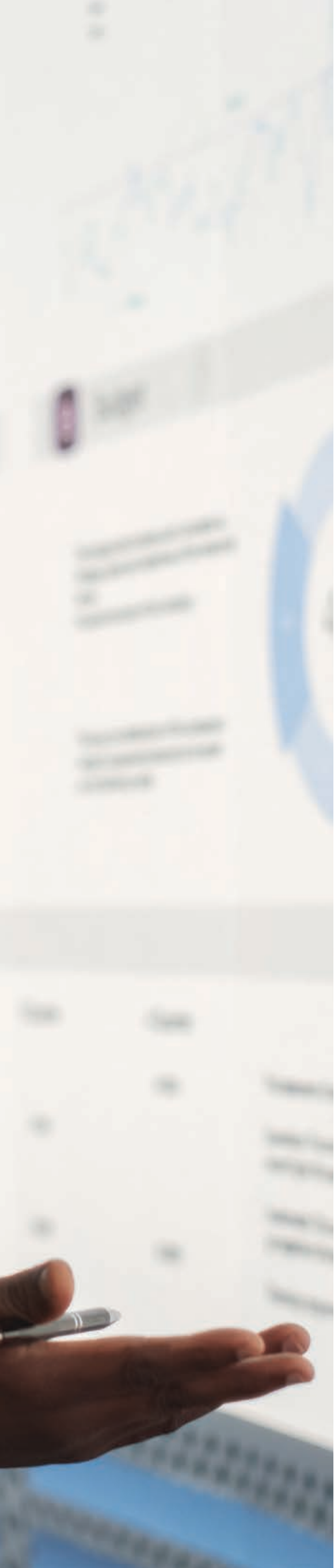
THE CURRENT OPPORTUNITY FOR CRE LENDING

STRUCTURAL CHANGES TO THE MARKET FAVOR NON-BANK LENDERS

April 2024



EXECUTIVE SUMMARY

Favorable lending conditions for non-bank commercial real estate ("CRE") lenders have emerged from a confluence of cyclical and structural tailwinds:

1. Stringent regulatory actions coming out of the Global Financial Crisis ("GFC"), including Dodd-Frank, Basel III, and asset management challenges from legacy investments created obstacles for traditional sources of CRE debt capital.

2. A volatile economic cycle caused by a global pandemic, geopolitical unrest, and aggressive government spending the last few years led to inflation, causing the Federal Reserve to raise short-term interest rates at the fastest pace in 40 years. This backdrop created uncertain valuations and a wide bid-ask spread between sellers and buyers, causing CRE transaction volumes to plummet. The resulting market uncertainty has further reduced debt capital availability.

3. Increased borrowing costs are creating pressure throughout the capital stack, particularly for floating-rate loans and loans with near-term maturities. At the same time, lower transaction activity has slowed the volume of loan payoffs and restricted the lending capacity for banks in particular, the largest holders of shorter-duration, floating rate CRE loans.

4. Private debt providers, including those representing the more conservative non-bank lenders (i.e., life insurance companies) are poised to further capitalize on the current market dislocation.

This confluence of factors is creating one of the best lending environments since the post-GFC era, which generated some of the highest risk-adjusted returns in real estate.

MARKET ENVIRONMENT

The current disorder in the capital markets arose from a variety of factors. A global pandemic, geopolitical conflict, and the highest inflation in 40 years have created seismic shifts in fiscal and monetary policy since early 2020. **Exhibit 1** summarizes the swings in the capital markets over the last 48 months, relative to the pre-pandemic baseline. The Federal Reserve veered from historically accommodative monetary policy during the pandemic (0% short-term rates, doubling the size of its balance sheet to nearly $9 trillion) to raising rates at its quickest pace since the early 1980s while letting nearly $1.5 trillion run off the balance sheet, in an attempt to battle elevated inflation. CRE borrowing costs have more than doubled from their lows at the end of 2021, and a challenging financing environment, combined with discount rate uncertainty, led to **CRE transaction volumes declining over 80% in Q4 2023 from their cyclical peak, the largest drop since the GFC.**

EXHIBIT 1: KEY CAPITAL MARKETS INDICATORS

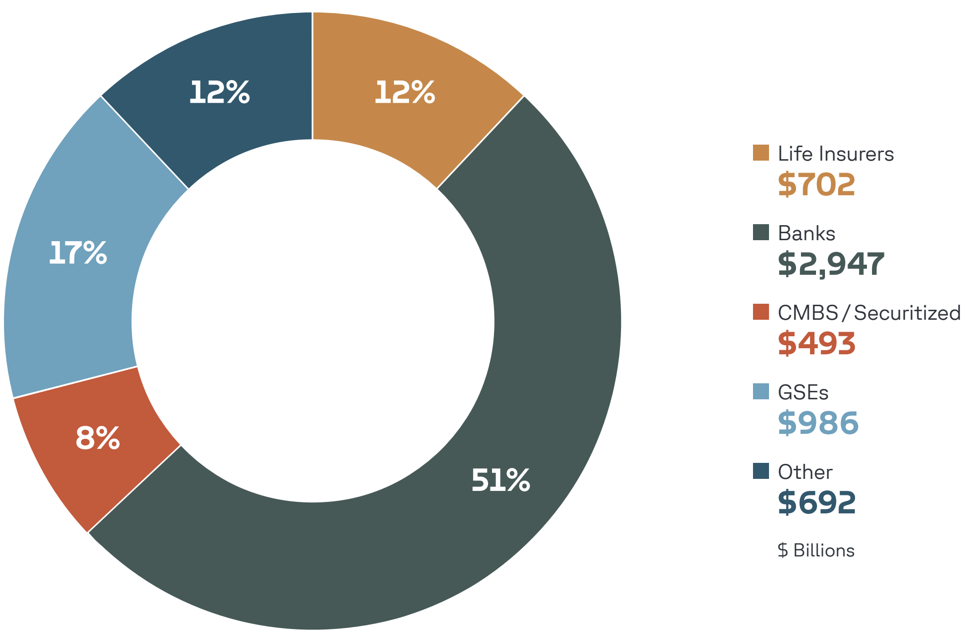
	2016-19 AVG	Q1 2022	FEB 2024
FEDERAL FUNDS RATE	1.3%	0.2%	5.3%
FEDERAL RESERVE TOTAL ASSETS (TN)	$4.3	$8.9	$7.6
CRE DEBT COST	4.0%	3.5%	6.5%
TRAILING 12-MONTH TRANSACTION VOLUME (BN)	$529	$921	$363

Source: Federal Reserve Bank of St. Louis, Commercial Mortgage Alert, RCA, Affinius Capital Research. Note trailing CRE transaction volume as of February 2024. CRE debt cost is from Commercial Mortgage Alert and represents a 50-59% LTV whole loan with 10-year term on one of the four major property sectors: industrial, multifamily, office, retail.

CRE Lender Trends

Exhibit 2 highlights the holdings of traditional lenders of the $5.6 trillion of CRE debt capital outstanding. Banks are the largest lender in the space, followed by the GSEs (i.e., Fannie Mae and Freddie Mac), life insurers, and the securitization market. Note this excludes private debt funds that are not explicitly tracked by the Federal Reserve; however, RCA lending data suggests that private debt funds have comprised approximately 10-12% of all private U.S. lending over the last several years, up from high single-digits in the five years leading up to 2020.[1]

EXHIBIT 2: U.S. CRE LOANS OUTSTANDING BY LENDER SEGMENT AS OF Q3 2023

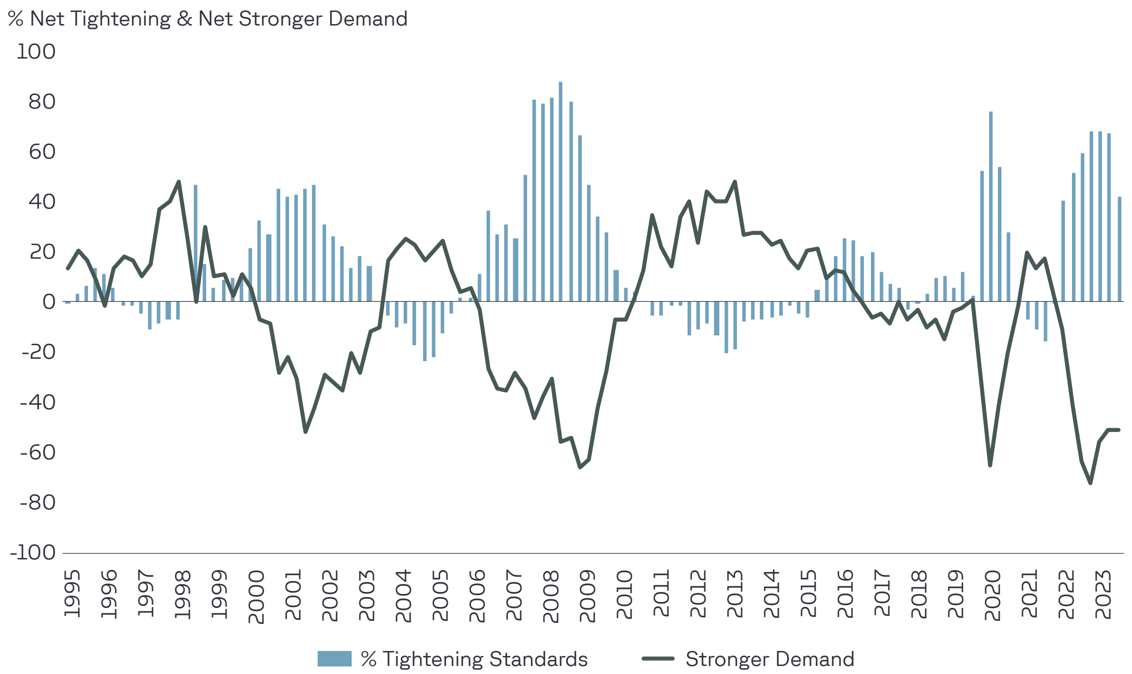


Source: Federal Reserve Flow of Funds, Affinius Capital Research

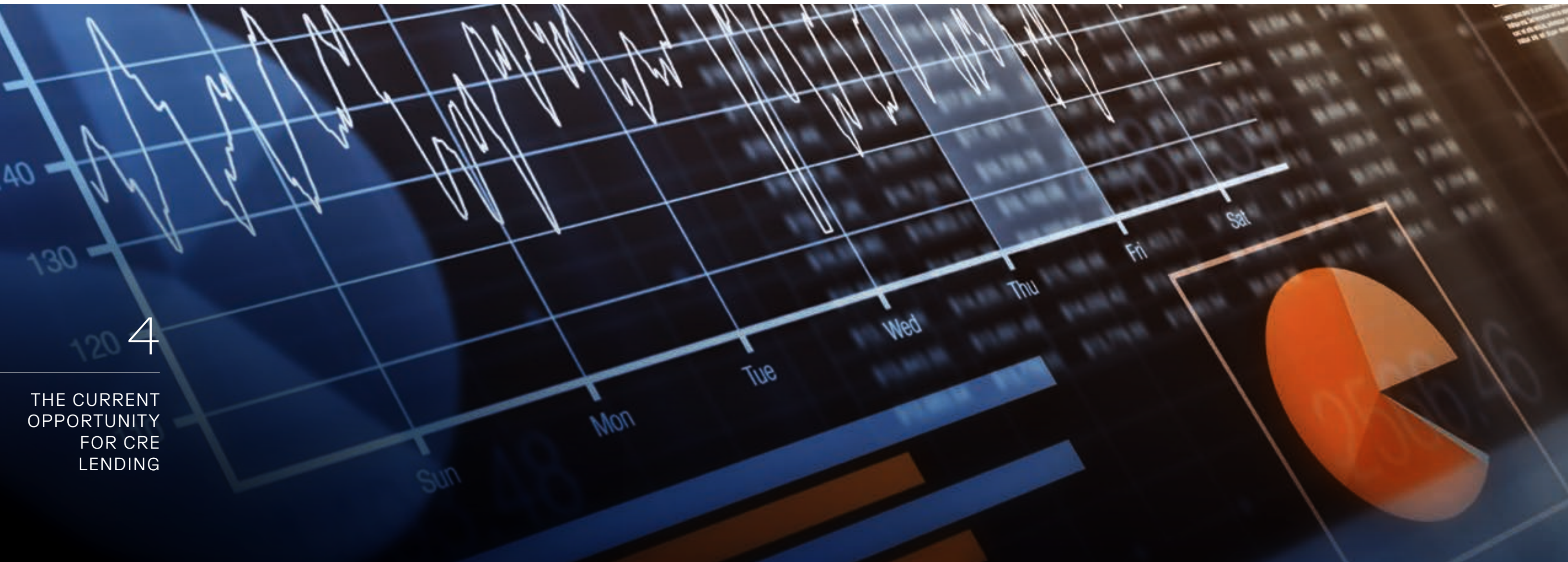
1. RCA Capital Trends, US Big Picture, August 2023. Note that private debt funds have taken an even larger share of construction financing at 22-23% the last couple years, vs. 13% from 2015 to 2019.

Coming out of the GFC, traditional CRE lenders such as banks and life insurers experienced a secular shift with the advent of regulations imposed by Dodd-Frank and Basel III which created a more risk-averse lending environment for balance sheet lenders and Commercial Mortgage Backed Securities ("CMBS") issuers. Risk-retention requirements for CMBS securities took effect in December 2016. In addition, certain types of real estate projects (e.g., transitional properties or real estate development) were classified in bank regulations as "high volatility commercial real estate" ("HVCRE") and required higher capital allocations. This reduced profitability and investment appetite for this type of lending. **Uncertainty regarding the economy and interest rate policy has exacerbated the issue.** As demonstrated by the Federal Reserve Senior Loan Officer Survey in **Exhibit 3**, lending standards have tightened dramatically since early 2022 as banks responded to the uncertain outlook. The percentage of banks tightening lending standards reached levels and duration not seen since the GFC. The tightening of underwriting criteria for construction lending has been even more pronounced. This has exacerbated the capital gap that resulted from regulation during the last expansion and has created further opportunity for non-traditional lenders.

EXHIBIT 3: NET PERCENTAGE OF U.S. BANKS REPORTING TIGHTENING LENDING STANDARDS AND STRONGER DEMAND



Source: Federal Reserve Senior Loan Officer Survey, Affinius Capital Research

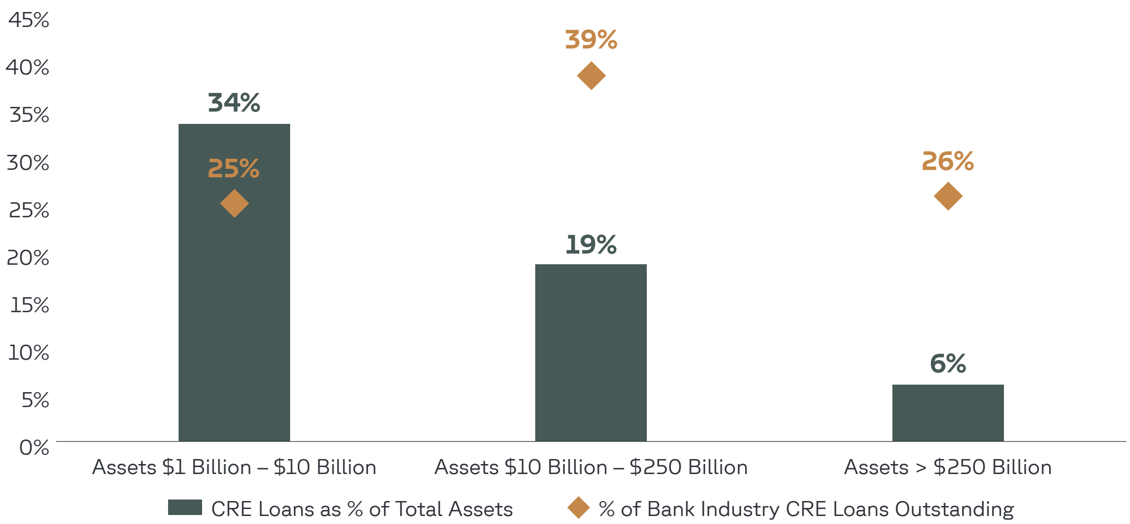


In addition to the challenges posed in underwriting a commercial real estate credit investment in the current environment, banks have retrenched due to balance sheet issues, including:

Unrealized Losses on Investment Securities. As of Q3 2023, unrealized losses on investment securities were $684 billion, having declined very little from the peak in Q2 2022, following the collapse of Silicon Valley Bank in March 2023. Because of the mismatch in the duration of assets and liabilities – long term investments, including high quality treasury securities, declined in value with rising rates while the withdrawal or repricing of short-term funding comprised of deposits led to the evaporation of net interest margins and/or a liquidity squeeze. For context, unrealized gains/losses in the banking sector fluctuated between unrealized gains of ~$125 billion and unrealized losses of ~$75 billion going back to 2008.[2]

Elevated CRE Loan Exposure. As shown in **Exhibit 4**, regional banks ($10-$250B in total assets) have higher exposure to real estate than the money center banks (>$250B in total assets), and hold 39% of all bank CRE loans outstanding.[3] Community banks (<$10B in total assets) have even higher exposure. CRE exposure played a role in the failures of Signature Bank and First Republic Bank in the first half of 2023; both were in the top 10 of absolute CRE loan exposure (Signature Bank CRE loans were 33% of assets, much higher than First Republic at 17% of assets).[4] To date, banks have not been able to reduce their exposure, as CRE loans outstanding are up $169 billion (5.9% growth) over the last twelve months.[5] As banks sort out portfolio issues, particularly related to office lending, and experience a lack of portfolio run off, they have drawn in their horns.

EXHIBIT 4: CRE LOAN EXPOSURE BY BANK SIZE



Source: FDIC, Affinius Capital Research

The pullback in debt capital availability has not been limited to the banking sector:

- CMBS origination volumes were $39.3 billion in 2023, down 64% from $110 billion in 2021.[6] Partially due to the regulatory actions mentioned above, CMBS origination volumes have never recovered to the $200 billion per year they averaged from 2005 to 2007.
- Life insurer commitments of $47.9 billion in 2023 were down 32% from the cyclical peak of $70 billion in 2021.[7]
- GSE originations in 2023 were down 37% from their 2020 peak, and 27% from their average over the previous five years.[8]

2. FDIC, as of Q3 2023.
3. Ibid.
4. Trepp Bank Navigator, https://www.trepp.com/trepptalk/q1-2023-regional-bank-earnings-first-republic-the-cross-other-takeaways-for-cre.
5. Federal Reserve Flow of Funds, as of Q3 2023.
6. Commercial Mortgage Alert.
7. ACLI.
8. MBA Commercial/Multifamily Mortgage Bankers Originations Index.

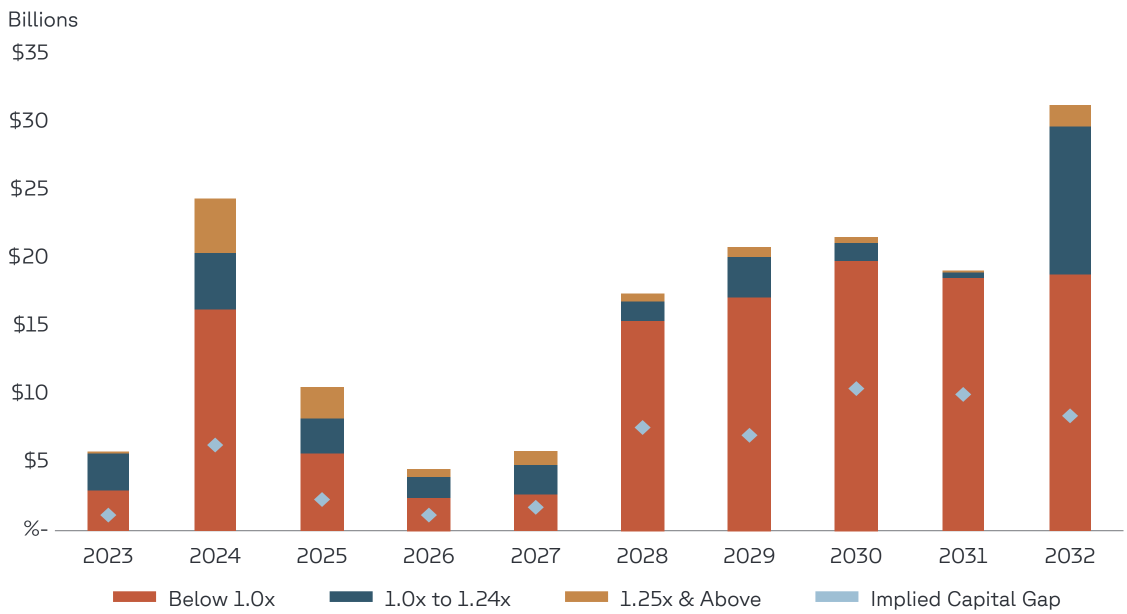
Filling the Capital Gap

While CRE transaction volumes have slowed considerably over the last 18 months, we expect a wave of capital will be required to address the near-term demand stemming from three primary drivers:

1 **Floating Rate Mortgages.** In 2021 and the first half of 2022, the CRE market experienced record transaction volumes, the majority of which utilized floating rate debt.[9] Existing floating rate debt, even without near-term maturities, may need to be restructured as rising LIBOR/SOFR rates mean many of these properties can no longer satisfy their loan payments. Debt restructuring is challenging for borrowers in the current environment; obstacles include more expensive interest rate cap agreements, increased lender imposed reserves, and increased borrower deposit requirements.

- As an example, consider $160 billion in floating-rate CMBS multifamily loans maturing over the next nine years (see **Exhibit 5**). As of December 2023, over 75% of these loans had a debt service coverage ratio (DSCR) of less than 1.0, based on current borrowing costs. While multifamily fundamentals have held up, how long will these borrowers be willing or able to come out-of-pocket to service their debt? Sustained higher borrowing costs require changes in the capital stack, which should create opportunity for fresh capital to invest at an accretive basis upon loan maturity. Based on current rates and a 1.30x DSCR requirement, this subset of CRE loans faces a financing gap of $55 billion and is just a small fraction of the financing used for over $640 billion of multifamily transaction volume in 2021 and 2022, not to mention other property sectors.

EXHIBIT 5: MULTIFAMILY FLOATING RATE CMBS LOAN BALANCE BY DSCR, BASED ON CURRENT RATES



Source: Bloomberg, Affinius Capital Research

2 **Near-Term CRE Loan Maturities.** More than $1.6 trillion of CRE loans are maturing over the next three years.[10] Maturing construction loans will need to secure take-out financing, and maturing short-term floating rate loans are far more expensive for the borrower today than at origination (see **Exhibit 1**), particularly when they no longer enjoy the benefit of interest rate caps with low strike rates, of which over half were originated during the low cap rate/interest rate environment of 2021 and 2022.[11]

9. Over 60% of loans originated in 2021 and 2022 were floating rate, per RCA Capital Trends, US Big Picture, August 2023.
10. https://www.trepp.com/trepptalk/cre-mortgage-maturities-debt-oustanding-2.81-trillion-coming-due-by-2028
11. MSCI Capital Trends, U.S. Big Picture, February 2024.

