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DEBT DEBT DEBT

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Videos in This Report

On Camera

Robert Little, Cornerstone Real Estate Advisors

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Growing Lender Appetite for Core Debt, Cash-Flowing Mezz
Despite yields compressing by as much as 20 basis points for senior first mortgages in the first months of 2014, Cornerstone Real Estate Advisers' Robert Little says there will be considerable appetite for core debt.

U.S. Debt Markets: Overfunded and Mispriced
Former CBRE Capital Partners president Ethan Penner talks about finding relative value in debt and why opportunities lie in Europe.

CRE Debt in "Equilibrium" as World Eyes U.S. Market
The U.S. real estate market is at the top of the list for the world's investors, as a rate roller-coaster ride could stabilize in the coming year, says Drew Fung of Clarion Partners.

Opportunity Remains in Commercial RE Debt, Despite Yields
Jack Taylor of Prudential Real Estate Investors says despite an influx of capital, opportunity remains for commercial real estate debt—if you know where to focus.

Opportunity in Legacy CMBS Bonds
Robert Lieber of C-III Partners says the firm is focused on CMBS legacy trust bonds and sees liquidity—and opportunity—coming back to the B-piece market.

COMING SOON on PrivcapRE

A Hospitality Comeback
The hospitality business—particularly limited-service hotels—has bounced back from recent lows, says Tyler Morse of MCR Development.

Brazil's Real Estate Evolution
Jim Worms of Paladin Realty delves into changes in Brazil's real estate market in the past 15 years, the state of the housing market, and challenges of building affordable housing.

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Q2

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Institutionalizing Single-Family Homes

The opportunity for institutionalizing ownership of single-family homes is huge, says Starwood Waypoint's Colin Wiel.

KKR and Its Capital Partners

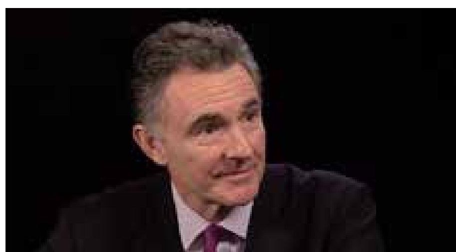
Suzanne Donohoe, who leads investor relations for KKR, describes the evolving needs of the firm's institutional investor clients.

2014 Outlook

Real Capital Analytics' Bob White gives an overview of the geographies and sectors he thinks are set to outperform—and underperform—this year.

Rebranding Olshan, Retaining Focus

Michael Odell of Olshan Properties talks about the company's move torebrand after 55 years, without changing its focus.



U.S. Core Performance to Slow in 2014

Core real estate in the U.S. is "fully priced," prompting calls for investors to start exploring a global portfolio, says Jeremy Plummer of CBRE Global Investors.

The Rebirth of Fannie and Freddie

Ryan Severino of REIS and Pat Carroll of Carroll Organization consider the rebirth of Fannie Mae and Freddie Mac, and the implications for multi-family investors.

About PrivcapRE Special Reports

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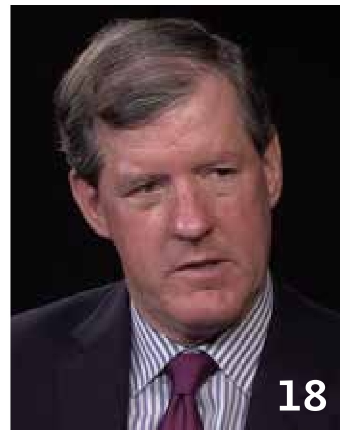

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Interviews in this report have been edited for length and clarity.

Commentary
How Far Will You Go?

Compressing yields and a **rising number of RE debt players** have led to fears that the debt opportunity is over. The real issue is **how far managers will go to hit their target returns.**

Market Analysis by Editor **Zoe Hughes**

Is the window of opportunity closing on subordinated real estate debt investments?

Given the sheer weight of capital that has entered the U.S. commercial real estate debt space in the past few years—and the increasing investor appetite for mezzanine, B-piece, CMBS and preferred equity strategies—it's certainly a fair question for LPs to be asking their GPs.

The fear stems from the yield compression of the past four years and, more specifically, the past 12 months, as competition for deals has increased. Spreads for mezzanine debt were roughly 200 to 300 basis points higher in 2010 than they are today, according to Jack Taylor, a managing director and head of global debt at Prudential Real Estate Investors, who we interviewed in this special report. For Taylor, it has prompted nostalgia for the opportunities of four years ago.

Yet to argue that the opportunity is over—or that the U.S. debt market is oversupplied and mispriced, as Ethan Penner, former president of CBRE Capital Partners, argues—is, for many, oversimplifying matters.

With an estimated $1.4 trillion in commercial mortgages maturing between 2014 and 2017, including roughly $346 billion in CMBS legacy loans, the wall of maturities facing the industry is immense. Improving fundamentals and lending liquidity will mean much of the maturing debt is dealt with rationally. Fire sales were not commonplace in the depths of the Great Recession and are certainly not going to be in the run-up to 2017.

> THE REAL QUESTION INSTITUTIONAL INVESTORS SHOULD BE ASKING IS HOW FAR MANAGERS WILL STRETCH THEIR STRATEGIES TO HIT TARGETED RETURNS.
>
> -ZOE HUGHES

But real estate fundamentals are not improving evenly, or universally. There lies the opportunity for higher-yield debt managers.

Institutional investors should now be asking their debt-focused managers how far they will go to hit their targeted returns. How far are they willing to stray from their mandate by pushing into riskier parts of the capital stack or moving away from their core competencies?

Competition among debt players has increased dramatically in the past eight years. Between January and August of 2013, 37 percent of all real estate capital raised for closed-ended, commingled funds targeted a debt and mixed-debt-and-equity strategy. In 2006, according to a survey done by Preqin, that figure was just 7 percent, representing a more than five-fold increase in the number of funds targeting debt strategies. Together with new entrants to the field, existing players raising ever-larger funds, and the market's improving fundamentals and liquidity, yields are naturally compressing across the capital stack.

What remains to be seen is whether this race for yield will push managers away from their stated mandates, as they try to meet their original return objectives. Or if they will willingly hand back their LPs' capital, if the market moves beyond the risk appetite of their investors. /

Hungry for Real Estate Debt

Opportunities abound in commercial RE debt markets, and Cornerstone's Robert Little says there is considerable lender appetite. But there are red flags to watch out for.

Robert Little, Cornerstone Real Estate Advisers

PrivcapRE: How much of the Cornerstone portfolio is core fixed-income, and how much is mezzanine, bridge, and commercial-mortgage-backed securities (CMBS)?

Robert Little, Cornerstone: The debt portfolio today is roughly two-thirds of our asset base, which is about $43 billion overall. If you look at the breakout of that, it's about $18 billion of core stabilized commercial mortgage loans. We think of those in terms of 65 percent to 70 percent loan-to-value, or less on stabilized income-producing properties. The balance of the portfolio is CMBS, which is roughly $4 billion.

We buy pools of single-family loans in the secondary market, which is a bit of a niche business, and that's about $2 billion. We have other businesses in affordable-housing tax credits—both debt and equity—as well as our alternative portfolio, which is high-yield debt as well as mezzanine loans.

PrivcapRE: Cornerstone is a significant player in the commercial real estate debt world, and your approach is from all parts of the capital stack. Where are we in the cycle?

Little: We're a four-quadrant player—in debt and equity, public and private—and that gives us a tremendous advantage in markets like this, that have evolved post-crisis and feel healthy right now, although there are some heated pockets. We view the core mortgage lending activity that we're involved in as a good place to be, in terms borrower behavior, capital market behavior, and orderly nature and liquidity flowing to the marketplace.

PrivcapRE: One of the things that you must have seen is lenders coming back to core fixed-income. How much did yields compress through 2012 into 2013?

Little: I'll take you back even farther. In 2010, when the market was in complete disarray, there was a window for about nine months where we saw yields in the 8 percent to 9 percent range for high-quality core mortgages. [There was] zero liquidity in the marketplace, and people that had to refinance had no other choice. That window was short-lived, and we then saw lenders come back into the marketplace. From the beginning to the end of 2013, we saw spreads come in 20 to 25 basis points. In the beginning of this year we've seen additional appetite for commercial mortgages and we've seen spreads come in another 15 to 20 basis points.

PrivcapRE: How much do you think spreads will tighten in the next 12 months?

Little: There continues to be tremendous demand for fixed-income investments. We've heard a willingness in the insurance company arena to do more than last year. In some cases, meaningfully more than last year—50 percent or 100 percent. Looking at the industry as a whole, the insurance companies did a record of about $65 billion of lending last year. So there is considerable appetite.

PrivcapRE: Where are debt yields today?

Little: Debt yields vary depending on market and property types, but we're seeing the highest-quality apartment transactions going at 7 percent, up to hotels that might be at 10 percent. We spend a lot of time in our program on the exit, and I like to say that real estate transactions are like children. They're all cute when they're little. It's incumbent upon the lender to understand how that property is going to perform five, 10, 15 years from now, so we can understand the potential outcomes of that loan when it comes time to repay it.

PrivcapRE: What is the scale of opportunity in mezzanine and bridge lending in the next few years?

Little: You hear enormous numbers out there for maturing loans in, say, the 2015-to-2017 time frame—north of $1 trillion of real estate debt coming at us—much of which was originated in that peak period of 2006 to 2007. There are going to be great opportunities in mezzanine lending to help bridge those gaps in situations that had too much leverage put on them, yet good real estate deserves to be financed.

PrivcapRE: Given the number of players that have entered mezzanine lending, do you still see yield opportunities?

Little: We do. If you look at the number of managers out with mezzanine products and funds, the yield expectations of those funds are vastly different. That depends on a couple of things. One is the level of risk that they're willing to take at the property level, and the second is the amount of leverage they're willing to put on at the fund level. It's been our policy to not put leverage on mezz, because it's levered to begin with. Some did it in the last cycle, with unsavory consequences.

PrivcapRE: Investors are wondering whether the mezzanine debt opportunity has disappeared or is shrinking. Adding leverage to the fund to juice the returns sounds as though we're going back to the heady days.

Little: One of the fundamentals that people forgot in the run-up to the end of the last cycle was to make sure you're getting paid for the risk you're taking. It became difficult to parse risk among tranches in the CMBS transaction. There might have been six or seven layers of mezz. I remember trying to decide if the mezz D was a better value than the mezz C. If it gets too complex or there's too much dependence on leverage, that's a red flag.

PrivcapRE: What volume of mezzanine deals do you think you'll be doing in 2014?

Little: Between the mezz and the high-yield first-mortgage business, we'll do at least $1.5 billion this year.

PrivcapRE: Where are you seeing the best opportunities in the mezzanine debt space?

Little: There are two things we like right now. One is multifamily development mezz. That's among our highest-yielding mezz investing. The other is cash-flowing mezz, where you might have had a loan that was put on around 2009-to-2010, when values were depressed, lender values were low, and the property might handle incremental leverage. /

BIO / ROBERT LITTLE

Little is chief investment officer of finance at Cornerstone Real Estate Advisers. Previously, he worked at Cornerstone affiliate Babson Capital Management, and prior to that was a member of MassMutual's investment management division. He received a bachelor's degree from Bates College.

Reaching Equilibrium

Supply and demand for commercial RE debt has balanced out, as investors around the world eye the U.S. market, says Drew Fung of Clarion Partners

Drew Fung, Clarion Partners

PrivcapRE: In the past few years we've seen a lot of investor attention in commercial real estate debt, particularly non-senior debt. Can you characterize the state of the commercial real estate lending market, and where Clarion is playing within it?

Drew Fung, Clarion Partners: The RE debt market is in equilibrium with somewhat of a balance between consumers and suppliers. When you drill down into subordinate debt, you're seeing competition, but there's still opportunity. One driver is that transactions have been increasing, so there's more demand for financing. In 2012 versus 2013, real estate transactions were up almost 19 percent, which generates demand. Also, the U.S. is the current star in the global economy and there are many non-U.S. investors. Asia, the Middle East, and Europe are all looking to the U.S. real estate markets as a good opportunity.

PrivcapRE: How does this compare to 12 months ago? How much have transactions improved?

Fung: The biggest change in the last 12 months has been more uncertainty, as opposed to interest rates. You've had a roller coaster ride with rates. The bottom line is we're more or less at the same levels as 12 months ago; maybe we're tighter by 50 to 70 basis points. There are opposing forces. Treasury rates have come back down, but the amount of capital coming into the market has an impact.

PrivcapRE: There's talk of a huge wave of commercial real estate debt maturities coming through. What is the current opportunity for mezzanine debt?

Fung: Right after 2008 and the great recession kicked in, a lot of transactions were geared toward outsized returns on distressed situations, and others were because liquidity was basically nonexistent. We've moved into a different part of the life cycle where the best risk-adjusted opportunities are providing mezzanine financing in the 60 to 80/85 percent loan-to-value tranche. That's the best place to be, as opposed to the higher-risk end of the spectrum where there isn't much distress in the market. You're left with a lot of speculative development. That's not a compelling opportunity at the moment because yields are not as high. We're staying in the middle of the risk spectrum.

PrivcapRE: Are there too many or too few lenders to take advantage of the scale of the mezzanine debt opportunity?

Fung: In order to be successful in the mezzanine business, you need a certain skill set, and it's the ability to find the deals, originate them, and underwrite them properly. It's the ability to manage the asset, once the loan is made. Right now we have the right number

of active specialists in the mezz market. Going forward, we'll have a healthy market—the right balance of lenders versus consumers of mezz capital.

PrivcapRE: Where are the growth areas? Will Clarion look outside of mezz, or will you expand your current offering?

Fung: We'd like to stick to what we see as a good risk-adjusted mezz spread—that 60 to 80, 85 percent LTV. Looking forward, we may branch out into bridge lending, which is effectively providing senior and mezz together in a higher-leveraged loan. We have a strategic partnership with a large U.S. life insurance company where they provide the senior loan and we provide the mezz in a one-stop-shopping arrangement. This gives borrowers in this competitive market the surety that their senior and mezz lenders are in place and will execute on time.

PrivcapRE: As you look at the mezz market, what are your expectations for the next three to five years?

Fung: It will be a good market in the next two to three years. One game changer is the U.S. again being a standout amongst global investment opportunities. We'll continue to see capital inflows into U.S. real estate, and that's going to drive demand for debt in general. What also gives me comfort that the opportunities will continue is that life companies doing a lot of senior lending have remained disciplined in their LTV and underwriting.

PrivcapRE: What are the triggers that would cause concern about the state of the market?

Fung: A lot of the red flags would be supply-related. We have a good handle on that with our active equity acquisition practice. Other than in a few select markets—multifamily, in particular—supply is in check. The other indicator would be the level of pricing for mezz loans versus other alternatives. If spreads came in quite a bit, and we looked at alternative investments and we weren't being adequately compensated for the risk, that would cause us to pull in our horns, take a breath, and see where the market's going. /

BIO / DREW FUNG

Fung is a managing director and head of the debt investment group at Clarion Partners. Prior to joining Clarion, he was at RREEF, and has 25 years of real estate experience. He received degrees from New York University's Stern School of Business and the State University of New York at Albany.

Peeling Back the Layers of the Mezz Opportunity

Despite an influx of capital, the commercial real estate debt market remains favorable—if you know where to focus, says **Jack Taylor** of **Prudential Real Estate Investors**

Jack Taylor

PrivcapRE: Describe Prudential Real Estate Investors's portfolio that you manage, and your strategy for the mezzanine lending space looking forward.

Jack Taylor, PREI: The U.S. opportunity has been so large that you don't need to make macroeconomic bets. Our market approach is to extract value by focusing on income-producing, institutional-quality properties in the top 25 MSAs [Metropolitan Statistical Areas]. The target zone is between 60 percent and 80 percent loan-to-value. Most of what we've done has been around 75 percent LTV. They're often high-quality properties that are over-levered or being acquired by major institutional owners. We focus on the underlying real estate fundamentals. We'll do pools, but we examine each building and do fundamental underwriting to make sure there's durable and visible cash flow. The focus is on making sure that if there's another downturn or stumble, we can weather the storm.

PrivcapRE: Are you expecting yields to compress? How much market activity are you expecting in the next 12 months?

Taylor: We'll see an increase in sales transaction volume and mezzanine lending. There's a tremendous amount of debt coming due in the next four, five years—about $1.8 trillion out of the $3 trillion market. Much of it is still over-levered. The capital supply from all sources—the government sponsored entities, the insurance companies, and, predominantly, the banks and the CMBS providers—is still not adequate to meet the demand.

PrivcapRE: With the entry of more lenders into the market, is there excess capital in the system, as some argue?

Taylor: There's been a huge infusion of liquidity from the Fed and central banks around the world. Not only our firm, but the whole system is driven by that liquidity, and there are a lot of new entrants. In each deal, you have to compete and you're strategizing about what the other party might be doing. There's a misconception in the market that there's so much money that there's no opportunity. People need to step back several layers to examine what's really going on.

PrivcapRE: There weren't many participants, but is there a nostalgia for 2010?

Taylor: That's an excellent word, nostalgia, because it tends to look backward and eliminate all the negatives. So when people look back to 2010 and say, "Boy, it was such a terrific time to invest," what they're focusing on is spreads on senior loans being 100 or 200 [basis points] higher, and 200 bps to 300 bps higher on mezzanine loans, and you could drive credit terms more because borrowers were desperate.

This is a better time to be a mezzanine lender than in 2010. We have functioning markets. We have a stuttering, but growing, economy with not a lot of discussion about Europe falling off the planet and the U.S. falling into a depression. What the Fed did actually worked. /

BIO / JACK TAYLOR

Taylor is a managing director and head of global debt at Prudential Real Estate Investors. Prior to joining Prudential, he was a partner at Five Mile Capital Partners, and portfolio manager for its structured income fund. He also was co-head of real estate investment banking for the Americas and Europe at UBS, and led the real estate group at Paine Webber. He received degrees from Yale Law School, the London School of Economics and Political Science, and the University of Illinois.

Threats and Opportunities in Debt Investing

Three experts give PrivcapRE their thoughts on the state of commercial RE debt investing as asset values continue to improve, yields tighten, and rising interest rates loom

Tom Fink
Senior vice president, managing director
Trepp

Fink is the former chief financial officer of the North American Development Bank. He received degrees from Georgetown University and Seton Hall University School of Law.

Bill Lindsay
Founding partner
PCCP

Lindsay was previously the head of the real estate department at Gibson, Dunn & Crutcher LLP. He received degrees from Dartmouth College and the University of California, Berkeley, School of Law.

Jim Corl
Managing director
Siguler Guff

Prior to joining Siguler Guff, Corl spent 13 years in the REIT investment industry and was the chief investment officer for real estate at Cohen & Steers. He received degrees from Stanford University and the Wharton School.

Tom Fink of Trepp

/ on the robust lending market

PrivcapRE: Interest rates are expected to rise. When and by how much do you anticipate they will move? What will the impact be on the commercial real estate market?

Fink: Given the flood of capital, I don't see them moving significantly for a number of years. There is plenty of capital in the market. I was talking to someone the other day who said even in the CMBS conduit market it's very competitive. Through the downcycle, commercial real estate held up OK. Yes, there were a lot of issues around CRE, a lot of losses. If you look at what banks and CMBS lost, it was loans based on future expectations. Like single-family development loans and CMBS pro-forma underwriting. That kind of reposition lending is riskier. A lot of the losses were being driven by turnaround or development loans.

PrivcapRE: Can you characterize the state of the CRE lending market today? How does it compare to one year ago? And how do you expect it to change in the coming year?

Fink: It's robust. A year ago, we had new categories of investors starting to come into the market. They are running at full pace now.

Groups like insurance companies and pension funds continue to increase their exposure to real estate debt. I don't see it changing in the next 12 months; there is still going to be a large amount of capital. If anything, it's

going to remain a competitive environment for lending. Now is as good a time as any to raise capital. But if you have a poor market or challenged project, it's still going to be hard to raise capital. It's the same as a year ago and it will be the same in a year. Lenders are striving to only do quality projects. Are projects more aggressively underwritten than a year ago? Yes, they are. Are we back to 2006 2007 levels? No, we are not.

PrivcapRE: How great is the refinancing opportunity that is expected between 2015 and 2017? Has it been overplayed, or have lenders already missed it?

Fink: There is still opportunity, but there isn't going to be as much distressed debt as some people expect. A lot of those loans have already been through the wringer. The really bad properties and loans are already making their way through the system. A lot of lenders have been aggressive in terms of working with existing borrowers to refinance debt. There is still more debt coming due, but markets do have mechanisms to deal with loans that aren't able to be refinanced on same terms.

PrivcapRE: Do you expect loan delinquency rates to continue improving?

Fink: They will because borrowers have not been able to over-lever. One thing we noticed is that property values have continued to increase, which has helped owners to delever.

There will still be properties that go bad. There will still be opportunities, and distressed debt and turnaround situations, but I don't see any reason for the delinquency rate to go up.

PrivcapRE: Do you expect CMBS issuance to hit pre-crisis levels? Do you think it will reach $150 billion?

Fink: We might get close to it in 2016, but there was a lot that was going on to pump that number up [the last time we reached it]. There were a couple of transactions where there were two refinancings in the space of a year, with interest rates so low. I would be hard-pressed to say we would reach $150 billion any time soon. That said, I never believed property values would come back this strongly.

PrivcapRE: Where are the best opportunities for yield, in terms of investing in the capital stack? Are there particular geographies or sectors that look attractive?

Fink: In terms of investing in real estate projects, do you want to be a first lender, mezzanine lender, or equity holder? The best returns are probably in the mezzanine space, compared to what's available in the first mortgage market and equity. There are a lot of people trying to move into that space. People are starting to pitch redevelopment deals and turnaround situations; the returns are getting larger, but there are a lot of people who are active in that space. The best projects probably have capital available to them. What are the pressure points that are going to underperform? Where the market is most challenged is in smaller properties in smaller markets.

Bill Lindsay of PCCP

/ on rising interest rates

PrivcapRE: How fast and how far do you expect interest rates to move? And what impact will that have on commercial real estate lending?

Lindsay: If you believe in reversion to the mean, we've got a way to go on fixed and floating rates to get them back to their historical norms. And those moves would be fairly substantial. When you ask people their expectations on how fast interest rates will move, it depends on who said what last from the Federal Reserve. The latest communications from Janet Yellen were not as concerning as previous ones. But, unfortunately, the interest rate market is largely political. I expect slow interest rate increases over the medium term. There should be plenty of time for real estate investors to react. The only caveat is that external factors could change everything. If something happens in the Ukraine that we don't expect, then who knows?

There are two factors offsetting each other in the commercial real estate market right now. Every CRE investor, whether a lender or an owner, is focused on interest rates because they're correlated with capitalization rates. There's a bit of nervousness all around

because as rates and the cost of capital go up, real estate pricing will be affected.
But there are countervailing factors in the market like increased liquidity, leading to activity from non-bank lenders. The U.S. banking system is looking strong; banks are relatively sober in their underwriting and not taking much credit risk. There is strong availability of debt capital, and generally speaking, the macro trends in investment are favoring alternative assets. In general, we are seeing more capital coming into the asset class.

PrivcapRE: Do you expect CMBS issuance to hit pre-crisis levels? Do you think it will reach $150 billion any time soon?

Lindsay: Reaching $150 billion isn't a problem. The U.S. mortgage market is about $3 trillion, which includes construction loans made by banks. The average loan is outstanding, say seven years, then you have about $450 billion a year rolling over. Could CMBS be a quarter of that? I don't see any reason why it couldn't.

As real estate values rise, you can originate more CMBS, so increasing real estate values will allow CMBS, as well as every other lending category, to move up in total dollar volume. Will CMBS get to 2007 levels? That's more of a question of what is happening in the bond market than real estate. People will tell you that the appetite for CMBS bonds depends on what else is happening in the bond market, because those guys are the buyers. If the bond markets are healthy, I don't see any reason why we couldn't get back to that level.

PrivcapRE: There has been an increase in the number of lenders in the market. Are there too many?

Lindsay: There's more competition now than a year ago, but demand still outstrips supply and will continue to do so. Almost everybody is trying to raise a commercial real estate debt fund. At the end of the day, we only see the same group of lenders originating, and everyone else seems to be buying parts of other people's loans.

PrivcapRE: Has the wave of debt maturities expected between 2015 and 2017 been exaggerated? Or is there still an opportunity for lenders?

Lindsay: It's a huge opportunity. Most people think that all of the distress in the U.S. real estate system has been taken care of, and that's not true. There was about $420 billion in distress tracked by Real Capital Analytics, and by the end of 2013, about $260 billion of that had been solved. We believe there was much more distress in the system than the statistics revealed.

We still see deals where the bank is trying to resolve something with a borrower from 2009. Lawsuits take a long time to wind their way through the system; there are still big transactions in litigation; there are transactions where past borrowers have been working with banks to recapitalize for years, and low interest rates have made it easy for both sides to take their time. Those loans are going to mature at some point, and somebody will have to take a loss.

Jim Corl of Siguler Guff

/ on the distressed debt opportunity

PrivcapRE: To what extent are there distressed debt opportunities in the U.S.? Some in the market believe most of the distressed commercial real estate debt has already worked its way through the system.

Corl: The people who think the distressed debt has worked its way through the system are those who have been distressed, still are distressed or caused the distress in this past cycle and would therefore like to minimize it. The facts are that in each of the next four years, there will be over $300 billion of commercial real estate debt maturities. These loans were underwritten during the boom phase, when lenders were more aggressive in their terms and very lax in their underwriting and they were lending against very highly valued assets. Most of those loans are still unable to be refinanced, because the value of the property remains lower than the loans against it.

Someone is going to have to take the pain—the equityholder, or the equity holder and the debt holder. Probably both are going to wind up having to take a write-down. And that's where our capital steps in.

It's not broad-based, macro, top-down distress; it's asset by asset, deal by deal, loan by loan. We are working with local operating partners who drive by zombie assets every day. They know the borrower, the lender, the tenants, the condition on the ground, and they recognize the opportunity to recapitalize the asset and return it to its operating health. There is a big uplift in value that is derived from that.

PrivcapRE: Do you think there are too many lenders coming into this space to compete for distressed debt deals?

Corl: Lenders are lenders, so what you find is that in situations where there is recurring cash flow, where there are leases in place, where there is a fully functional building, they are going to bend over backwards to refinance that asset. But when you have a zombie building, the lenders are few and far between. Most of them don't want any part of an empty warehouse or a 40-percent-leased office tower. There is a lot of equity out there for the fully leased, stabilized, high-quality property. But for the high-quality property that has stumbled because someone overlevered it, there isn't debt capital for those deals.

PrivcapRE: How would you characterize the state of the lending market compared to a year ago, and how do you think it will change in the coming year?

Corl: The lending market goes through the same cycle as the equity side of the equation, gradually. On the debt side, it's a process of greed gradually replacing fear as the dominant psychological disposition of the actors in the marketplace. There is still a lot of fear out there. But I'd say increasingly the lending markets are getting more competitive. They are nowhere near where they were in the prior decade at this point in the economic cycle.

The CMBS market tends to be on the leading edge of aggressiveness, and we are starting to see lending practices becoming a little more aggressive, a little less tight than they were.

PrivcapRE: Which part of the capital stack do you believe will offer the best yields in the coming years?

Corl: That is shifting around all the time. It's tough to say. Generally speaking, real estate is a very capital-intensive asset class. What you often find is that the debt market conditions inform the value of the equity; they tell markets how to value things. My view is that debt leads the way, so there is less value in the debt markets today than there are in some niches of the equity markets. Also, if you believe that the economy is in an uptick, there is more opportunity on the equity side of things than on the debt side. /

Ethan Penner

Debt Investors, Prepare for Disappointment

The U.S. real estate debt market is overfunded and mispriced, says CMBS market pioneer Ethan Penner, with better opportunities in Europe

Some players may be optimistic about the potential returns available in the U.S. debt market. Don't count former CBRE Capital Partners president Ethan Penner among them.

"The U.S. debt market is, in my mind, overfunded and therefore mispriced," Penner says. "So I don't really see that as a very exciting opportunity today. And if I did, I'd be out there raising a fund to do it. And I'm not."

The concentration of capital into large investment-management companies has created a "value disparity" between large and small deals, Penner believes. If a company has the operational capacity to pick up smaller deals, it is more likely to find relative value compared to larger deals.

Penner is wary of the much-vaunted opportunities in the U.S. mezzanine lending space.

"Why wasn't it an opportunity in 2009 and 2010 and 2011?" he says. "And it wasn't a very big opportunity. People, including me, thought it would be bigger than it would be."

> I DON'T KNOW WHY ONE WOULD THINK THAT THE NEXT FEW YEARS WOULD BE DIFFERENT THAN THE LAST FEW. I'M JUST SO SKEPTICAL.
>
> - ETHAN PENNER

He is likewise suspicious of the scale of the looming opportunities in the CMBS market. Penner believes the coming wave of maturities is not going to amount to the huge funding gap that some are predicting. He notes that $1.5 trillion worth of CMBS are set to expire between 2015 and 2018.

If half of those were in trouble, it would leave $750 billion to be refinanced. If there was a funding gap of 20 percent on those maturing loans, that would leave a $150 billion gap—potentially "a gigantic opportunity," according to Penner. "If it's anywhere near that, then everyone's going to have a very good time of it. And the returns will be pretty good."

But he believes the gap will be far smaller: "My sense, given what I saw in the last three or four years, would be that people would be somewhat disappointed."

While running funds for CBRE Capital Partners, Penner says the group redesigned its strategy late last decade to prepare for a predicted debt shortage, which he expected would create a need for the kind of capital CBRE raised. But the opportunity never materialized.

"I don't know why one would think that the next few years would be different than the last few," he says. "I'm just so skeptical."

Penner's preferred investment location is Europe. Prices are more conservative because less capital is chasing deals. "One can create a good relative value, a good risk-return profile there," he says.

Overall, Penner says the key to being a successful investor, both in real estate and in general, is to have a mandate broad enough to accommodate changing market conditions. Investment managers tend toward narrow mandates that could quickly be rendered obsolete. "It could be that for two and a half years they're investing stupidly, not because they're stupid but because the mandate [they executed on] has become stupid."

For LPs concerned about strategy drift, he says the solution is to find managers whom they trust to invest in a broad range of strategies, not just one real estate sector.

"When I raised debt funds at CBRE, I made the case that you're investing in me and my team and our acumen and understanding the business of real estate finance," Penner says. "You're not investing in our acumen to underwrite a sliver of that business but the totality of that business."/

BIO / ETHAN PENNER

Penner is former president of CBRE Capital Partners. He previously served as president of Nomura Asset Capital Corp. Penner received a bachelor's degree from New York University.

The Third-Inning Stretch for Legacy CMBS

There are opportunities in commercial real estate debt, particularly vintages, Robert Lieber of C-III Capital Partners tells PrivcapRE

Robert Lieber

PrivcapRE: There's been a lot of attention paid to the commercial real estate debt opportunity by investors and players. Could you characterize where we are in the cycle and what it means for the scale of the opportunity ahead?

Robert Lieber, C-III Capital: What inning you're in depends on what game you're playing. In the long term, we're in the third inning in terms of how we go through these cycles. If you go back to the 2000 time frame when the commercial-mortgage-backed-securities business (CMBS) blossomed and boomed, it was the 2005, 2006, and 2007 vintages where you saw annual issuance volume of $200-plus-billion a year, which dwarfed any prior year by a magnitude of four or five times to one.

Oftentimes when you see those huge expansions, it's like an embolism in a vein. Sometimes it blows, and that's what happened in 2008 in the global financial meltdown. We've seen a significant pickup in the last three years, with annual issuance volume almost doubling each year.

PrivcapRE: A lot of people are looking at 2015 to 2017, particularly for the maturities for CMBS. Is that where we're going to see the bulk of the opportunity?

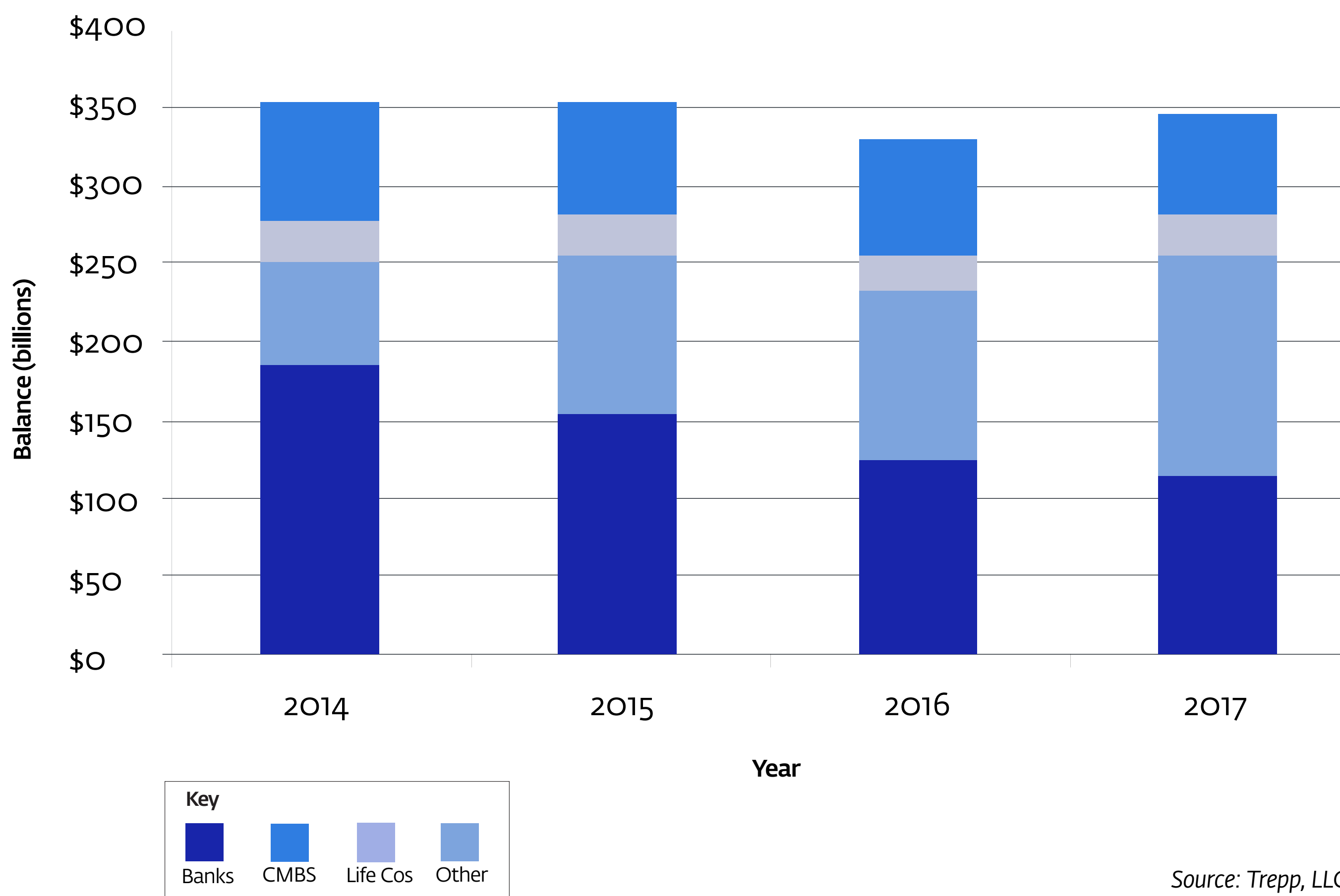
Lieber: There's going to be a lot of activity for sure, because the 10-year '05 deals are coming due in 2015, but borrowers are trying to figure out what they're going to do when those loans come due. We're going to see a significant percentage of those loans not be able to refinance at par when they mature. The looming potential defaults and restructurings and recapitalizations and foreclosures that are to come are going to dwarf much of the activity from 2010 through 2013.

PrivcapRE: Where is your activity at the moment? Is it in the legacy bonds coming due, or are you looking at new issuance?

Lieber: We still look at new issuance, but haven't been active participants. Our focus has historically been in the legacy trust. That's where we have the most competitive advantage, because as a special servicer and the controlling class holder, we have a view of what's happening in the markets and with the individual properties that secure loans.

Our competitive advantage is that we have so much experience managing these trusts

Annual Commercial Real Estate Debt
A wave of debt maturities will sweep through the market in the coming four years



and know what's happening. The new issue B-piece CMBS market's been a great business. A lot of liquidity's come back. We continue to look at the new issue B-piece markets, but there's competition out there that may not understand the risks they're stepping into for the types of returns they think they're getting.

PrivcapRE: Do you look at any particular food group in legacy bonds?

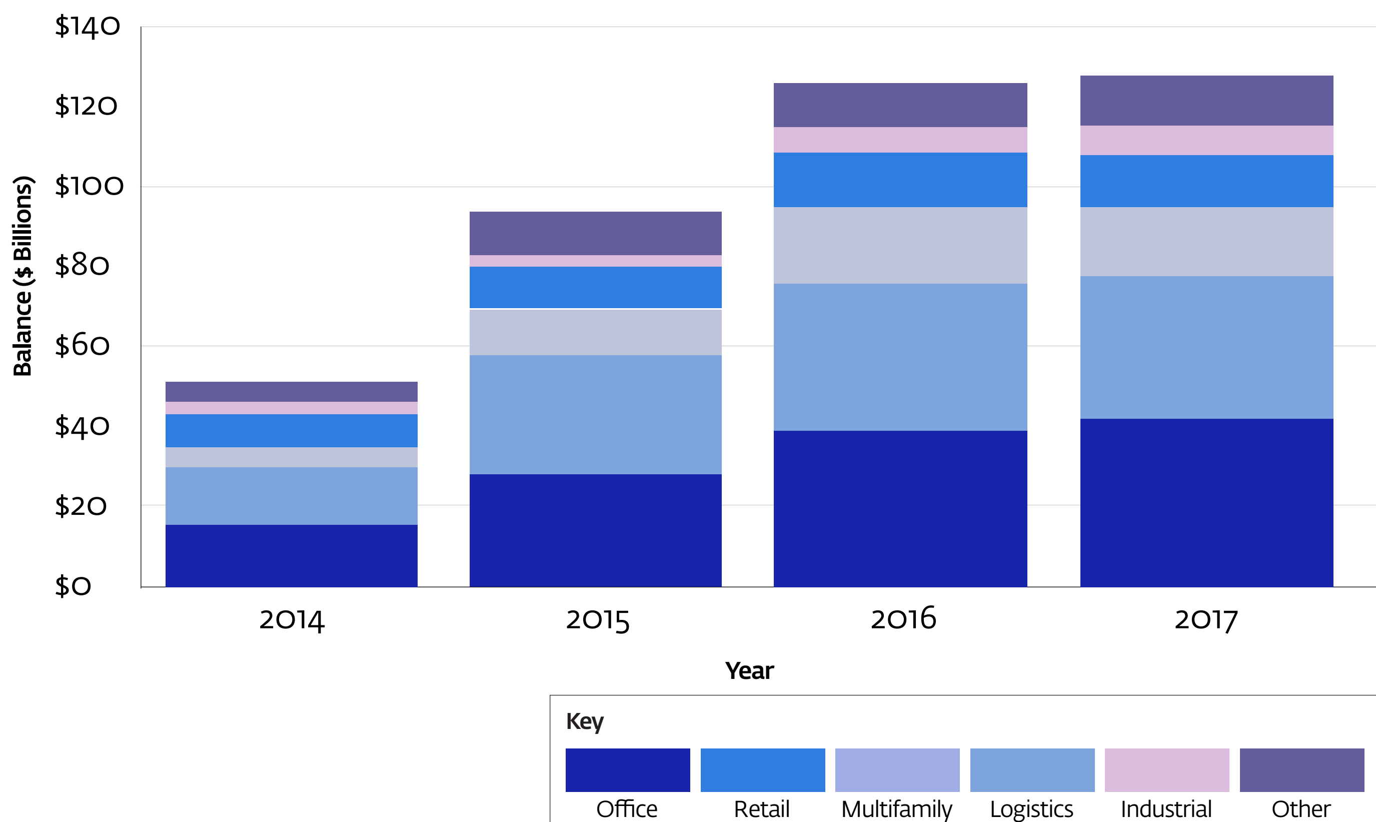
Lieber: One of the advantages of these trusts is this great diversification, at least theoretically. We look carefully at each trust and the loans that make up that trust; we look even more carefully at the assets that underlie those loans to get an understanding of an individual property's ability to pay on the loan. There are some scary things out there today in some of these asset classes. Retail is tough, and if you have a regional mall in a secondary or tertiary market, that's a loan that's difficult to get any confidence about paying off.

PrivcapRE: What will CMBS issuance be in 2014?

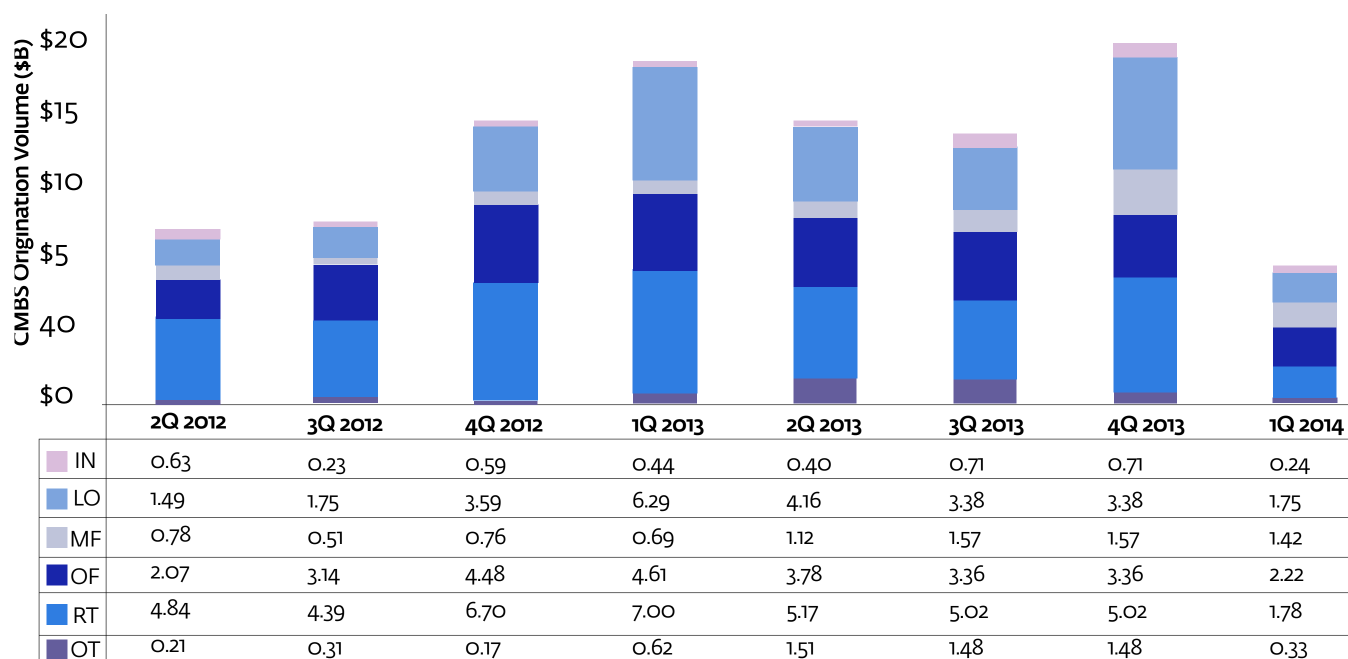
Lieber: I don't think it's going to be $160 billion. If you go back three years it's moved from $20 billion to $40 billion to $80 billion. There's been a backup in the market so far this year in on-the-run rate pace. But you'll see volumes exceed what we did last year, in no small part because there's so much opportunity to refinance—and then the question's going to be the price.

PrivcapRE: What's the number one question an LP should be asking a GP when it comes to debt investments?

U.S. CMBS Maturity Schedule, by Property Type, 2013-2018
The refinancing opportunity, by sub-sector



National CMBS Activity
Issuance creeping higher as values rise and lender aggression returns to the market



	2Q 2012	3Q 2012	4Q 2012	1Q 2013	2Q 2013	3Q 2013	4Q 2013	1Q 2014
IN	0.63	0.23	0.59	0.44	0.40	0.71	0.71	0.24
LO	1.49	1.75	3.59	6.29	4.16	3.38	3.38	1.75
MF	0.78	0.51	0.76	0.69	1.12	1.57	1.57	1.42
OF	2.07	3.14	4.48	4.61	3.78	3.36	3.36	2.22
RT	4.84	4.39	6.70	7.00	5.17	5.02	5.02	1.78
OT	0.21	0.31	0.17	0.62	1.51	1.48	1.48	0.33

Lieber: The big issue in debt investment today is how volatile the market is.

We've seen huge swings in relative value. You talk about where the opportunity is, whether you're buying up or low in the capital stack to hit your target returns. The window moves so quickly that it's difficult to put together a fundraising effort to raise sufficient capital to pursue a narrow strategy. The question is how far you as a GP will go to chase deals, to meet the criteria you're talking about, and whether you're prepared to shut the fund down if you don't see opportunities that meet the objectives you started with.

PrivcapRE: Part of the problem is that it takes a long time to get LPs into an opportunity. Has the opportunity already gone away by that point?

Lieber: That's exactly right. If it's a broad strategy, then you have more time to raise the money, and the returns may be lower, higher, or at least on target, but not when you realize it, because the markets move so quickly. We've seen success in keeping the fund sizes small, doing a quick raise, pursuing a specific strategy. And if you can't find deals that you like, then you stop investing money and start liquidating the assets. /

BIO / ROBERT LIEBER

Lieber is an executive managing director at C-III Capital Partners. Previously, he served under New York mayor Michael Bloomberg as deputy mayor for economic development and is retired from Lehman Brothers. He is currently an executive managing director at Island Capital Group and a vice president for Anubis Advisors. He holds degrees from the University of Colorado and the Wharton School.

The Last Shall Be First
The value of B-piece debt

By **Christopher O'Dea**

Being last in line doesn't always mean getting the worst seats. