# ❖ Real Estate Debt: Which Opportunity Offers the Most Competitive Return in the Near- to Mid-Term?

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## I. Introduction

Real estate investors today seeking investments for a high-quality or value-added portfolio may want to consider "looking up" for opportunities—to the debt portion of the capital structure. In general, real estate debt investments give investors an opportunity to select their position in the capital structure and provide liquidity advantages over real estate equity. Real estate debt investments—by design—do not enjoy the same upside potential as equity investments. However, the performance of real estate debt investments is generally not dependent upon increasing real estate values. This provides an effective hedge against real estate equity portfolios in a flat—or down—real estate market.

In this paper, we will compare four real estate debt opportunities that are available today—commercial mortgage-backed securities ("CMBS"), REIT debt, mortgages and mezzanine debt. Following an overview of each of these investment options, we will compare three of these investments (investment grade CMBS, REIT debt and mortgages) that may be considered as alternatives to other high-quality investments. We will then compare non-investment grade CMBS and mezzanine investments—both of which can be looked to as alternatives to value-added real estate equity.[1]

## II. Overview of Real Estate Debt Investment Opportunities

### *CMBS*

CMBS are generally multi-class debt or pass-through securities backed by a pool of first-lien mortgage loans secured by commercial real property. The typical pool consists of 125–150 mortgages that are highly diversified (by property-type, geography, borrower, etc.) and have an aggregate outstanding balance of approximately $1 billion. Principal and interest paid on each mortgage provides the funds to pay debt service on the CMBS.

A CMBS offering is issued in multiple classes, with each class generally rated by one or more of the rating agencies (Moody's, S&P and Fitch). The "first pay"

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1 While investors can also earn value-added returns from distressed mortgage investments, the size of the market and unique nature of these investments makes it difficult to draw conclusions for the purpose of this analysis.

class (generally rated AAA and accounting for 80–85% of the offering) receives all principal payments from the underlying mortgages until it has been paid in full (at which point the "second pay" class moves up in line to become the "first pay" class). The last class to receive principal (called the "first loss" class) is the most credit-sensitive class in the CMBS issuance because any losses incurred on the pool are applied to this class first. (Exhibit 1)

### *REIT Debt*

REIT debt securities represent an unsecured claim against the REIT as a company, rather than a claim against the underlying properties. The issuance of REIT debt generally obligates the company to adhere to certain standard covenants—such as a limit on the amount of company-wide leverage or to ensure adequate debt service coverage. Unlike CMBS, REIT debt is issued as a single security class, with most REITs carrying a rating in the BBB- to BBB+ range.

### *Mortgages*

Commercial mortgages generally represent a secured claim on a single commercial real estate asset. While the typical commercial mortgage structure calls for the amortization of principal over a 25- to 30-year amortization period, there will generally be a balloon payment due at the end of the mortgage term, typically 10 years. The lender is generally provided some form of protection against borrower prepayment through a prepayment or yield maintenance penalty.

### *Mezzanine Debt*

Mezzanine debt investments have customized deal structures based upon a number of factors, including the creditworthiness of the property owner, the amount of capital required relative to the property value and the positioning of the property. Deal structures may include the payment of a coupon by the borrower as well as a participation in cash flow or the residual value of the property.

## III. High-Quality Real Estate Debt Investments

In this section, we provide a comparison of the relative strengths and weaknesses of investment grade CMBS, REIT debt and first-lien mortgages—all of which may be used to earn 5.5–6.5% while investing in high-quality investments. (Exhibit 2)

### *Property Leverage (advantage: REIT Debt)*

On average, the "total debt-to-market cap" for REITs is between 40% to 45%, while the average loan-to-value ("LTV") on mortgages from institutional investors typically ranges from 50–65%. The average LTV on mortgages included in

Exhibit 1

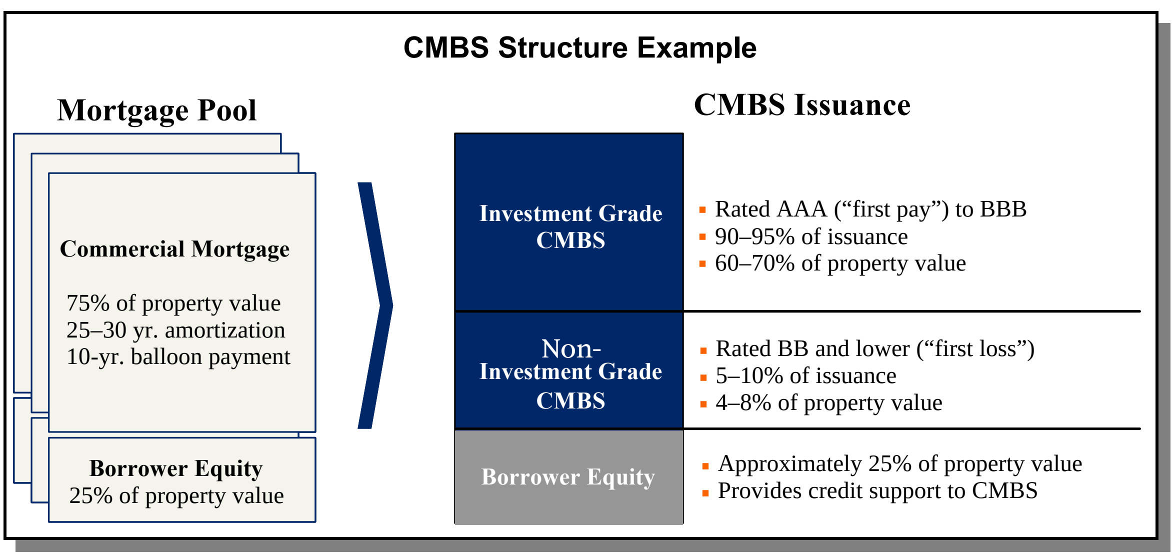
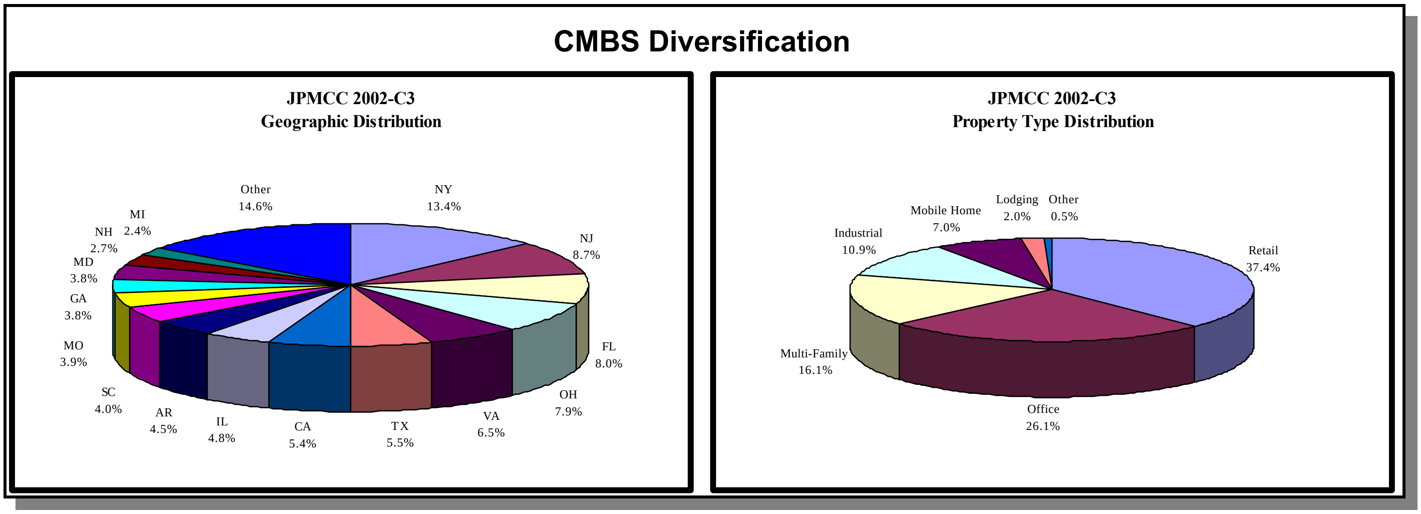


