



Investors Look to High-yield Debt Funds

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The ongoing credit crunch has led to a huge number of high-yield real estate debt funds trying to cash in on the distress: There are now close to 70 such funds, and they are attempting to raise US\$40 billion. Some are veteran investors that have operated in real estate debt for 20 years or more, but many others are newcomers. The funds use different strategies, usually including some combination of CMBS, mezzanine, preferred equity, whole loans, B-notes, RMBS and, increasingly, originating new loans.

Institutional investors are cautiously entering the debt arena. For example, the Los Angeles City Employees' Retirement System (LACERS) has committed US\$60 million to four high-yield real estate funds; US\$25 million of that is committed to Walton Street Real Estate Fund VI, which targets both debt and equity opportunities domestically, as well as in India and Mexico. LACERS has other real estate debt investments as well, including ING Clarion Partners' CMBS fund. Dan Gallagher, CIO at LACERS, says, "Liquidity has drained out of the debt markets, beginning with the subprime mortgage crisis. Even high-quality borrowers who are current on their debt payments have been impacted, and have had difficulty borrowing money to refinance maturing loans. Demand for liquidity outstrips supply, and we believe that investors will be rewarded for providing liquidity in a liquidity-starved market."

When the credit crunch hit, banks had loans stuck on their books that they could no longer securitise. That has resulted in debt investing opportunities over the past year. "The dislocation in the capital markets and the lack of liquidity has resulted in a relatively sudden repricing of debt that was held both by commercial banks and other lenders with an exit strategy of securitisation," says Alex Gilbert, who is managing director and head of US funds for JER Partners. "The repricing of that debt that started in mid-2007 continues today. That's been one of the opportunities we look to, because that's debt that's in pricing distress, as opposed to credit distress." Gilbert says these types of loans generally can be had for a 10-20% discount.

CMBS on the Radar Screens

Bill Krauch, managing director and head of global marketing at ING Clarion Partners, says there has been increased interest in debt products among the more sophisticated investors because "they recognise that the credit markets have highly overreacted to the situation in the US, setting pricing levels that we have never seen." CMBS, in particular, has been on investors' radar screens since the crunch hit last year. Krauch says, "You have definitely seen increased interest in CMBS because of the tremendous shift in the credit markets as far as spreads widening." They are, in fact, historically wide spreads. "CMBS, if you are careful in your selection, provides a far better return than equity real estate does today," Krauch adds.

Krauch points out that while the CMBS market has been tainted by the problems originating on the residential side, fundamentals remain much stronger on the commercial side than the residential side. Defaults remain very low, generally less than one-half of a percent. Still, not all CMBS was created equal. "We certainly favour the older vintage CMBS because the underwriting was better," says Jeffrey Gandel, senior vice-president and investment director at Fidelity Investments. Gandel oversees fundraising and product development for Fidelity. In addition to being better underwritten, Gandel says older CMBS product was better structured.

When the credit crisis hit, spreads blew out on all CMBS, whether it had good underlying fundamentals or not. "The proverbial baby got thrown out with the bath water," says Gandel. The spreads for older CMBS are not as wide as the newer but still offer good discounts. In general, Fidelity is able to buy older vintage CMBS at 500bps over Treasuries, says Gandel, whereas 18 months ago they would have been trying to get it at 200bps over Treasuries. "It's good quality stuff; we're happy with the credit worthiness of what we're buying," he says, adding that they are able to find below-investment grade, as well as A and AA CMBS at these spreads.

Kick-out Rights Return

Another appealing feature of the current CMBS market is the return of "kick-out" rights. Historically, buyers of junior tranches could take certain loans out of the pool – those loans they thought were of too poor quality or too risky. "When you look at a pool of securities, a certain number of loans aren't appropriately



priced, and you can take the bad apples out of the barrel," says Jonathan Grunzweig, principal and CIO of Colony Capital. For the two years leading up to the credit crunch, buyers lost the ability to do that because the demand for CMBS was so high. "The issuers had all the levers," says Gandel. "There was such a demand for capital deployment that no banks selling paper would allow you such a luxury," adds Grunzweig. Now investors can once again kick certain loans, which mean investors can pick the best and leave the banks with the rest. But the banks do not hold on to the bad apples, either. "They repackage the kicked-out loans," says Grunzweig. "These loans have a fair value, it's just less than the original price."

Distressed Priced Debt

The California Public Employees' Retirement System (CalPERS) has committed US\$200 million to a joint venture with veteran firm JER Partners, and JER has committed US\$20 million. The US\$220 million JER US Debt Co-Investment Vehicle focuses on CMBS, mezzanine loans, whole mortgage loans, B-notes and preferred equity. It is staying away from RMBS, single-family residential debt and non-performing loans. Alex Gilbert, who co-manages the fund, says, "Our strategy has been to pursue distressed priced debt, not distressed debt from a credit perspective."

The JER/CalPERS high-yield debt fund has with has two major strategies: to purchase loans that have price distress and to purchase different tranches of CMBS. Gilbert says his firm is looking for gross returns in the high teens. JER is not trying to fill specific allocations in particular sectors. "We're just looking for the best risk-adjusted returns across property types and across sectors," says Gilbert. "We're looking to build a diversified portfolio across property types."

The CalPERS fund is 100% domestic and includes no residential investments. But JER Partners also is evaluating the residential side as another strategy. That will include land, finished home sites and debt on residential developments. "We think the space has opportunity and we continue to evaluate it, but we have not yet made a significant commitment," says Gilbert. "In our view, the opportunities will continue to improve."

Due Diligence is Critical

When investing in debt products, due diligence is absolutely critical. "We underwrite the property fundamentals, we underwrite the property pro forma and then we come to a decision. We're a real estate firm first," Gilbert says. "Property fundamentals are primary to how we operate. We do it from the bottom-up. We're not doing it from the top-down."

This may be a good time to jump into real estate debt, but only if you are careful. "It's far too general a statement to say it's a good time to invest in high-yield debt," says Grunzweig. "Rather, I'd say carefully structured investment approaches that play to your competitive advantages can be very rewarding. We're not calling the bottom, nor are we catching a falling knife. Our business is all about finding attractive risk-adjusted returns." Grunzweig says Colony's success comes from its ability to underwrite the value of the collateral, as distinguished from what the market is willing to buy or sell it for. "As long as we have attractive collateral coverage, in a space where we would know what to do with that collateral, then we're comfortable making investments, regardless of whether we've caught the bottom or how they mark to market," says Grunzweig.

Concerns about Floating-Rate Paper

When the credit crunch hit, the immediate investment opportunity was buying debt stuck on balance sheets, but that is tailing off. "There's a smaller and smaller inventory of this debt in pricing distress," says Gilbert. Adds Gandel, "In general, investment banks don't have any more fixed-rate mortgages or CMBS on their balance sheets. They have been able to sell almost all of that." What they do have remaining are floating-rate mortgages that they have issued over the past 12-18 months. "Part of the reason they can't sell those is because of concerns about the credit-worthiness," says Gandel.

The other problem is that the floating-rate paper has a much lower yield than the fixed-rate paper. The high-yield debt funds that have been formed to capitalise on the situation cannot get the mid- to high-teen yields they are targeting through investments in floating-rate paper. According to Gandel, "They would themselves have to borrow to buy this floating rate paper, and they can't borrow because nobody can borrow now." Gandel is concerned that these loans were made at the top of the market, and he is concerned



about the pricing and the fundamentals on the recent issues. "It's pretty widely recognised that the 2006 and 2007 CMBS are very risky, which is part of the reason spreads have blown out so much," he says. "People are demanding a huge premium to buy this stuff."

Too Many Funds Buying Paper at Small Discounts?

Not everyone likes CMBS. Paul Dougherty, president of Perseus Realty Partners in Washington, DC, is not a big fan. "The discounts are not as significant as you'd think – 80 cents or 90 cents on the dollar. This is primarily due to the fact that there are so many people buying these loans. I'm not looking to buy CMBS. I'm interested in buying whole loans at a much steeper discount. If I'm buying something for 80 cents on the dollar, I'm never going to get to the minimum level of return I need as an opportunistic investor, which is the high teens or low 20s. Furthermore, to the best of my knowledge, there is no one providing warehouse lines to lever your equity in these investments. You can use takeback financing from the seller, but that is Russian roulette. One month after you close, you can find yourself out of balance, and you get margin called."

Many funds are focused on debt strategies (such as issuing debt, buying defaulted notes or purchasing deeply discounted securities) as debt begins to penetrate the asset level, and Dougherty thinks those strategies are overpopulated. "There are too many funds that have been raised or are being raised in reaction to current market conditions. The discounts aren't there and frankly, we don't see widespread distress in the commercial mortgage market right now," he says. "My point is that there are distressed holders of paper, but there's not necessarily a lot of distressed paper secured by operationally distressed assets out there. The only distress we see right now is in condominiums or in land and homebuilders. If you see a continuation of the current malaise in the economy, the continued deleveraging and the lack of commerce that's taking place, then you'll see some distress at the property level."

Fundraising Slows

A lot of money is being raised for distressed debt. According to Private Equity Intelligence's (Preqin) *Global Fundraising Update*, distressed debt funds raised US\$32.4 billion in capital commitments in the second quarter of 2008 alone. The report states, "Preqin believes that 2008 is likely to be the most successful year for distressed debt fundraising." Importantly, these figures reflect distressed debt fundraising overall, not just for real estate.

While real estate debt also has shown a lot of activity, there are factors now slowing it down. "Despite the fact that there is a lot of money being raised for distressed debt overall, real estate fundraising has slowed," says Gandel.

The 70 different funds in the market targeting high-yield real estate debt include those that have successfully raised money and those hoping to raise money. "Not all those funds will get raised," adds Gandel. One reason for that is pension funds do not want to put that much money into these funds. "I've had meetings recently that have absolutely confirmed that," he says. "That target of US\$40 billion being raised for real estate debt? It's not going to hit US\$40 billion; my hunch is that it's not going to even get close. The pension funds are running out of money."

