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Private real estate debt: A range of yield opportunity for insurance companies

The search for higher yielding investments secured by quality collateral and a desire for diversification has spurred insurance companies to explore alternative investing options such as private commercial real estate debt, including subordinate debt like mezzanine loans. Based on our view of the U.S. real estate market, we currently believe CRE debt can benefit from strong underlying commercial real estate fundamentals, continued favorable economic growth, strong borrower demand, and a diversified choice of strategies across the capital stack (senior mortgage loans, mezzanine loans, etc.) which may offer attractive risk-adjusted returns.

Executive Summary

Private commercial real estate (CRE) debt has a number of potential advantages, including current income in the form of monthly payments, a position senior to the first loss equity of the borrower (equity cushion), tangible collateral in the form of high quality properties and experienced borrowers that often have material equity in the transaction, and lower volatility than some other asset classes (Giliberto-Levy Index, 1Q2018), based on the structure of the loans. Furthermore, we have been observing in transaction documents over the past few years more protective lender structures, disciplined underwriting, and conservative advance rates (Loan to Value Ratio), which makes investing in CRE Debt a potentially attractive alternative for investors.

A continued supply of maturing debt, borrowers continuing needs for refinancing or acquisition financing, and a general pullback in the lending activities of some traditional lenders such as banks and CMBS, primarily due to regulatory matters, allows other types of lenders such as insurance companies an opportunity to step up their activity.

Furthermore, there is a renewed realization of the potential relative value advantages and attractive risk-return profile that CRE debt not only has versus other types of debt but other types of asset classes as well. This paper will review the CRE debt market, the structure of CRE loans, focusing on mezzanine loans, and the regulatory aspects of investing in CRE debt for insurance companies.

Market Overview

In our view the real estate cycle is stable and nearing a mature point. Depending on property type and location, market fundamentals are strong. We expect to see stability and growth in net operating income, occupancy and rents depending on market and property type. Generally, new supply remains supported by demand in most CRE sectors. We expect deliveries to remain below long-term historical levels. Although there has been a degree of softness in certain sectors, like retail, and some markets where there has been overbuilding in the apartment sector, in general, the fundamentals remain stable and strong.

CRE debt investments present a strategic and effective way for investors to gain exposure to the private real estate markets and the yield profile that they provide. Historically, the debt markets have been centered on traditional lenders such as banks, depositaries, and other customary lenders. However, several of these traditional lenders have limited certain lending activities and in an attempt to increase regulatory capital to comply with regulatory reforms passed in the wake of the Great Recession.

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Similarly, regulatory issues in the commercial mortgage-backed securities market could hamper the CMBS market's ability to handle the demand for new loans. General market estimates (such as Trepp, as of Q1 2018) forecast that there will be more than $1.0 trillion in debt maturities over the next six years, of which CMBS represents approximately 18 percent; bank loans, 43 percent; and life insurance company loans, 9 percent. A funding gap for the refinancing of these loans exists, although a bit less pronounced in 2018 than several years ago.