Exhibit 2




conduit CMBS transactions issued from 1995 through 2002 is 69%. However, to draw a fair comparison, we must take into consideration the credit support that is embedded in the CMBS structure. Since losses on mortgages in the pool are absorbed by the "first loss" CMBS classes, the typical CMBS mortgage pool can withstand up to 12% in losses without reducing the amount of principal that will ultimately be paid to the investment grade CMBS classes. This credit enhancement (or "subordination") leads to an average "effective LTV" for the investment grade classes of approximately 60%.

***Portfolio Diversification (advantage: CMBS)***

The typical conduit CMBS is comprised of 125–150 mortgages that are highly diversified by property type, market, borrower, etc. (see Exhibit 2 for the distribution of mortgages by property type and geography for a recently-issued conduit CMBS). This focus on broad diversification is driven by the rating agencies and market participants that view this as necessary in order to mitigate single-event and concentration risk.

While a REIT portfolio may be comprised of numerous properties, the portfolio is likely to face much greater concentration risk. Most REITs specialize in a specific property-type or region—and are discouraged from expanding their mandate.

As institutional mortgages are generally collateralized by a single asset, they are significantly less diversified than CMBS or REIT debt.

***Security (advantage: Mortgages and CMBS)***

A mortgage represents a first-lien on the real estate collateral, giving the mortgage holder a claim on the underlying property in the event of default. A CMBS represents a share in a pool of first-lien mortgages. In the event of default on any individual mortgage, the CMBS security-holders have a claim on the underlying property and they can recover some/all of their principal through the foreclosure process. Alternatively, REIT debt represents an unsecured claim on the REIT as a company, not on the individual assets. As such, a default would require REIT debt holders (along with other creditors) to enter the bankruptcy process in order to seek repayment from the disposition of the assets of the real estate company.

***Liquidity (advantage: CMBS)***

The investment grade CMBS market is estimated at approximately $300 billion in size—approximately six times the size of the REIT debt market. In terms of new issuance, approximately $50 billion in investment grade CMBS was issued in 2002 compared to approximately $10 billion in the REIT debt market. In terms of secondary trading activity, bid list volume for REIT debt currently runs at about $50 million per week—significantly lower than the $500 million to $1 billion a week that is traded in the investment grade CMBS market. While both securities are included in the Lehman Brothers Aggregate Index, the relative contributions are significantly different. Investment grade CMBS now account for 2.4% of the overall Aggregate Index, as compared to REIT Debt which is approximately 0.4%. As such, the bid/offer spread for investment grade CMBS ranges from 1–10 basis points while the bid/offer spread for REIT debt ranges from 5–25 basis points.

At approximately $1.4 trillion, the unsecuritized commercial mortgage market is significantly larger than the market for CMBS or REIT debt. It does not, however, provide investors with the liquidity options available to CMBS or REIT debt investors.

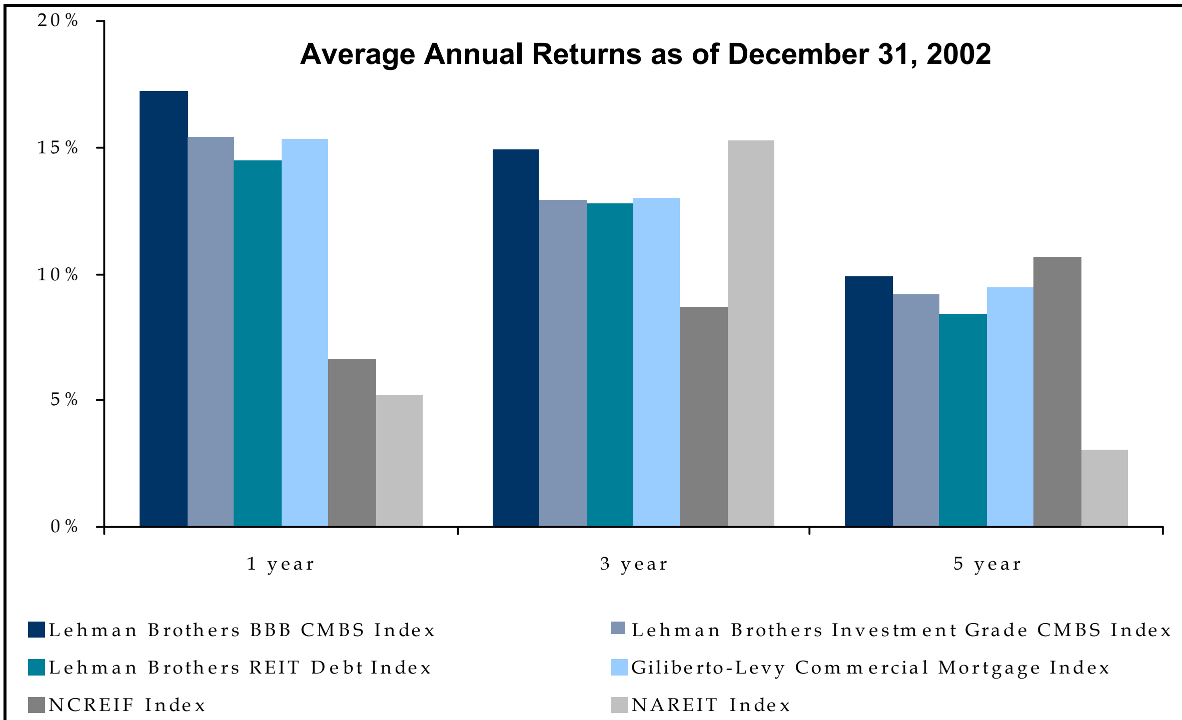
***Current Income (draw)***

The "cash yield" or current income component for mortgages, REIT debt and investment grade CMBS (BBB rated) is comparable—at approximately 5.5–6.0%.

***Performance (advantage: Mortgages and CMBS)***

While both the REIT debt and the CMBS markets are relatively young—both taking shape in the early 1990s—the CMBS market has outperformed the REIT debt market. Over the one-, three- and five-year periods ending December 31, 2002, BBB rated CMBS outperformed REIT debt as well as commercial mortgages. (Exhibit 3)

Exhibit 3




*Sources: Lehman Brothers, Giliberto-Levy Commercial Mortgage Index, National Council of Real Estate Investment Fiduciaries (NCREIF) and National Association of Real Estate Investment Trust (NAREIT)*

## IV. High-Yield Real Estate Debt Investments

In this section, we provide a comparison of the relative strengths and weaknesses of non-investment grade CMBS and mezzanine debt investments—both of which may be considered as alternative investments for a value-added or opportunistic real estate allocation.

***Property Leverage (advantage: CMBS)***

Mezzanine debt investments are intermediate financing that lie between the first mortgage (that may be contributed to a CMBS transaction) and borrower equity, if any, in the capital structure. Typical mezzanine debt structures can increase the property leverage by 15–20% over the leverage from the first-lien mortgage.

***Portfolio Diversification (advantage: CMBS)***

Because mezzanine debt incurs losses before the first-lien mortgage, CMBS have an advantage. Additionally, the diversification inherent in a CMBS issue contributes to portfolio diversification as opposed to mezzanine investments that are typically structured from a single asset.

***Security (advantage: CMBS)***

CMBS are secured by first-lien mortgages, while mezzanine debt investments are structured in a variety of ways, including second-lien mortgages as well as a lien on equity interests. Mezzanine structures can present significant hurdles in the event of a workout.

***Liquidity (advantage: CMBS)***

While BB rated CMBS can typically be traded within two to three days with bid/offer spreads of 10–35 basis points, the bid/offer spread on B rated and unrated CMBS may be significantly wider (100–1,000 basis points) and the securities can take four to six weeks to trade. Mezzanine debt investments may be sold (assuming that there are no transfer restrictions), but it would likely take a few months to identify a buyer and the bid/offer spread is unknown.