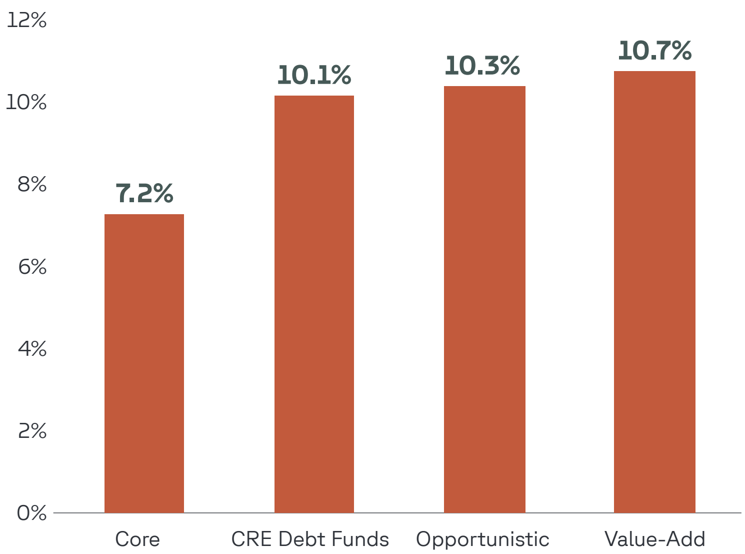
3 **Accumulating Capex.** While leasing costs, replacement reserves, and defensive capex projects have been deferred because of recent market uncertainty, their inevitable necessity in maintaining the value of real estate assets simply shifts outlays into the future. Increasing focus on ESG factors and amenities needed for properties to remain competitive further serves to increase demand for financing.

Taken together, **even a conservative estimate would place the capital gap debt opportunity in the hundreds of billions of dollars over the next few years, providing the opportunity for private lenders to fill the gap as they did post-GFC when some of the strongest vintage loans were made.**

Relative Value

Debt funds were able to take advantage of the post-GFC dearth of credit availability and increased lending standards to produce some of the best absolute and relative performance in real estate. As shown in **Exhibit 6**, over the past decade, total returns for CRE debt funds have compared favorably versus other types of CRE fund investment, especially considering their lower risk profile in the capital stack compared to equity funds.

EXHIBIT 6: CRE AVERAGE ANNUAL TOTAL RETURNS, PREVIOUS 10 YEARS[12]



Source: NFI-ODCE, Preqin, Affinius Capital Research

12. Period is ten years ending Q3 2023. Core returns are NFI-ODCE net total returns, CRE debt funds, CRE value-add, and CRE opportunistic are from Preqin Private Capital Quarterly Index.

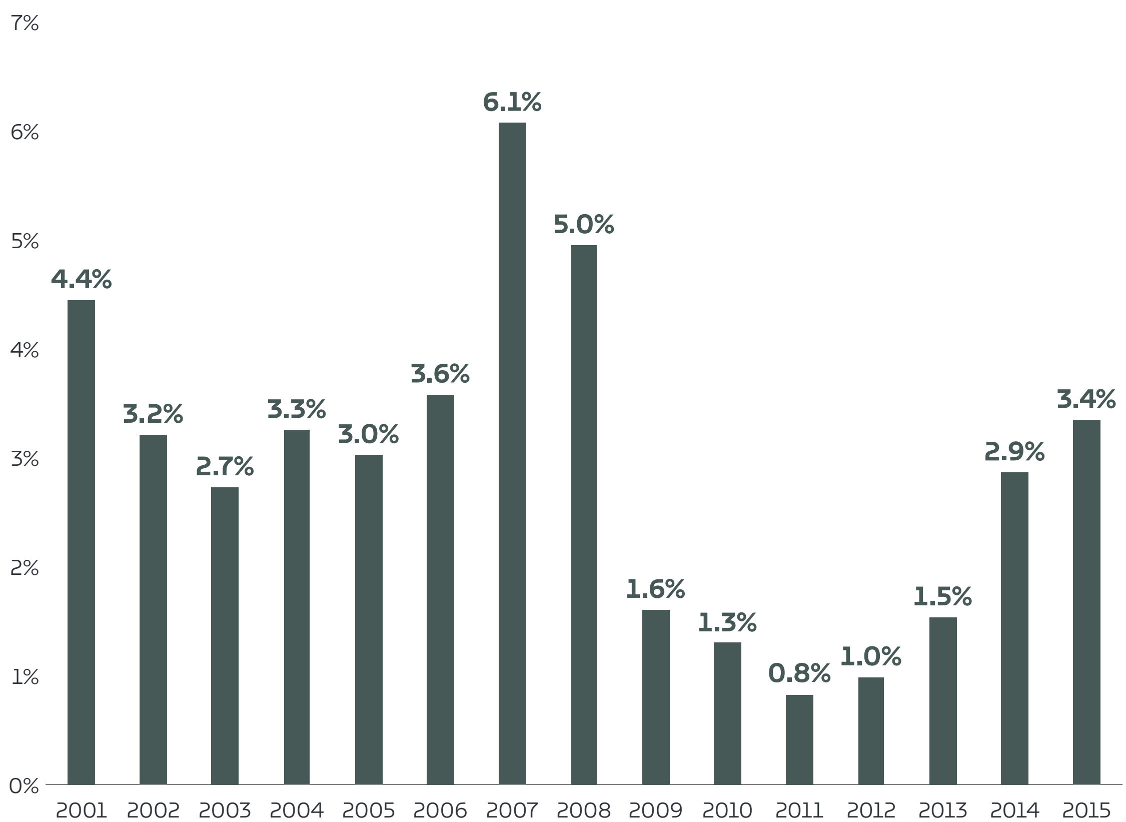
While debt fund performance is strong over the longer run, there are also cyclical factors to consider that might make relative debt fund performance even more appealing in the near term:

