Kayne Anderson Real Estate

The outlook for real estate debt, and how to underwrite in today's market

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Andrew Smith,** senior managing director, real estate debt, Kayne Anderson Real Estate. Following is an excerpt of that conversation.

Tell us why you brought debt into the Kayne Anderson Real Estate platform?

Kayne Anderson has a successful real estate–equity platform focused on the acquisition and development of assets in specific alternative sectors. Over time, we were seeing deals and/or opportunities that made a lot of sense, but just not from an equity perspective. Therefore, being able to add debt capabilities is an organic extension of what we already do on the equity side, allowing us to participate in all areas of the capital structure.

Specifically, how do the debt and equity strategies complement each other?

Our focus is the same: capital preservation while seeking to generate attractive risk-adjusted returns in our target sectors, which include class B multifamily, student housing, medical office, senior housing and self-storage. To achieve this, Kayne's debt team approaches the underwriting process from an equity investor's perspective, where every investment we make needs to clear that initial hurdle: Are we completely comfortable that if everything goes wrong, we are still able to protect invested capital? Only once we clear that threshold will we move forward to figure out structure, pricing and all the other elements that go into an investment. When we evaluate debt opportunities for our platform, we are not thinking of it in terms of a trading strategy with loss-adjusted returns where, by making a wide variety of debt investments with a "some win and some lose" mindset, you come out with a return in the middle. The debt platform benefits from the broader real estate platform's experience and institutional knowledge when evaluating investments. This provides an underwriting advantage that typical debt funds do not possess and allows us to position ourselves as a true financing partner for our borrowers, able to tailor solutions specific to a borrower's needs because we truly understand their business. As the real estate platform is vertically integrated, it provides us with an operating capability should there be a loan issue that requires us to take over operations of an asset.

Why should every investor have real estate debt in their portfolio?

When you focus on the debt part of the capital structure, you participate in a way that has a higher consistency of returns, because you have a significant equity cushion secured by real assets that are cash flowing and that you can underwrite to ensure you size each investment appropriately. We take it a step further by focusing on multifamily, plus other alternative, demographically driven sectors that exhibit low correlation to the broader economic cycle. No matter what is going on in the macro environment, we are very comfortable with cash flows on each property we finance, so we know we are not exposed to bigger shocks to the system, or a borrower forced to sell a project at a bad time. The combination of debt investing and the broader Kayne real estate platform produces additional downside protection, by ensuring robust underwriting as well as possessing operating capabilities if there were to be a loan issue. Implementing a debt strategy also ensures that even if markets move against you, interest rates rise or there is pain in terms of property values, you can withstand it in a way that protects the investments. Our place in the capital structure and our ability to tailor solutions for the end borrower and our lending partners have allowed us to produce stable returns for our platform over the long term, no matter what is happening in the overall market. Then, when broader markets are getting dislocated, we're able to step in and fill holes that arise in the market and generate strong risk-adjusted returns for our investors.

What are the key areas you focus on during the underwriting process?

With real assets, it gives us comfort being in a debt position secured by something we feel we can accurately underwrite and value — knowing that, even if there are unforeseen issues that impact the value or performance of our collateral, we have a significant equity cushion behind us to ensure we protect our invested capital. The crux of our underwriting is making sure we are doing everything we can to eliminate macro risks we can't control, or any factors we can't control — whether that is staying away from a market with limited demand drivers or thinking about how we are structuring our deals and our financing to make sure we are not exposed to big moves in rates that could impact performance. Once we remove all that, we look at our risk as a property-operations issue, and if there is trouble with an underlying asset, it goes back to our in-house expertise. We think of ourselves as a financing partner for borrowers, so we have no interest in ever taking a property back. Our interest is working with the borrower to help them get things on the right track. Being in the right market with the right deal structure ensures that is really the main factor we are exposed to, and over which we feel we can have a lot of control.

How has the current market environment changed your underwriting?

For us, it really has not, with our focus being on a property's cash flow and a loan's ability to be refinanced by maturity, as opposed to just being a loan-to-value-based lender. When a loan opportunity comes in, we spend the time to do our own equity-style underwriting and figure out our cash-flow projections. Then, we use that information to back into a loan size that makes sense from a debt-yield and debt service–coverage basis. We have constraints around LTV and loan-to-cost, but that is secondary to the underwriting of cash flows. We utilize normalized interest-rate levels, which we did even when rates were at all-time lows. The result is our underwriting hasn't changed, although recently our leverage points have come down with rates rising so quickly and stress being put on the broader economy.

