KEYNOTE INTERVIEW

Holding steady in a choppy market

Private real estate lenders need to focus on underwriting in today's uncertain market, but there are opportunities for well-funded players offering flexibility, says Kayne Anderson Real Estate's Andrew Smith

The sharp rise in the Federal Reserve rate in the second half of 2022 sent the previously buoyant US real estate market into a tailspin as cap rates expanded and transactions slowed. Now the risk of a banking crisis has added to the mix, exacerbating liquidity concerns, and giving many borrowers and lenders a new set of fears.

However, there are attractive real estate sectors that have proven resilient during market downturns and volatile times, which private lenders can capitalize on. Andrew Smith, head of Kayne Anderson's real estate debt platform, explains how the market is developing and the best approaches across alternative sectors where lenders may thrive.

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Q What is the state of the market for real estate debt?

We've seen a steady but orderly removal of liquidity from the real estate lending and financing environment over the last 18 months. The impetus was when the Fed realized that inflation was not transitory and rates needed to be elevated quickly. Those rate hikes created fear that a recession could be triggered causing banks to pull back on lending and, combined with other factors such as geopolitical tensions, raised concerns about the broader real estate market and economic environment.

The securitized market, including commercial mortgage-backed securities and collateralized loan obligations, along with the warehouse lines lenders utilize to aggregate loans for these securitizations, were also squeezed. As soon as the money managers, who were by far the biggest bond buyers, started seeing redemptions, there was a quick removal of support for a lot of the senior bonds. So, if you are a non-bank lender or a bank heavily involved in the securitized space, the strategy doesn't work very well anymore because selling into the bond market is no longer attractive.

Q How much of a pullback are you seeing from banks and other lenders?

There's been stress on banks with increased regulatory pressures and scrutiny over what their real estate exposure should be going forward. This has contributed to a steady removal of liquidity in the markets with many banks taking a step back from lending or ceasing lending altogether. Other lenders continue to make loans but at lower leverage points and more conservative terms, which are more onerous for borrowers, as most lenders are not willing to take on risk in this environment.

While most warehouse providers haven't had to issue margin calls or require facilities to be repaid, their capacity will become an issue. They are not clearing those lines through the issuance of securitizations, which allows them to recycle the capital to fund new loans. All of these factors have contributed to a dearth of activity across the lending market, which is further exacerbated by the effects of rising rates and cap rates.

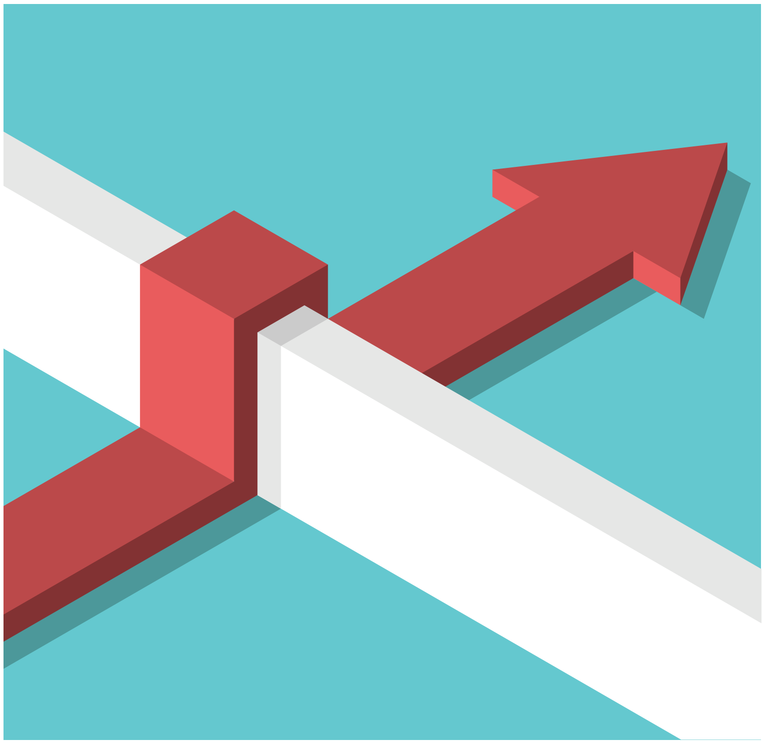
Q Is there an opportunity here for less constrained lenders?

Yes, and this applies to us. If you are a lender that is well capitalized and generally doesn't take exposure to mismatched mark-to-market funding sources, there is a tremendous amount of opportunity. There are areas of the market, multifamily for example, where there was a food fight for the chance to fund those loans in 2021. Now, in a less competitive market, we are able to capture a higher percentage of those opportunities and underwrite the loans at more favorable terms with the best-capitalized borrowers.