- In the immediate post-GFC recovery period (2010 to 2012), debt fund cumulative total returns were 38.2%, versus 31.7% for opportunistic funds, and 20.5% for value-add funds.[13]
- Lending spreads widen when debt capital is scarce. Since 2001, transaction volumes and lending spreads have a strong negative correlation (-0.62).[14]
- Attractive basis: According to Green Street, CRE valuations are down 22% overall since early-2022, though value decreases vary by property type. Tighter lending standards, as shown in **Exhibit 3**, provide more accretive attachment and detachment points for gap financing. The combination of lower asset values and more conservative attachment points significantly reduce the lender's basis in the capital stack creating greater margins of protection as evidenced by reduced delinquency and loss experience in recent vintage lending.

  > **Exhibit 7** depicts this for Fannie Mae multifamily loan purchases by vintage.[15] Loans originated during a tight credit environment during and following the GFC, from 2009-2012, had relatively lower delinquency rates.

- We expect that demand for non-bank construction lending will accelerate in 2024 and into 2025 as supply and demand fundamentals for new product remain in favor for best-in-class assets, with no sign of traditional banks re-entering the space in the near-term. Non-traditional lenders are increasingly being relied upon to meet the borrowing needs of developers. Development capital needs may face additional tailwinds from the pandemic, as tenant demand is shifting across sectors and demand for certain types of new product (e.g., data centers) remains strong.

EXHIBIT 7: PERCENTAGE OF ORIGINATIONS THAT WENT 60+ DAYS DELINQUENT BY VINTAGE



Source: Fannie Mae, as of January 2024.

13. Per Preqin Private Capital Quarterly Index.
14. Using correlation of CRE transaction volumes from RCA and lending spreads on first mortgages from ACLI.
15. Contains over $822 billion or multifamily loan purchases. Only includes vintages where 50%+ of loan balances have been repaid.

Making the Case for Core First Mortgage Lending

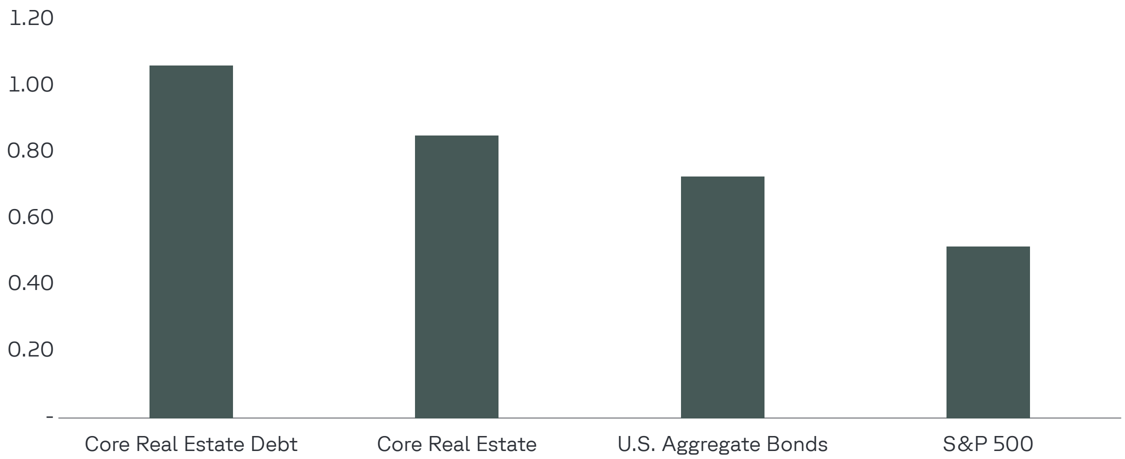
Current lending opportunities are not limited to gap capital and construction lending. Core lending, consisting of lower leverage first mortgages back by stabilized or near-stabilized properties, has exhibited compelling attributes over the last 20 years, with strong relative value, risk-adjusted returns, and low correlations versus other asset types. Market dynamics are presently producing loan origination opportunities with credit spreads and coupons not seen since the post-GFC timeframe. Core lending's diversification properties are demonstrated in **Exhibit 8**, with particularly low correlation to core real estate and stocks. Core lending's return/risk profile, shown in **Exhibit 9** by historical Sharpe Ratio over the past twenty years, has been robust.

EXHIBIT 8: ASSET CLASS CORRELATIONS, 2004-2023

	U.S. AGGREGATE BONDS	S&P 500	CORE REAL ESTATE	CORE REAL ESTATE DEBT
U.S. AGGREGATE BONDS	**1.00**			
S&P 500	0.07	**1.00**		
CORE REAL ESTATE	(0.26)	0.04	**1.00**	
CORE REAL ESTATE DEBT	0.62	0.34	(0.07)	**1.00**

