Real Estate

Principal℠

Subordinate Debt: a valuable complement to your commercial real estate portfolio

The following paper discusses:

- **What subordinate debt is**
- **Why we believe it is a good complement for a commercial real estate portfolio**
- **Why we think now is a good time to invest in the asset class**

Equity markets have recovered from the global financial crisis (GFC), but still remain volatile because of geopolitical concerns, lackluster economic growth, and declining oil and commodity prices. At the same time, fixed income markets haven't fared much better, causing investors to chase yield in a low-interest rate environment that has persisted since the aftermath of the GFC.

As a result, many investors have found that private commercial real estate debt, including subordinate debt, offers a viable investment alternative that can serve as a complementary product in the construction of their commercial real estate investment portfolios. Moreover, subordinate debt can function as a portfolio diversifier in times of financial market volatility.

Given current and expected near-term financial market volatility, subordinate-debt investments can be an attractive addition to a commercial real estate portfolio. According to an investor panel associated with a CRE Finance Council event in 2016, estimates of the current annual volume of subordinate real estate debt originations in the United States are between US$12 billion and US$20 billion.

Defining Subordinate Debt

There are different types of subordinate debt, and each has its own advantages and disadvantages. Subordinate-debt investments are commercial real estate loans that are subordinated in interest and rights to more senior debt positions. They can be structured in different ways, including mezzanine loans, subordinated "B" notes, and preferred equity. These loans are generally offered by conventional lending sources such as insurance companies and banks. Investors in subordinate debt products include insurance companies, pension funds, sovereign wealth funds, mortgage real estate investment trusts (REITs), endowments, foundations, and other investors via funds.

Mezzanine Loans

Mezzanine loans are a form of debt that are subordinated to other lending instruments, but ahead of the borrower's equity. Mezzanine loans are not collateralized by the underlying property, but rather are secured by the pledge of 100% of the borrower's ownership interest in the property. Given this structure, mezzanine loans provide a simpler and expeditious foreclosure process in the event of a default, and provide the mezzanine lender with a high level of influence and control. However, a mezzanine lender that does not have adequate capitalization to remedy a senior loan default may have limited remedies at its disposal to "work out" a situation, and as a result, may have its interests foreclosed upon by the senior mortgage lender.

Subordinated "B" Notes

Subordinated "B" notes are a form of debt that is subordinate to other lending instruments (an "A" note in this case), but unlike a mezzanine loan, a "B" note's position is secured by the property. In the event an "A" note lender forecloses on the property, the "B" note generally survives this process, and the "B" note holder retains its rights to participate in the "waterfall" of property cash flows once the senior lender has been paid in full. However, "B" note holders generally do not have the same level of control and influence as mezzanine loan holders and are oftentimes at the mercy of decisions made by "A" note holders. The foreclosure process for "B" note holders can oftentimes be lengthy, which is largely dependent upon what state the property is located in.

Preferred Equity

Preferred-equity investments are equity ownership interests uniquely structured between the preferred-equity investor and the property owner. Investors receive a preferred return that is paid after all debt payments are satisfied, but before any distributions of common equity. Preferred-equity investments generally command a higher pricing premium than mezzanine loans and "B" notes. However, in the event a property performs below expectations, there is no guarantee a preferred return will be paid on the investment since it is not a loan instrument. In the event a senior lien holder forecloses on the property, a preferred equity interest may also be foreclosed, thereby wiping out the entire preferred equity investment.

How subordinate debt can complement a commercial real estate portfolio

The flexibility that subordinate debt adds to a commercial real estate portfolio is one of its main benefits. One place this flexibility can be found is embedded in the structure of the product. For instance, subordinate debt products can be sized and placed at different levels within the capital stack, allowing for varying levels of risk and return, based on how the product is structured.

Another advantage of subordinate debt may include the ability to obtain diversity by investing in a portfolio of assets, which provides geographic, tenant, and property diversification. Subordinate debt investment may also give investors access to trophy properties, which are larger assets with higher valuations and premier quality. First-mortgage investments in these trophy assets typically require

very large blocks of capital (oftentimes US$100 million or more) in order to access these assets. Subordinate debt investors, on the other hand, can invest a smaller sum of capital to acquire a smaller portion of the capital stack through a subordinate-debt investment. For example, the owner of a US$500 million New York City office building is seeking a loan with 65% leverage (i.e., a US$325 million loan request). Most commercial real estate lenders do not have adequate capital to access an investment of this scale, but it is possible for a subordinate-debt investor to step in and lend US$50 million for the top 15% of the capital stack (from 55%-65% loan to value (LTV).

Subordinated debt can also provide unlevered equity-like returns, but with an equity cushion to protect the lender in the event of a down cycle. Over the next several years, NCREIF anticipates annualized unlevered equity real estate returns ranging from 5.7% to 6.9%. Subordinate-debt lenders have been able to replicate a similar or better return profile with a 75% last-dollar exposure LTV. The remaining 25% equity cushion provides protection to help preserve the capital if valuations begin to fall.

Lastly, subordinate debt offers a high level of current return for a commercial real estate debt portfolio. Most subordinate debt is lent on properties that are generating a relatively steady stream of income. Therefore, the return is almost all in the form of current income, compared to an equity investment, which may rely in part on future appreciation. This nuance has become especially important given the current ultra-low interest rate environment. Put another way, this ultra-low interest rate environment has allowed subordinate-debt investors to obtain extra yield that they would not normally receive from equity real estate investments or alternative fixed income instruments. Many subordinate-debt investors find this characteristic extremely valuable when constructing their commercial real estate investment portfolios.