How has the private real estate debt market evolved in the past 10 years?

During the past 10 or 15 years, we have seen the rise of the nonbank lender, particularly in the debt fund space. Borrowers now have a variety of options, and the overall types of debt funds have evolved. In a market that historically had more closed-end, private equity–style funds, you now see more perpetual vehicles with a range of structures, whether that is nontraded REITs or open-end versions of those closed-end vehicles. Many funds don't necessarily feel all that different than their closed-end predecessors, other than offering investors some level of liquidity and the option to reinvest proceeds. Overall, the private real estate debt market is efficient and now more accepted by the investor community. A decade ago, the response from investors on real estate debt or real estate credit would have been, "We don't know where this goes: Do we put this in our actual real estate bucket? Do we put this into the credit bucket? Or our alternatives bucket?" Over time, they have seen how attractive the asset class is for all the reasons we have been touching on here and have made it a dedicated part of their portfolio.

As an investor, what are the key attributes or competitive advantages to look for in a debt fund manager?

First, look for managers that are industry veterans — they should have the experience of having been through multiple market cycles. Having seen the pitfalls that have happened over prior decades is a huge part of what has informed our strategy since we built the debt platform and is what drives our equity-style underwriting process. Consequently, we prioritize strong, steady cash flows over inflated rent growth assumptions and work to size loans to levels that ensure they can be refinanced based on interest-rate assumptions that make sense. Second, debt managers that have an in-house operator-oriented equity platform like Kayne Anderson's are at an added advantage, as we have deeper insight into the markets in which we invest, with the added security of being able to operate the assets if we need to take control of the asset. Third, having an extensive network of partners, developers, operators and money center bank relationships creates a competitive sourcing advantage for us and often leads to "first look" or off-market opportunities at attractive pricing. We want to avoid focusing on deals that have many bidders where the cheapest cost of capital wins. You are not generating any real excess return, but just moving with the market. You will be highly correlated to the market, which can be volatile.

Managers can further differentiate themselves on the underwriting and operating side. This involves partnering with your borrowers as an experienced player in their sector, so you can tailor deals that make sense not only as a lender, but that the borrower understands and appreciates, avoiding those scenarios where you end up with tough decisions, loan defaults or problems that you can't solve. A manager needs to derisk up front.

Where do you see the most attractive opportunities in real estate debt in the next 12 months?

First, on the loan origination side. While transaction volumes are lower than they have been in recent years, there are still a lot of deals out there that need to get done. The lack of liquidity available in the market means deals that may not have been so interesting to us in 2021 — when there was a kind of food fight and leverage was moving up while pricing was grinding tighter — now, we are able to spend time on those deals, work closely with borrowers to come up with solutions that work for them and allow us to generate attractive returns, despite the lower overall volume of financeable opportunities in the market. We are very excited about that, as well as opportunities to provide subordinate debt behind senior lenders and even to purchase loans on a one-off or portfolio basis from lenders that need to generate liquidity or are seeking regulatory capital relief. Second, we have seen some real dislocation on the securities side, particularly in the single-asset, single-borrower CMBS space. We have seen much wider spreads than historical levels, and we think there may be continued opportunity in that space to participate with very low LTVs, strong cash flows, in protected portions of the capital stack, and in deals within our target sectors.

CONTRIBUTOR

Andrew Smith

Senior Managing Director, Real Estate Debt

Kayne Anderson Real Estate

Andrew Smith is a senior managing director on KA Real Estate's debt platform and is responsible for sourcing, underwriting, acquiring and managing the portfolio of commercial real estate–related debt and securities. Prior to joining Kayne Anderson in 2014, Smith was a portfolio manager and founding partner of Aqua Investment Management.

CORPORATE CONTACT

Ashley Webster

Director, Investor Relations | Kayne Anderson Real Estate

+1 561-300-6273 | awebster@kaynecapital.com

CORPORATE OVERVIEW

With assets under management of more than $14 billion, **Kayne Anderson Real Estate's** investment objectives are to create strong risk-adjusted returns by focusing on current cash yield and increasing value through cash-flow growth, while remaining sensitive to capital preservation. Since 2007, KA Real Estate has invested in alternative real estate sectors, including medical office, high-end senior housing, off-campus student housing/multifamily and self-storage. Our vertically integrated team brings expertise in all aspects of real estate investing and management to each of our investments, thereby maximizing operating capabilities.

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