Source: Bloomberg, ACLI, NCREIF NFI-ODCE, Affinius Capital Research

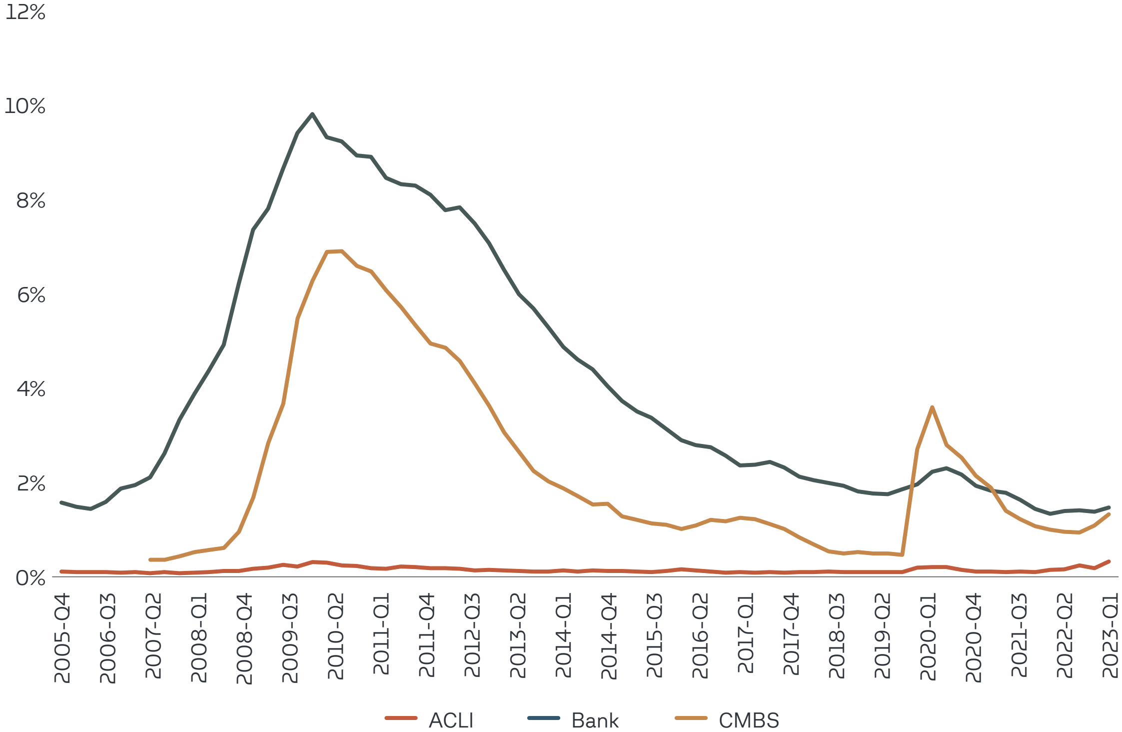
EXHIBIT 9: SHARPE RATIO BY ASSET CLASS, 20 YEARS ENDING Q4 2023



Source: Bloomberg, ACLI, NCREIF NFI-ODCE, Affinius Capital Research

Bank and securitized loans have also shown higher delinquency rates historically, relative to life insurance lending, the bulk of core lending in the marketplace. As shown in **Exhibit 10**, the American Council of Life Insurers ("ACLI") represents life insurance lending.

EXHIBIT 10: CRE DELINQUENCY RATES BY LENDER

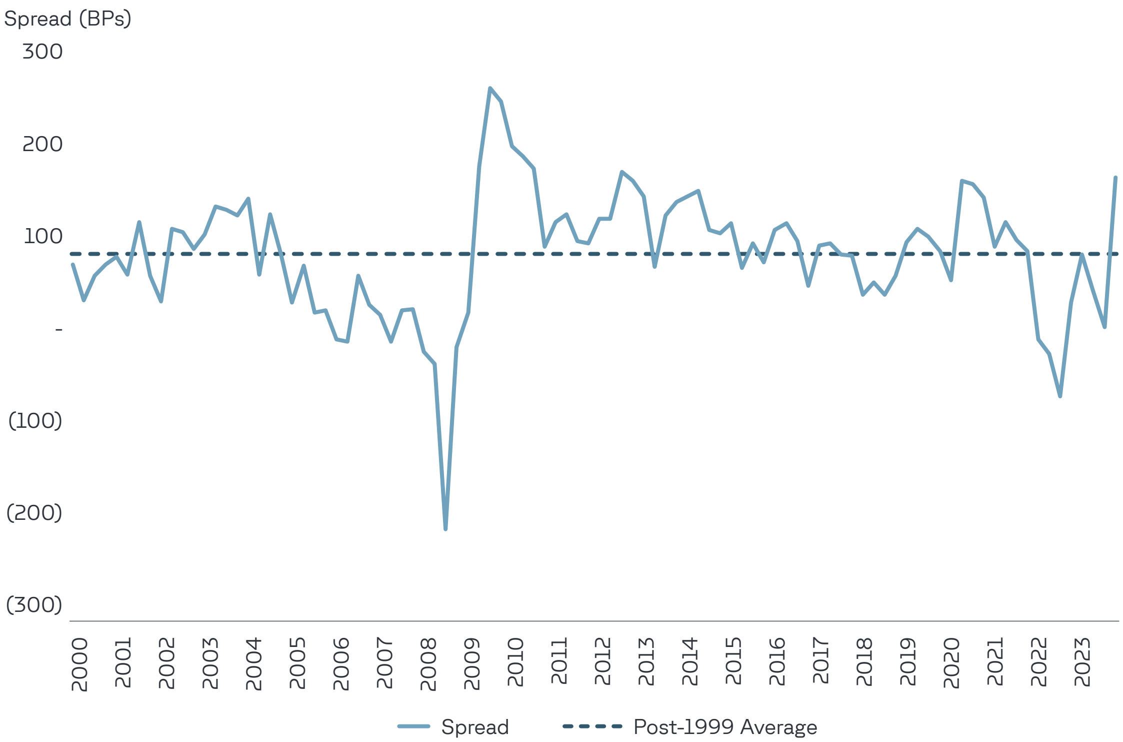


Source: Bloomberg, ACLI, FDIC, Affinius Capital Research

In addition to favorable historical performance through market cycles, current conditions are primed for what we believe is attractive first mortgage lending:

- The retrenchment of traditional capital sources will allow core first mortgage lenders to be more selective, and with higher base rates and credit spreads, overall coupon rates are more than double where they were two years ago.[16]
- Call protection in the form of market-standard yield maintenance provisions embedded in fixed rate loans offers the ability for investors to "lock in" today's high returns and utilize these mortgage assets for liability matching/offsets within their portfolios.
- LTVs on new core originations have fallen to the mid-50% range on average, versus averaging in the mid-60% range from 2012 to 2019.[17]
- First mortgage lending spreads relative to A-rated corporate bonds are at their highest level since the GFC, demonstrating attractive relative value (see **Exhibit 11**).