***Current Income (advantage: CMBS)***

Non-investment grade CMBS are acquired at prices ranging from 30–85 cents on the dollar—producing current income at a blended annual rate of approximately 10–12%. Some mezzanine debt structures include a coupon stream (or a participation in the cash flow from the property), typically at a spread of 250–500 basis points over LIBOR or Treasury rates.

***Market Size (advantage: Mezzanine Debt)***

New CMBS originations totaled approximately $65 billion in the United States in 2002 and are expected to continue at a rate of $60–70 billion per year. The non-investment grade classes typically represent around 7 to 9% of total issues. Therefore, assuming annual issuance of $60–70 billion, annual issuance of non-investment grade CMBS is likely to be between $4 and $6.5 billion (par amount) annually. Due to the discounted price at which these securities are acquired, the value of this annual issuance is approximately $2–3 billion.

The size of the potential market for mezzanine debt investments is more difficult to estimate—although it is clearly larger than the potential non-investment grade CMBS market. If we assume that the total size of the U.S. commercial real estate market is $4.5 trillion and that between 10–15% of this universe calls for some form of mezzanine financing, and that on average, the mezzanine component of the capital structure represents 15–20% of the property value, the overall size of the mezzanine debt market is between $65 and $135 billion. With an average maturity of five years, annual mezzanine debt origination is likely to be between $13 and $27 billion.

***Supply/Demand (advantage: CMBS)***

While the demand from borrowers for mezzanine debt is strong, the market is also becoming crowded with lenders. A growing number of commingled funds are now targeting mezzanine loans for their portfolios.

The non-investment grade CMBS market is widely-considered a "buyers market" due to the limited number of investors (currently five active buyers) and the high barriers to entry. This has led to significant control by these buyers over the quality of mortgages that are included in the CMBS mortgage pools and low prices. It is estimated that the current pool of buyers will have appetite for approximately half of the new issuance over the next two to three years.

### Performance (advantage: CMBS)

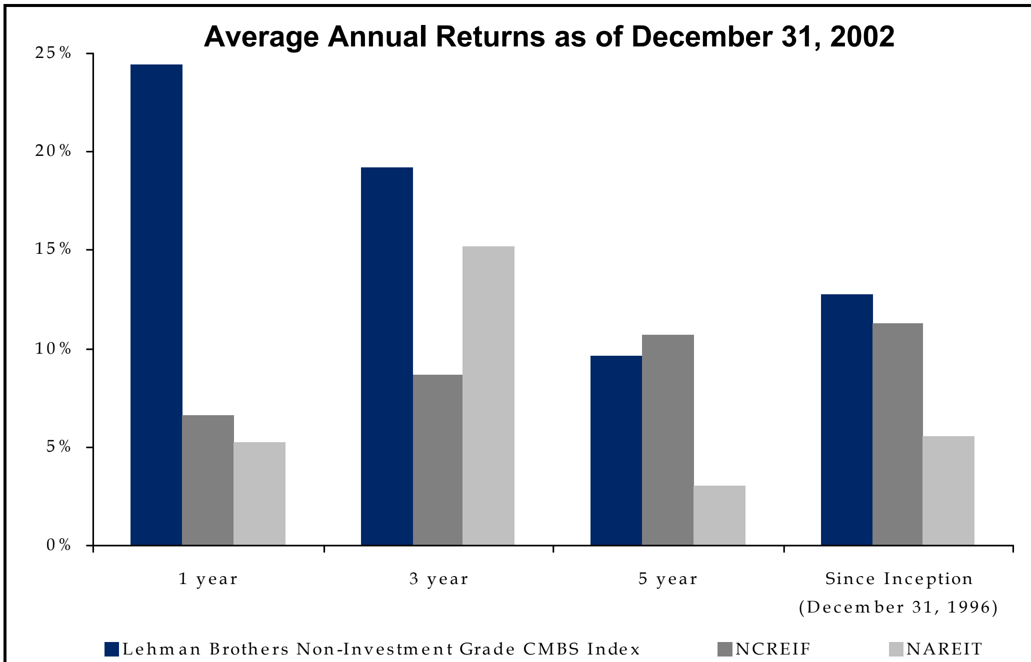
Although both the REIT and CMBS markets are relatively young, they may provide periodic diversification benefits to real estate private equity. While the real estate private equity market has experienced a period of significant performance since the inception of the CMBS benchmark, CMBS has outperformed by 150 basis points annually.