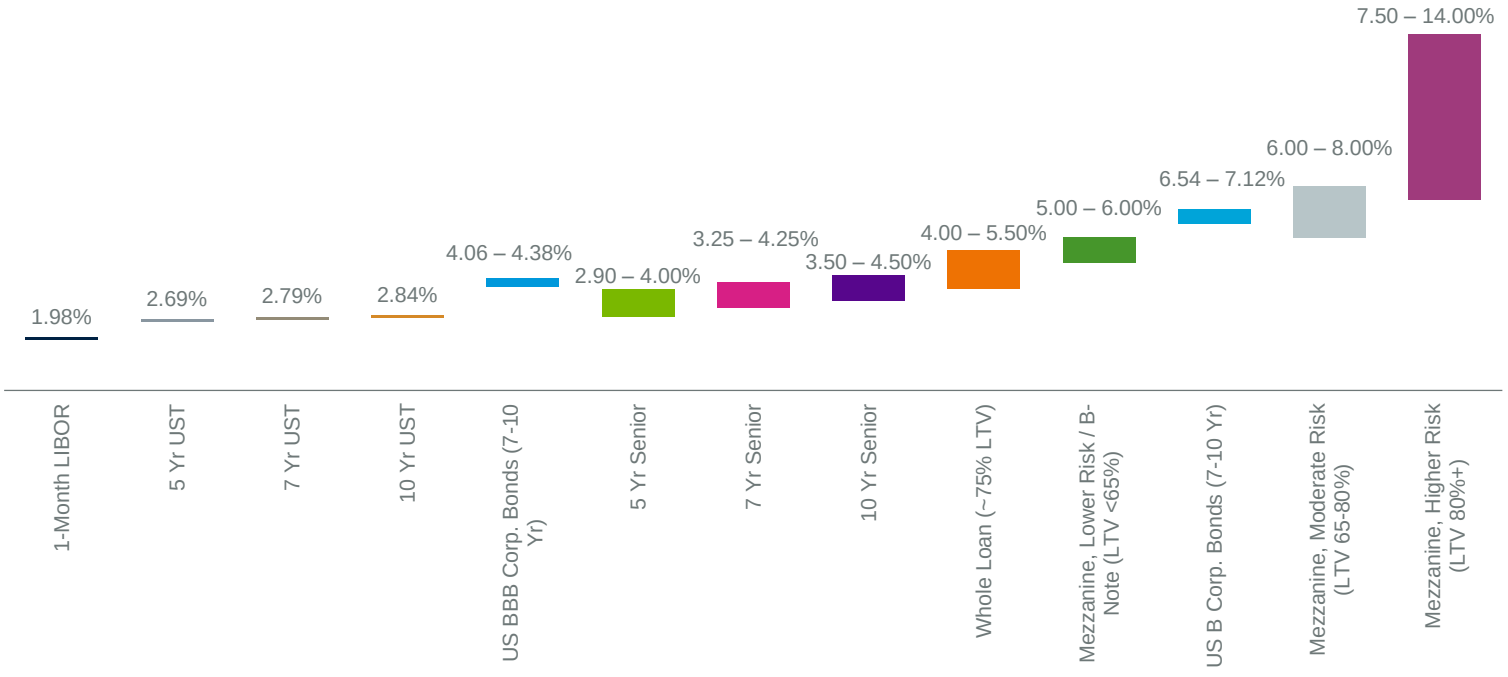
The limitations of traditional lenders, such as banks and CMBS, creates an opportunity for alternative lenders and new investors to fill the void. These alternative lenders create specific strategies that can be designed to meet the needs of borrowers seeking financing to acquire or refinance their properties and investors seeking to enter the CRE debt space. It is worth noting that CMBS pools together a portfolio of commercial real estate loans so investors need to have an expertise to analyze and underwrite these portfolios as opposed to individual loans. Furthermore, CMBS are already structured with defined terms and are more diversified, compared with single real estate loans.

Key Benefits

Investing in private commercial real estate debt may provide investors the ability to achieve returns in the range between approximately 4 percent to 14 percent for select senior and mezzanine debt transactions, with the majority of those returns realized through current income.

Another benefit is the relative value of real estate debt compared with some higher-yielding fixed income investments. For example, typically, there is a 200 to 300 basis point premium over the corporate bond triple-B index, as of February 2018 (see Figure 1). Although investors may give up some level of liquidity to achieve such premium, we are seeing them allocate their private CRE exposures to the less-liquid portion of their fixed-income portfolios. Comparing this to high yield bonds, investors in private CRE debt are typically in a more secured or controlling position, given the tangible real estate collateral and structuring of CRE debt instruments.

Figure 1: Interest rate ranges



Note: The above interest rate ranges are for illustrative purposes only and represent current market pricing. Actual interest rates for individual investments may be higher or lower. Interest rates are not warranted and past performance is not indicative of future results. Interest rate ranges cover the main real estate sectors across a range of quality levels and locations.
Sources: Cushman & Wakefield, MarkIt, Bloomberg, Moody's and DWS. As of May 31, 2018.

The third key benefit is flexibility and diversification in the design of an investment portfolio to fit the individual investment strategies or parameters of an investor. Investments can be long or short term, fixed or floating rate. There is also flexibility in access points for investing in CRE debt, for example, lower or higher LTV ratio loans and the position within the capital stack such as senior loans or mezzanine loans. These loans contain robust legal structuring in the loan documents with the borrower and also contain agreements governing the relationship and rights among lenders in different parts of the capital stack (e.g., the Intercreditor Agreement)

Mezzanine Opportunities

Mezzanine loans have been in existence for decades and became institutionalized in the late 1990s with the advent of definitive documentation. Mezzanine or subordinate debt lending serves an important role in the capital stack.

In the last real estate cycle there was a trend towards senior lenders going higher into the capital stacks and financing many of the highest quality properties. As a result of that, mezzanine loans moved up the capital stack and, in many instances, focused on transitional assets.