We have the potential to provide investors with excess returns relative to unlevered core equity

National, All Property Types (NPI)

Year	Income return	Total return
2016	4.9%	8.5%
2017	5.0%	6.9%
2018	5.1%	5.7%
2016 - 2020	5.1%	6.8%

Source: Pension Real Estate Association Consensus Forecast Survey of the NCREIF Property Index, 2Q 2016

- Commercial real estate equity returns may have reached their cyclical peak
- Appreciation returns are likely to slow as cap rate compression comes to an end
- Income returns are likely to drive sustained but lower property returns over the duration of the cycle
- Since debt generally provides an equity cushion of 20-30%, the lender is provided additional protection from losses

Why is now the right time to invest in subordinate debt

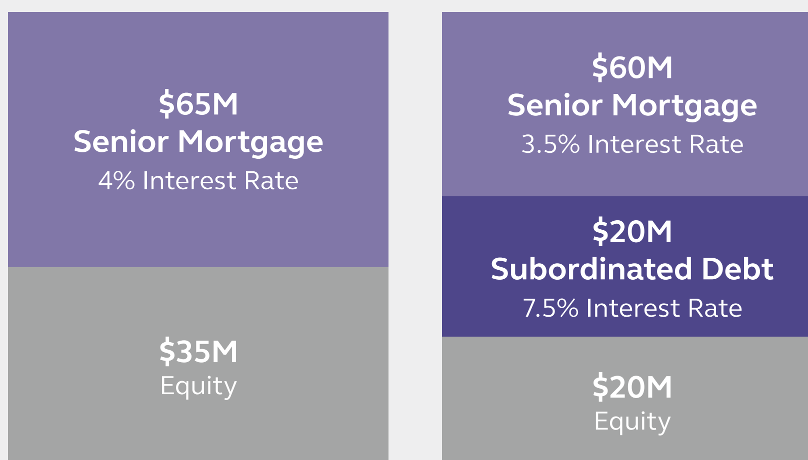
Over the next four years, loans from CMBS, banks, and life insurance companies— totaling more than $750 billion — will be maturing, known in the industry as the “wall of maturities”. Many of these maturing loans will require some level of “de-leveraging,” either through additional equity infusion from borrowers or through other lending sources. Traditional senior lenders remain mostly focused on core stabilized loans, primary markets, moderate leverage points; and they remain largely disciplined. Further, because of the current volatility and pending regulations within the CMBS market, CMBS lenders have become a lender of last resort. As such, a capital gap will likely exist that may prove to be an ideal opportunity for subordinate-debt lenders.

In addition to the upcoming "wall of maturities," it is also anticipated that real estate equity transaction volume will remain robust. With an estimated US$500 billion of private equity real estate transactions closed in 2015, it is clear that the U.S. is still a preferred investment destination for both U.S. and non-U.S. commercial real estate investors. This momentum is expected to continue in the coming years, providing increased opportunities for commercial real estate lenders.

In today's ultra-low interest rate environment, there is also a segment of borrowers seeking to "up-leverage" their real estate holdings to take advantage of the lower cost of capital available today. Blending low first-mortgage interest rates with higher subordinate-debt interest rates still provides borrowers with an attractive total cost of capital. This has become an appealing financing strategy for real estate investors seeking to increase overall equity yields.

In the hypothetical strategy example below, a borrower's return increased from 8.3% to 9.5% by up-leveraging from a 65% LTV traditional first mortgage at a 4% interest rate to an 80% LTV financing package comprising a 60% LTV first mortgage at a 3.5% interest rate and a subordinated debt loan at a 7.5% interest rate, which increases the overall LTV from 60% to 80%. The borrower's overall cost of capital is slightly higher by utilizing subordinated debt, but the equity yields realized by the borrower are higher due to the materially lower equity requirement for this up-leveraged strategy.

"Up Leverage" Strategy Example



Cost of Debt to Borrower:	4.0%	4.5%
DSCR:	2.12	1.53
Borrower Required Equity:	$35,000,000	$20,000,000
Borrower Return:	8.3%	9.5%
Client Debt Yield:	0.0%	7.5%
Borrower Motivation:	Increased return from higher leverage point	

*Assumes a 25 bp LIBOR Floor

Source: Principal Real Estate Investors

For illustrative purposes only. This strategy is presented for discussion/demonstration purposes only and are not a projection of returns to any investor. There is no guarantee that the investment strategy will achieve these results. The actual results may differ materially from that depicted based on numerous factors, including market changes. This example is based upon our current expectations, observations and market conditions and is not intended to be, nor should it be relied upon in any way as a forecast or guarantee of future events regarding particular investments or the markets in general.

Outlook for subordinated debt still strong

At this time, real estate fundamentals remain strong, supply appears moderately well contained because of the lack of construction activity, and vacancies are low. Rental rates also continue to grow, albeit at a moderated pace. Despite good market fundamentals, commercial real estate investors should be cautious of potential volatility over the next two to five years. Although some markets have exceeded their prior peak valuations and rental rates, there are many markets and property types in which there is still an opportunity for continued growth. Investors that are selective and strategic can still find solid opportunities to invest in assets that have strong "real estate 101" fundamentals, a higher-quality and durable rent roll, and the potential for additional rental rate and valuation growth.

In summary, the commercial real estate sector is once again experiencing significant recapitalization needs that the traditional sources of real estate capital do not appear to be in a position to meet. Subordinate debt investments are well suited to fill the capital gap and provide an attractive opportunity to achieve real estate equity-like returns with downside protection provided by borrower equity. Such an investment strategy not only offers attractive current cash returns (appealing to many liability-driven investors) but also some downside protection should the economy soften and the real estate cycle weaken in the coming years. Subordinate debt is as relevant today as ever, and if tactically implemented, can help provide strong risk-adjusted returns, while using a more accepted form of commercial real estate financing.

For additional information: www.principalrealestateinvestors.com

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