Q What are the key considerations for underwriting real estate loans today?

Everything we do, in terms of underwriting, is through the perspective of a real estate owner, aided by having both equity and debt businesses under the KA real estate umbrella. Being able to leverage our institutional knowledge and gain access to information on the relevant market and the real estate securing our debt provides confidence that, even if everything goes wrong, the last dollar of debt is still going to be in a protected position.

On the financing side, we have a variety of partnerships with banks and other lenders, where they are a counterparty which is locked in, so we're not exposed in terms of margin call risk or financing term risk. Loan to value is an important constraint; typically, we



Q What are borrowers looking for?

It depends, but typically a private lender will provide some level of flexibility and more tailored solutions for borrowers. As we focus on alternative sectors with greater operating elements, borrowers need thought and creativity around their loans. Borrowers are also looking for flexibility and shorter-term solutions in an uncertain market. We offer a lot of flexibility through our lending program, which typically offers loans with three- to five-year terms and flexible prepays.

There are also borrowers looking for solutions where their leverage on existing debt might be too high, and we are able to offer creative solutions involving mezzanine debt or preferred equity. The gap between what banks and non-banks can provide is as wide as it has ever been, creating attractive opportunities.

have ended up at an average of around 70 percent, but that's come down a bit.

However, our analysis focuses heavily on our projections of the cashflow from the property that will secure our debt. This is the biggest driver of loan performance, and we size our loans to ensure borrowers can pay debt service and comfortably pay our loan off at maturity. We tend to issue loans on a floating rate basis to ensure we aren't taking uncontrollable exposures, such as rate risk. Every one of our loans has interest rate protection in place at the borrower level ensuring that borrowers don't get overwhelmed by increased debt service requirements from rising rates.

Q Are there profitable opportunities to buy loans from banks?

There is potential for banks needing to raise cash for liquidity purposes and unload loans for regulatory purposes. We have seen some banks quietly testing the market but there is not a fire sale underway. Another opportunity is when banks, which see deals they would typically originate, feel a deal is not the best use of their capital. Especially if it is an existing client, they might ask a lender like us to underwrite the deal and they would take a senior portion, allowing the bank to still service their clients.

Q Which sectors are most attractive to lenders? Are there sectors to avoid altogether?

The sectors where lenders are most interested are those which performed well over the last few years, particularly through the pandemic. Alongside multifamily, we focus on niche sectors experiencing strong demographic tailwinds, with strong supply and demand dynamics going forward, including student housing, seniors housing, medical office and self-storage. We expect those sectors to maintain a low correlation to broader economic cycles.

On the other side, for the last 12 months, office has been unattractive in every shape and form. Banks have been attempting to sell down office exposure, particularly large single asset deals secured by older buildings in major central business districts. However, there haven't been many takers because the bid-ask spread is too enormous.

> *"There's been stress on banks with increased regulatory pressures and scrutiny over what their real estate exposure should be going forward"*

Q What can be done when things go wrong?

The first step is to be protected through strong underwriting to ensure a loan is sized appropriately, but we also typically require a variety of performance covenants that we are testing on an ongoing basis in our loans. If a property is performing dramatically below its business plan, and starts breaching these covenants, we work with the borrower to find solutions which could include instituting things like increasing reserves. We are willing to be flexible and come up with tailored solutions, if borrowers are acting in good faith to maximize property performance.

If all else fails and the borrower wants to hand back the keys, we believe that our equity-style underwriting, and conservative loan sizing will mean that our debt is well protected from a value perspective and that proper management will allow that value to be realized.

Q Where do you expect the market to be 12 months from now?

We think the market will remain fragmented with significant opportunity. The interest rate curve shows the market is pricing in cuts at a pretty fast pace. However, that doesn't match with the Fed's messaging or with what we are seeing in the market. Our view is that rates are going to be higher for longer. The big question is whether the dislocated but mostly orderly markets we've seen over the past year become disordered.

We know banks have maturities coming up, but what is less clear is the actual performance as opposed to valuation of those holdings. The biggest driver of loan performance is property cashflows and if that is holding up, you will see banks and other lenders extend those loans and wait for a better market environment. If we start to see more and more distress on the underlying performance side, that's another issue.

There are sectors where real estate opportunity funds or other real estate investors were buying at incredibly tight levels, making assumptions around rent growth and long-term values which weren't sustainable. Those who did that aggressively while using short-term debt might get crunched on the liquidity side. However, I don't believe the pain from those buyers will, by itself, be enough to create market wide distress.

Our outlook when originating loans hasn't changed; we might have missed some deals when the market was super tight but that has led to very strong performance in our book in the current environment. Nobody really knows where things are going to end up, but you need to make sure that you are prepared for a range of outcomes. ■