## V. Is It Time to Invest in Real Estate Debt ...and Where?

Several factors currently affect the commercial real estate market, which lead us to believe that commercial real estate loans originated over the next few years will experience low default levels. Market rents have generally returned to sustainable levels (following excessive growth from 1998–2001) and national occupancy levels will continue to stabilize. Also, the significant drop in construction starts in 2002 in most markets that is projected to continue over the next few years will limit supply-side pressure. These factors lead us to believe that property revenue projections on most loans will be highly predictable over the next few years.

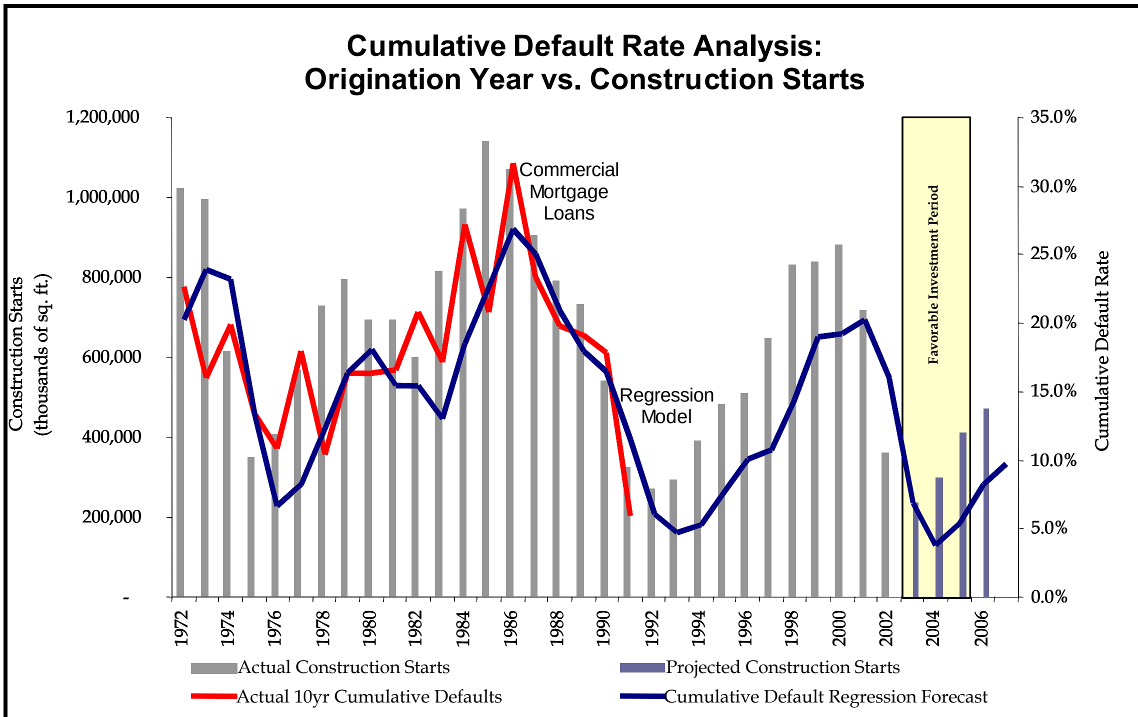
Not surprisingly, there is a strong relationship between construction starts and the default rate on commercial mortgages. The chart in Exhibit 5 represents a bivariate regression model used to test the correlation of real estate construction starts to cumulative defaults on mortgages originated during the year of construction. Construction starts