By contrast, we have witnessed a much more disciplined approach in underwriting standards by both the senior and mezzanine lenders since the financial crisis. Senior detachment points today are lower than during the last cycle at approximately 60-65 percent LTV or so on average, and at times even lower. The mezzanine attachment points are also more conservative, picking up where senior leaves off and generally going up to 70 to 80 percent LTV[1].

Our observation on the current market, based on transactions and market data, is that we see mezzanine lenders having greater accessibility to high quality assets in core and gateway markets on properties with stable cash flows, and strong sponsorship, with substantial equity in the deals. Therefore we believe a well-constructed portfolio of lower, moderate and higher risk LTV mezzanine loans, balancing operating and financial leverage or risk, may be able to withstand a significant downturn in the economy relative to a liquid portfolio.

Mezzanine in the Capital Stack

A typical real estate structure capital stack is shown in Figure 2. At the top of the stack is the senior loan which may have a B note as part of it. This is the most senior part of the capital stack; it is secured by a first mortgage on the property, is senior to any potential B Note, the mezzanine loan and the borrower's equity. Generally such loans detach at 60 to 65 percent LTV[1].

The mezzanine loan is subordinate to the senior mortgage loan (which may include a B Note) but is senior to the borrowers' equity including any preferred equity The mezzanine loan is secured by a first priority pledge of the ownership interests in the real estate, and is granted certain rights of notice and cure, among other rights (see Intercreditor Agreements section below) Generally mezzanine loans detach at 70 to 80 percent LTV[1].

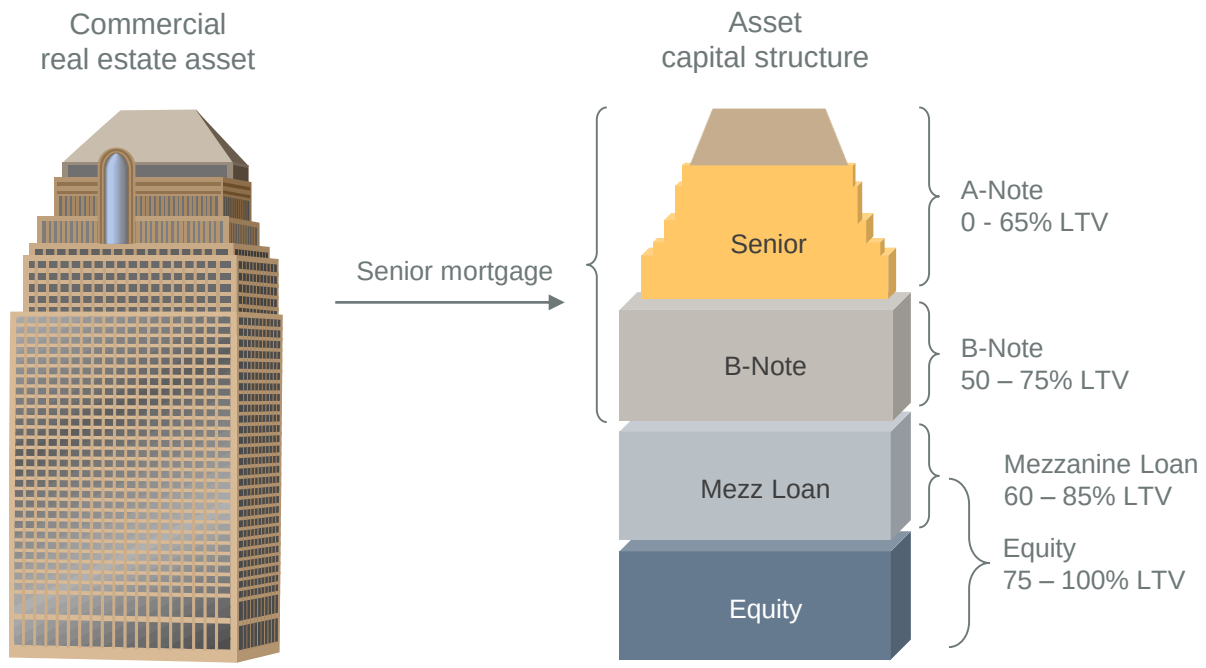
The equity in the capital structure is the first loss position, providing the equity cushion protecting the mezzanine and senior debt. The equity is subordinate to both the senior loan and the mezzanine loan.