EXHIBIT 11: SPREAD OF CRE MORTGAGE RATES TO A-RATED U.S. CORPORATE BONDS



Source: Bloomberg, ACLI, Affinius Capital Research

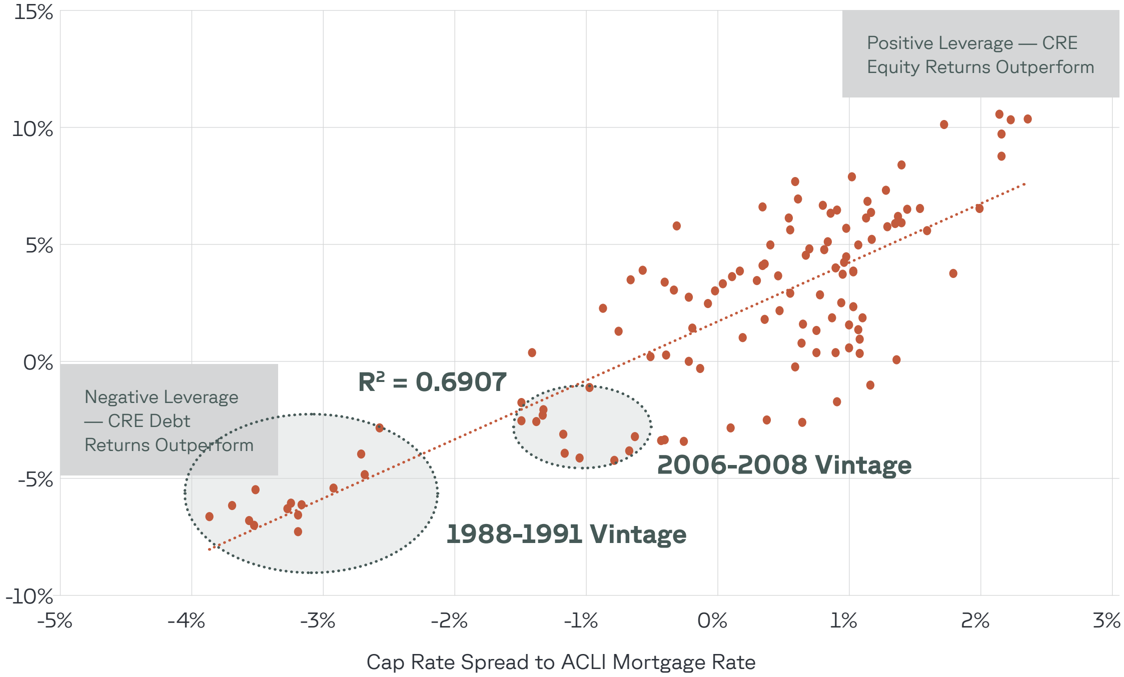
16. Per Commercial Mortgage Alert, first mortgage rates were as low as 2.9% in the latter half of 2021, and stand at 6.5% as of February 2024, after peaking at 7.2% in October 2023.
17. Per RCA lending data.

The current opportunity in debt investing is borne out by the historical relationship between NPI implied cap rates,[18] lending rates, and the relative performance of the NPI vs. debt. Higher positive leverage is strongly associated with outperformance of CRE equity over the next five years, whereas negative leverage is associated with debt outperformance. The relationship is robust, with an r-squared of 0.69, as shown in **Exhibit 12**.

Today's spread falls between the GFC vintage and SNL crisis, and suggests an, **elevated likelihood of outperformance of debt funds over the next few years.[19]**

EXHIBIT 12: CAP RATE SPREAD TO LENDING COSTS AND RELATIVE PERFORMANCE OF CRE DEBT VS. EQUITY

Subsequent 5-Year Annualized NPI Outperformance vs. CRE Debt



Source: NCREIF, Giliberto-Levy, ACLI, Affinius Capital Research, Q3 1988 – Q3 2023

18. NPI is NCREIF Property Index, one of the primary benchmarks for U.S. private real estate, and calculates cap rates based on NOI and appraisals of contributed properties to the index on a quarterly basis.
19. Note there are potentially some lagged effects with the analysis as implied cap rates and fund returns are appraisal-based, but we believe the analysis to be directionally correct.

CONCLUSION

In summary, the current landscape for commercial real estate lenders presents a unique opportunity stemming from a convergence of cyclical and structural factors. Regulatory measures following the Global Financial Crisis, compounded by recent economic volatility, have significantly constrained traditional sources of CRE debt capital. Notably, the tightening lending standards among traditional lenders, particularly banks, the largest lending segment in the U.S. CRE debt market, and the increased borrowing costs have further exacerbated the capital gap, leaving ample room for non-traditional lenders to fill the void. With over $1.6 trillion of CRE loans maturing in the next three years and a significant portion of floating-rate loans requiring restructuring, the demand for alternative capital solutions is expected to surge, presenting a vast opportunity CRE lenders to address market needs and generate attractive returns, similar to the post-GFC era.

Moreover, the relative value proposition of debt investing in CRE remains compelling, supported by strong historical performance and favorable market conditions. As traditional capital sources retrench and lending spreads widen, first mortgage lending emerges as an attractive avenue for investors, offering higher returns at lower attachments points and with greater call protection. Additionally, historical relationships between NPI implied cap rates, lending rates, and the relative performance of CRE equity versus debt suggest a heightened likelihood of debt funds outperforming in the coming years. In short, the current environment presents a strategic opportunity for debt funds to leverage market dynamics, address capital shortfalls, and deliver superior risk-adjusted returns to investors.

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