EXPERT Q&A

*Heading into the early months of 2024, real estate debt presents an intriguing mix of opportunity and challenges. Andrew Smith, head of real estate debt at Kayne Anderson, explains why*

# Mixed fortunes for real estate lenders as markets bifurcate

**Q How would you describe the health of the real estate debt asset class at the start of 2024?**

The asset class is bifurcated depending on which part of the market you're talking about. In the case of existing loans and outstanding real estate debt, there are a lot of pressure points, particularly for floating-rate loans originated in 2021 or early 2022 that are now approaching their initial maturity dates. These loans are part of the wave of maturities coming due in a dramatically higher interest rate environment.

Higher rates are creating pressure for borrowers that need to replace interest rate hedges or need to refinance or sell an asset in a market where transaction volumes remain depressed. This market dynamic is also creating stress for a variety of different lenders, particularly those that lent aggressively on transitional properties.

SPONSOR
**KAYNE ANDERSON**

Meanwhile, stringent regulations and capital requirements have constrained banks' lending capacity, which has contributed to a dearth of liquidity in the market that is expected to spiral over the next year or so.

On the other side are market participants that have been disciplined during that timeframe and are well capitalised right now, and who are able to be liquidity providers. This environment is creating opportunities to provide financing and buy loans from banks and other lenders that need relief.

The way we have historically approached the business is through a real estate equity lens, trying to size our loans to make sense longer term where we feel comfortable taking exposure. We saw this approach pay dividends in 2020 and in the current market, where our book remains in good shape and where we are able to step in where others are backing away.

**Q What do you see as the most attractive sectors of the market, and why?**

The areas where we see the most

*"The areas where we see the most opportunities are in sectors that have strong demographic tailwinds and lower correlation to the broader macro environment"*

## Q What were the defining real estate debt transactions of 2023?

The defining deals in real estate debt all centred around the opportunity created by loan purchases from banks. One of those was a deal we consummated in September where we purchased a $1.3 billion medical office portfolio from Synovus Bank. It saw an opportunity to sell a high quality performing portfolio of loans at a justifiable dollar price that would allow them to generate liquidity they could redeploy into a higher ROI opportunity. For us, it was a transaction that we saw could generate very attractive risk-adjusted returns for our strategy.

That deal is representative of the types of deals we expect to see going forward. It demonstrates how smart, thoughtful players in the market can structure innovative transactions that are mutually beneficial while navigating a market challenged by high rates, regulatory pressures, and other constraints.

opportunities are in sectors that have strong demographic tailwinds and lower correlation to the broader macroenvironment. That informs where we are spending our time, which includes the student housing and seniors housing market, as well as medical office and certain segments of multi-family housing.

We are seeing continuing demand and a real supply-demand imbalance in many cases in those markets, as well as a thinner group of market participants with expertise in those sectors. Other than multifamily, we have also seen a limited amount of high quality new supply.

There is an enormous amount of new Class A multifamily happening, which is putting pressure on rents and occupancy. But when you drill down to more targeted areas – Class B and seniors housing for example – we expect those will be in high demand.

Geographically, our focus is generally primary markets with multiple demand drivers, including high inbound migration. While activity in some Sun Belt coastal markets that received attention during and after the pandemic has slowed, over the longer term, we see those markets remaining strong. They may not show the same year-on-year growth that they did, but we still think they make sense over time.

## Q How have the US regional banking problems of 2023 shaped today's real estate debt market?

There is a structural issue at play here, when rates were so low for so long and then accelerated so quickly that we are seeing deposit flight from those banks. This creates an environment where banks need to get lighter on the asset side to fund that deposit flight, so they are lending less.

When you layer in regulatory capital reserves for commercial real estate loan books, that creates a situation where it is hard for banks to lend at levels anywhere close to where they were previously. That has created a liquidity hole in the market.

In terms of shaping today's market, when we look at where we sit today, we see more positive information coming out on inflation and interest rates and there is pent-up demand from borrowers. But the only way we get back to a rate environment that bails a lot of banks out is if rates get cut overnight. We do not believe the market is going to see the kind of rate relief that helps banks to the extent they need as we get into the wall of maturities mentioned earlier.

So, even if the market remains positive, we anticipate a long road of a relatively illiquid and fragmented market from the banking side, leading to a continued increase in the importance of non-bank lenders. We are in for a couple of challenging years, with ups and downs and consolidation in the banking system and across many lenders and real estate owners. Plenty of borrowers and lenders are positioned well but there are parts of the market that were overly aggressive and are going to have a difficult time.

## Q What is driving investor appetite for the asset class?

Generally, the appetite for private credit has been enormous for the past year or so. The combination of higher rates and liquidity issues is creating opportunities to make investments at attractive risk-adjusted returns in a more senior part of the capital structure.

The prevailing rate environment eliminated a big piece of investor demand that sought higher returns in opportunistic strategies. As real estate and private credit have become bigger parts of portfolios, a lot of investors who were waiting for an entry point now see one. Right now, we see significant interest from investors for whom real estate credit was not previously a feature of their portfolios. As a result, we've seen a broadening investor base.

*"Right now, we see significant interest from investors for whom real estate credit was not previously a feature of their portfolios"*

## Q Do you see any shifts in the profile of the investor base? Are you making efforts to tap new investor classes?

Over the last 15 years or so, coming out of the global financial crisis, investors were often unclear on how to classify real estate credit: in fixed income, real estate, or alternatives. As real estate credit has got more of a foothold in private equity, the question is now 'does this go into private credit or real estate private credit?' That was getting more defined even without the current environment, which has steadily broadened investor appetite, particularly at an institutional level.

In this market, you have investors that had historically targeted higher returns, which for us means a variety of foreign investors from the Middle East and Asia, starting to look at real estate credit. In our debt funds, we see a lot more interest from non-US investors for more opportunistic debt, as well as from banks and platforms that service retail investors that are looking for products that make sense for them.

On the debt side of our business, we have several strategies that have a lot of demand from those private wealth markets and expect to see meaningful investor demand from those groups in 2024.

*"As real estate credit has got more of a foothold in private equity, the question is now 'does this go into private credit or real estate private credit?'"*

## Q What are your predictions for the asset class in the next 12 months?

We anticipate continued fragmentation and pressure on the market driven by rates, maturing loans, bank liquidity issues, real estate transaction volumes and real estate property and loan performance. The kind of ups and downs and positives and negatives that we have seen in 2023 will not go away for a couple of years.

Trillions of dollars of loans will be maturing over the next 24 months in a market with all the pressures we have talked about, and that market is not as strong as we would like but not as challenged as it felt in spring 2023, when banks were failing. For certain market participants, it will be a hard landing, while for others it will represent an opportunity. ■