we're only looking at construction loans."

One point of differentiation for Apollo, investing on behalf of retirement insurance vehicles in part of its business, is the long-dated nature of its capital, Theriault says. "For us, going shorter than five years on fixed rate loans doesn't make a lot of sense since we are trying to match assets with longer-term insurance liabilities.

"For other firms that can only offer floating-rate loans, it's hard to compete given the level of interest rate volatility in that market. For acquisitions, especially, we find that sponsors want to lock in today's rates if the returns work, rather than riding out interest rate volatility."

Singer notes that operating real estate is very different than trading rates: "The advice we have always given to our borrower clients, regardless of whether rates were very low or not, was to be in the real estate business, not the interest rate trading business."

Extending and pretending versus rational rolling

During the global financial crisis, sponsors often opted for an extend-and-pretend strategy, seeking loan extensions to buy time for a brighter market. But panelists noted they are seeing more of what they termed a "rational rolling" in today's market.

"This market presents a landscape unlike any we've encountered in recent years," remarks Jablonski. "The trajectory of inflation and interest rates will serve as pivotal factors shaping the fate of property asset values. These elements will not only influence short-term outcomes but will also significantly impact the formulation of both immediate and long-term strategies."

At the same time, unless the government forces the banks' hands on real estate loans, rational rolling is likely to continue.

"The problem is primarily in the regional banks. The money center banks have a relatively modest portfolio of real estate, and the rest of their credit is performing tremendously well," says Mack. "They are the first place that the government would look to clamp down on, but I don't think they're going to be pushed. I also don't think the government's going to push the regional banks."

Unlike previous cycles, the real estate market did not overbuild, and fundamentals are relatively strong, Mack says. "This is not a real estate market-induced recession that we're

"This is not a real estate market-induced recession that we're feeling"

RICHARD MACK
Mack Real Estate

"What helped us out of the global financial crisis was alternative lenders stepping in and being a different source of capital"

CHARLIE ROSE
Invesco

Deal pipelines

Volumes have been somewhat resilient. Deal speed? Less so

How are the tectonic shifts in the lending landscape impacting transaction pipelines?

Panelists point to an improvement in volumes – namely in core-plus and value-add – but acknowledge that transactions remain sluggish. "[Pipelines are] probably 60 percent of where they would have been [normally], which is way better than the 10 percent it was a year ago," Hernandez says. "The main difference is that you're not seeing that velocity. Transactions are taking longer."

For Avison Young, pipelines are strongest in the industrial and multifamily sectors, with rising activity in office refinancings too, Singer says. He believes it is a "fallacy" to suggest all the closed-end fund capital available will get invested. "What's key is finding sources that believe the market is close enough to a bottom to be excited to invest, and who can create capital structures that can handle the normal lack of linear progression that deals have at higher rates."

The development business has also gotten tougher, with Singer adding that an all-cash strategy can "flip the narrative" by changing debt from being the biggest risk in a transaction to becoming part of the upside: "It's hard to do, but if you can find deals that make sense now on an unlevered basis, then you can create the opportunity to refinance later as part of the upside strategy."

feeling. This recession was created by stimulus, and a reaction to the stimulus of raising the rates, and real estate not being able to adjust quickly enough from a revenue perspective while their expenses went up."

But while some may look to extend-and-pretend out of necessity until there is greater clarity on office usage, occupancy, rents and rates, certain borrowers – particularly in more capital-intensive assets – may not have that option.

Hernandez says: "In 2018 and 2019, you could get yield in hospitality and office, if you weren't doing development. If you're recapitalizing those deals today, the cost of capital is 20 percent. There is no debt capital for office because people view it as equity risk. People will be forced to work through all this sooner rather than later."

Outlook

Despite near-term stressors including a heavy near-term maturity wall and the potential for little rate relief, panelists expressed a degree of cautious optimism.

"If you look at the 2024-27 maturity wall and compare that to the last cycle, the maturity loom is 49 percent higher than it was last cycle. But if you look at the market value of real estate, it is up 80 percent," Hernandez says. "The refinance wave is a smaller portion of the overall market today. There will be some distress, but our general view is that it's not going to have as big of an impact."

What's crucial, though, is the need for creative solutions in addressing the challenges that lay ahead, panelists agree.

Rose adds: "What helped us out of the global financial crisis was alternative lenders stepping in and being a different source of capital – whether that's bringing insurance balance sheets to the market in more flexible ways or coming to the table with new channels of capital for real estate debt. There has to be an element of innovation." ■