How could they be running out of money? According to Gandel, there are a couple of reasons. One is the "denominator effect" – a drop in the market value of a pension fund's total portfolio in relation to the value of its real estate portfolio automatically increases the percentage invested in real estate. But, Gandel adds, "What's compounding that and makes the situation much worse is that real estate portfolios are not getting money back: Distributions in the past six months have dried up." Prior to the credit crunch, pension funds had been receiving a lot of money back from their real estate investments and were quickly putting that money back out. After the credit crunch hit, real estate and private equity funds have been unable to easily liquidate assets to raise money. Gandel concludes, "A lot of pension funds are over allocated to real estate, and that has impacted the ability of real estate equity funds and high-yield real estate debt funds to raise money."

The other issue is the hype about the high-yield real estate debt market – the buying opportunities have yet to live up to the billing. "We raised some money last year, but we've been very slow to put it out," says Gandel. Another reason for little activity is that many high-yield debt funds were formed with the idea of using leverage to buy loans. But it has been just as tough for real estate debt funds to get leverage as it has



been for everyone else. The real estate debt funds are victims of the same circumstances they are trying to capitalise on – the lack of available debt capital.

The experienced players in the real estate debt market are being joined by a host of first-time funds, and Gandel does not think all will succeed. "A lot of first-time funds have cobbled something together to capitalise on this phenomenon," he says. "They don't have a lot of experience. Pension funds are going to be very selective. If they're going to put out a limited amount of money in the sector, they're going to be very selective where it's going."

Filling the Gap

The dominant feature of the early part of the credit crunch has been helping providers of commercial paper move loans off their books. "In the next phase of the cycle, maturing loans will be unable to refinance under the present circumstances," says Grunzweig. That is just starting to happen, and Grunzweig says filling the void in the capital market by originating loans is clearly part of Colony's strategy to capitalise on the credit crunch.

According to Grunzweig, it is a little more risky to originate loans than to take on existing loans: "In this stage of the credit crunch, it's generally easier to underwrite an entry into an existing loan or set of loans than it is to originate, but there will be lots of exceptions to that rule." Whether they are participating in existing loans or originating loans, Colony's targeted gross rates of returns are 20% and above overall.

According to Gilbert, the CMBS securitisation market in 2007 totalled US\$230 billion. By most estimates, that market has declined 90% this year, to about US\$25 billion in 2008. And therein lies a big opportunity. "Even though transactions are down significantly, who's picking up the slack of US\$230 billion going to US\$25 billion?" Gilbert asks. "It's the grease, the debt that makes the whole system work, and it's creating more opportunities to originate debt as well as provide mezzanine debt."

One of the attractive areas of originating loans is "gap equity" lending, also called origination of mezzanine. This occurs as loans – whether five-year term or three-year floating-rate loans – come due and owners have to refinance. "If a bank was willing to provide up to 75% leverage, and now it's willing to provide up to 55% leverage, there's an opportunity to fill that void between the 55% and the 75%," says Gilbert. "That's a huge opportunity for the high-yield debt market." Many high-yield debt funds are now looking to provide lending for that 15-20% gap.

Dougherty also likes gap equity lending. "One issue many people have in their portfolios with 2003–2004 vintage funds is they levered up and they got caught when the dislocation took place in August 2007," he says. "During this current downturn, our goal is to provide that 15-20% gap equity, where we get high teens, low 20s preferred return, with upside above that."

He thinks there will be many loans coming to maturity over the next couple of years that will need refinancing. "If there's a continued slowdown in lending and a tightening of the debt market as a result of one or more financial institutions going south, then you'll see people having 'maturity defaults,' meaning the underlying loans come to maturity and the borrower cannot refinance into the current market because the current market is not there," he says. "We believe this will evolve into a substantial opportunity." Gandel agrees. "The number of properties that have to be refinanced is growing, and the number of borrowers who can't get extensions is increasing. So the sense of urgency is growing," he says.

We Expect to be Paid Well

Fidelity has been active in mezzanine and B-notes. They have purchased mezzanine notes and originated them. Gandel says the returns for these investments are generally low- to mid-teens unlevered. And now, like others, Fidelity is on the verge of originating first mortgages as well. Historically, Fidelity has not originated first mortgages "because they haven't offered the returns we're looking for," says Gandel. "But because so many lenders are pulling back, we see there's an opportunity to start earning returns of 10% in certain situations by originating first mortgages. We think that's coming in the second half of 2008. It's an opportunity to move up in the capital stack and still earn a pretty attractive return," he says.

LACERS also sees great potential in real estate debt. Gallagher concludes, "There are great opportunities



across the debt markets. Subprime has tainted everything. It's not just residential. It's corporate, commercial, industrial – opportunities are in almost every sector. But there's bad debt too, so investors must be cautious."

On top of the scarcity of available refinancing for existing debt, it is hard to develop new lines of credit. So a premium is being paid for providing liquidity. Gallagher would not put a number on his expected returns, but does say, "We're always looking for ways to add value. We expect to be paid, and paid well for taking advantage of these opportunities."

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