Exhibit 4




Source: Lehman Brothers, NCREIF, NAREIT

Exhibit 5




*Source: Property and Portfolio Research ("PPR"), Clarion Partners, Snyderman, Mark P., "Commercial Mortgages: Default Occurrence and Estimated Yield Impact, Journal of Portfolio Management, Fall 1991. Esaki, Howard, Steven L'Heureux and Mark Snyderman. "Commercial Mortgage Defaults: an Update." Spring 1999. Esaki, Howard. "Commercial Mortgage Defaults: 1972-2000." Winter 2002.*

*Actual default line based on loans with 10 years of seasoning.*

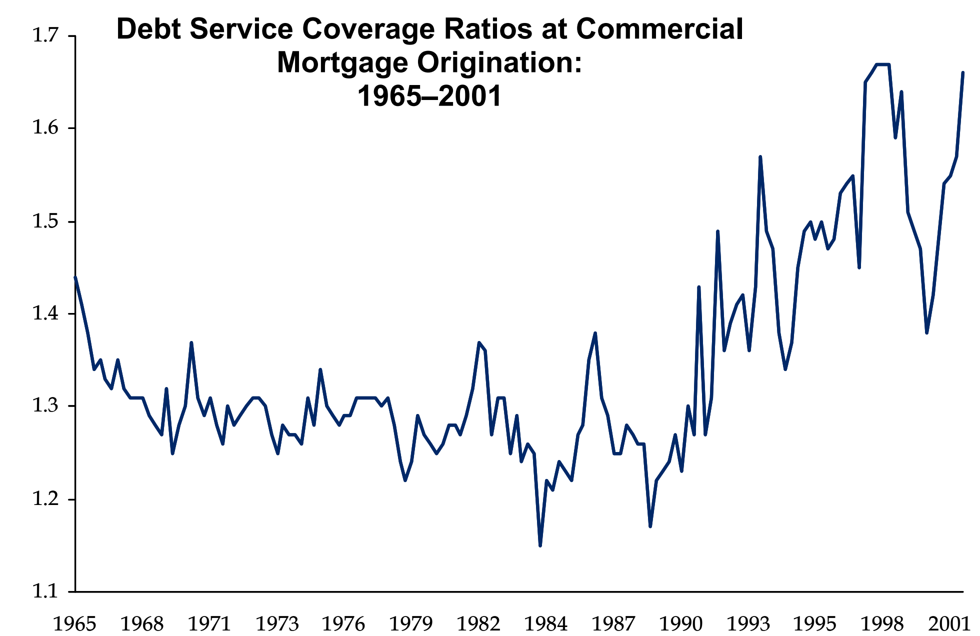
are used as an indicator and measure of the "irrational exuberance" that occurs around peaks in the market cycle. In order to test past correlation, 10-year default rates were regressed against construction starts for the relevant periods in anticipation that if a high level of correlation existed, this model could be used to project 10-year default rates on the basis of defined amounts of construction starts.

The bars on the chart (on the left axis) represent historical and projected commercial construction-starts as provided by *Property and Portfolio Research*, an independent U.S. real estate research firm. The construction-starts incorporate the following commercial industry sectors: office, multifamily, retail and warehouse distribution space. On the right hand axis, and represented by the two lines on the graph, are actual 10-year cumulative default rates experienced by commercial mortgage loans, and the forecasted 10-year cumulative defaults rates as produced by the regression model. The model predicts that delinquencies will increase on mortgages originated between the third quarter of 1998 and the second quarter of 2001. The model also predicts that loans originated in 2003, 2004 and 2005 will experience low default rates, providing investors in real estate debt investments with a compelling risk/return environment.

In addition, underwriting standards have generally become more conservative over the past 12–18 months. This has been caused by lenders seeking additional protection against continued economic uncertainty by lending less (as is evident in the increasing debt service coverage ratios in Exhibit 6).

Given the expectation of low default rates on <u>new origination</u> of commercial real estate debt over the next two to three years, it appears to be the right time to invest in the debt portion of the capital structure.

Exhibit 6




*Source: American Council of Life Insurers.*

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