A number of characteristics of mezzanine debt make it potentially quite attractive to investors. As mentioned above, the collateral is the ownership interest and not the real estate itself. As such, the exercising of remedies is governed across the U.S. by the uniform commercial code (UCC), which provides uniform and consistent foreclosure protocols versus the various and sometimes lengthy state-by-state laws governing the foreclosure of real property. The mezzanine lender can foreclose in a very short period of time of approximately 90 days, compared to the longer periods of time involved in a real property foreclosure, which can take as long as three years in some states.

This allows the mezzanine lender to foreclose quickly, step into the shoes of the borrower, and acquire the ownership position, thus reducing the possibility of impairment to the real estate asset because it happens in a short period of time.

[1] Cushman & Wakefield Capital Markets Update May 2018

Figure 2: Strategies up and down the risk-return spectrum



For illustration only. Actual portfolio composition may be different. Source: DWS, as of December 2017.

Risks for both Mezzanine and Real Estate Debt

Generally speaking, there are certain risks that investors should be aware when considering real estate, specifically private debt, including being subject to various risks, namely in adverse changes in economic conditions including changes in the financial conditions of tenants, buyer and sellers, changes in the availability of debt financing, changes in interest rates, real estate tax rates and other operating expenses. Furthermore, it is worth noting that mezzanine is more subordinated than senior loans in the capital stack.

In terms of return perspective, as illustrated previously in Figure 1, lower-risk mezzanine loans with about 60 to 65 percent LTV are returning 5 to 6 percent; moderate risk mezzanine loans with about 65 to 80 percent LTV loans return in the 6 to 8 percent range; and higher risk mezzanine loans can return from 7.5 to 14 percent, though loans on near stabilized assets fall into the lower range and loans at the higher end of the range typically include construction loans, development loans, opportunistic transactions and large repositioning of properties.

Intercreditor Agreements

Although the mezzanine loan is structurally subordinate to the senior loan, there is a document in place that governs the relationship between the two lenders known as the Intercreditor Agreement, or ICA. This document has been institutionalized since the late 1990s.

The ICA protects both mezzanine and senior lenders, and offers certain rights and remedies to each. There are some important points that potential mezzanine lenders should understand. In its simplest form, the ICA allows the mezzanine lender to foreclose on the ownership interest, step into the shoes of the borrower, and assume the senior loan, without creating a default on the senior loan. The ICA also gives the mezzanine lender the right of notice and cure of default as well as the right to purchase the senior loan, among other rights and remedies

Figure 3: Considerations for insurance investors

Accounting and Solvency

U.S. Statutory

— Mezzanine real estate debt is treated like commercial mortgage loans reported on Schedule B - part 1
— RBC charges are applied using NAIC mortgage calculations driven by three characteristics: debt service coverage (DSC), loan-to-value (LTV) and industry type (see table below)

RBC requirement

Office, Industrial, Retail and Multi-family

DSC limits		LTV limits	Risk Category	Factor[1]
1.50 ≤ DSC	and	LTV < 85%	CM1	0.0090
DSC < 1.50	and	LTV < 55%	CM2	0.0175
0.95 ≤ DSC <1.50	and	55% ≤ LTV < 75%	CM2	0.0175
1.15 ≤ DSC < 1.50	and	75% ≤ LTV < 100%	CM2	0.0175
1.50 ≤ DSC	and	85% ≤ LTV < 100%	CM2	0.0175
1.75 ≤ DSC	And	100% ≤ LTV	CM2	0.0175
DSC < 0.95	and	55% ≤ LTV < 85%	CM3	0.0300
0.95 ≤ DSC <1.15	and	75% ≤ LTV < 100%	CM3	0.0300
1.15 ≤ DSC < 1.75	and	100% ≤ LTV	CM3	0.0300
DSC < 0.95	and	85% ≤ LTV < 105%	CM4	0.0500
0.95 ≤ DSC < 1.15	and	100% ≤ LTV	CM4	0.0500
DSC < 0.95	and	105% ≤ LTV	CM5	0.0750

