EXPERT Q&A

Jack Gay, global head of real estate debt at Nuveen Real Estate, takes an in-depth look at the sector's key characteristics

Now is the time for commercial real estate debt

Q Where in the cycle do you think we are for commercial real estate debt?

We are approaching the trough in terms of the real estate downturn, which creates a good point in the cycle for debt. If you look back at how debt performs historically in real estate cycles, the best loans are typically made at the trough or in the early years following the trough when spreads are higher, loan terms are better and you are underwriting off of a reset value.

We can also see looking back that loans made early in the cycle tend to benefit from lower default rates and higher spreads, so we believe we are shaping up for a good vintage in commercial real estate loans.

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Q Why should investors back CRE debt versus other areas of private credit?

One of the unique aspects of commercial real estate lending versus other areas of private credit is that CRE loans are asset-backed and generally non-recourse, so when you flip into a new vintage, your new loans are underwritten off reset values and less dependent on any excess from the previous cycle. In other parts of the market, there may be more of an overhang as borrowers may still have excesses on their balance sheets from the previous cycle.

As a private asset class, CRE debt also benefits from being less correlated to other investment alternatives, there is less volatility in private mortgage loans, and there tends to be a bit of an inflation rate hedge, particularly if you lend on a floating rate basis.

Q How does lending risk differ between the US, Europe and APAC?

First, there are some remarkable similarities globally in terms of what economies have gone through. We are seeing higher interest rates introduced as a response to high inflation, which is now helping to bring inflation down.

The pace of adjustment has varied a little between markets. Europe has certainly faced a bit more uncertainty around the strength of the recovery, and real estate prices have adjusted quicker there than elsewhere. We have

seen less adjustment in Australia, while in the UK, the decline in valuations has been quicker and more pronounced. Those declines are taking longer to roll through in the US, yet the US economy is showing more resilience than Europe.

Q There is talk about an impending funding gap as borrowers hit a maturity wall. Where are the main vulnerabilities?

The maturity wall sometimes gets a little exaggerated in my view. We look at the absolute dollar amount of maturities ahead and there is not necessarily a big spike, though it is higher than in previous cycles.

In part, that is because valuations have gone up over the cycles, but on a relative basis there is less debt against peak values, so the wall is not quite what it has been made out to be. In other words, lenders were more disciplined and lent at lower loan-to-values in this past cycle as compared with the previous cycle.

That said, last year was a relatively illiquid year globally. Loans in the office sector often required short-term extensions as they approached maturity. We expect that to remain the case for some time, and those short-term maturity fixes will add to that maturity wall.

Q Where do you see the best opportunities right now for real estate debt?

The lack of liquidity caused by banks pulling back globally from commercial real estate lending is creating opportunities for alternative CRE lenders to fill the gap. That is why we are seeing higher spreads and better loan terms, given where we are in the cycle, as the large institutional lenders are focused on their own liquidity issues.

This has created opportunities across both fixed-rate and floating-rate executions, but the spread widening and absolute return levels for floating rate loans has created the best near-term opportunity.

Q Many new players, particularly equity shops, are entering the real estate debt space. Is there enough dealflow to support so many players?

The new entrants have been quite modest in terms of the amount of capital they have because of the constrained capital raising environment. We haven't seen a huge amount of activity from new players, with one exception being some equity office owners in the US that have pivoted to provide distressed or rescue capital in that sector.

"The lack of liquidity as a result of banks pulling back globally from commercial real estate lending is creating opportunities"

Dealflow has declined substantially and continues to be muted, given the mismatch in pricing expectations between buyers and sellers, but with capital constrained, there has been enough dealflow to satisfy loan demand.

Q How does the intensifying focus on the sustainability profile of assets alter lending risk?

Sustainability is an ever-increasing consideration when we are underwriting new credits. Over time, assets that are brown in nature will need significant investment to make them greener, so as a lender you need to know what kind of capital will be required and whether it is going to be possible to make assets more sustainable.

Assets that don't have a pathway to sustainability will be in less demand from occupiers and of less interest to other investors and debt providers, creating a meaningful risk to valuations.

Q What does the spread environment look like heading into 2024?

Spreads are high relative to the past decade, but there is hope that as we work through this year more liquidity will come into the market and spreads may compress. There is certainly no consensus around a dramatic drop in spreads in the near term though, and we expect them to stay elevated for some time.

Q Can you see Nuveen lending against traditional office assets again over the medium term?

Yes, but it will be selective. Most portfolio lenders probably have larger allocations to traditional office than they would like right now, so while there may be attractive office assets, lenders still may want to end up with fewer office assets in the portfolio. Until some of those existing office loans show the ability to be repaid, there will be a headwind to allocating to the sector.

Q With the CRE equity market seemingly heading towards recovery, is this the time for CRE debt lenders to move up the risk curve?

There are attractive opportunities across the risk spectrum, from the more conservative core end up to more transitional bridge lending. Transitional lending tends to be priced using floating rate indices, which enhances the yield as the yield curve remains inverted. Where an investor chooses to lend is reliant on each investor's risk/return appetite. ■