Hotels and Specialty Commercial

DSC limits		LTV limits	Risk Category	Factor[1]
1.85 ≤ DSC	and	LTV < 60%	CM1	0.0090
1.45 ≤ DSC < 1.85	and	LTV < 70%	CM2	0.0175
1.85 ≤ DSC	and	60% ≤ LTV < 115%	CM2	0.0175
0.90 ≤ DSC < 1.45	and	≤ LTV < 80%	CM3	0.0300
1.45 ≤ DSC < 1.85	and	70% ≤ LTV	CM3	0.0300
1.85 ≤ DSC	and	115% ≤ LTV	CM3	0.0300
DSC < 0. 90	and	LTV < 90%	CM4	0.0500
0.90 ≤ DSC < 1.10	and	80% ≤ LTV < 90%	CM4	0.0500
1.10 ≤ DSC < 1.45	and	80% ≤ LTV	CM4	0.0500
1.10 ≤ DSC	and	90% ≤ LTV	CM5	0.0750

[1] In Good Standing.
Source: NAIC 2017
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Insurers' Considerations

Mezzanine loans have their own statement of statutory accounting principle or SSAP. SSAP number 83 says that holders of mezzanine real estate loans "shall follow the accounting, reporting and disclosure requirements defined within SSAP No. 37—Mortgage Loans" (NAIC, Statement of Statutory Accounting Principles No. 83, Mezzanine Real Estate Loans, 2017 ed.). This means loans are held at amortized cost and reported on Schedule B—Mortgages. For U.S. statutory Risk Based Capital, the charges are applied in a similar manner as commercial mortgages. For each mortgage, a determination is made based on three characteristics, as shown in Figure 3.

Figure 3 shows the elements of the commercial mortgage and real estate mezzanine capital charge categorization calculation. Similar to bonds, there are risk categories that each have a factor, CM1 through CM5.

The characteristics that determine the risk-based factor category are a combination of the industry that the property is in, debt service coverage ratios and loan to value ratios. Using those characteristics, each loan can be placed somewhere on that table to determine the appropriate capital charges. While mezzanine loans can fall into any of the categories, the most common category is CM4.

Conclusion

Insurance companies continue to explore higher yielding investments that offer greater income potential, and commercial real estate debt offers various opportunities along the private real estate capital stack. The range of options available, the relative value advantage over other asset classes, and the risk characteristics and regulatory capital requirements make it a flexible option that should merit insurance company consideration as part of an overall asset allocation program.

Risk Factors

An investment in real estate involves a high degree of risk, including possible loss of principal amount invested, and is suitable only for sophisticated investors who can bear such losses. Investments in Real Estate are subject to various risks, including but not limited to the following:

1. Adverse changes in economic conditions including changes in the financial conditions of tenants, buyer and sellers, changes in the availability of debt financing, changes in interest rates, real estate tax rates and other operating expenses;
2. Adverse changes in law and regulation including environmental laws and regulations, zoning laws and other governmental rules and fiscal policies;
3. Environmental claims arising in respect of real estate acquired with undisclosed or unknown environmental problems or as to which inadequate reserves have been established;
4. Changes in the relative popularity of property types and locations;
5. Risks and operating problems arising out of the presence of certain construction materials; and
6. Currency / exchange rate risks where the investments are denominated in a currency other than the investor's home currency
7. Construction Risk: For projects that contain at least some element of construction, whether new development or redevelopment of an existing asset, there are additional risks present during the construction phase. Factors such as design error or changes in specifications during execution can lead to cost overruns or construction delays, which can result in postponed completion, delayed revenues and lower-than-expected returns. When investing in projects with a significant element of construction, it is crucial that the sponsor has experience in managing such projects.
8. Financial Risk: Real estate assets can be exposed to interest rate volatility and refinancing risk, depending on the debt structure and leverage. If not hedged, interest rate volatility can lead to rising interest costs, reducing operating cash flow levels, while exchange rate risk can be a factor for assets held in foreign countries. Changes in the interest rate can also affect the underlying property value through transmission to the property's potential exit yield.
9. Physical Asset Risk: Operational risks such as maintenance risk materialise when a real estate asset is in full operation. Such risks become more prominent for older buildings, where structural failure or equipment failure can lead to unplanned maintenance costs that reduce operating cash flow levels.
10. Political and Regulatory Risk: Certain sectors and subsectors of the investable real estate stock, such as healthcare and residential, are seen as essential to the effective functioning of society and the modern economy. For these types of property, governments prefer to maintain a greater level of control through regulation. All types of real estate are also likely to be subject to increasing levels of environmental regulation, as initiatives to tackle climate change gather pace globally. The regulatory framework can vary considerably from one country or sector to another and can have an impact on investment performance. Sector and geographical diversification within a strategic asset allocation framework can help to mitigate these risks. Real estate investment requires a detailed understanding of regulation, developed through knowledge and experience.

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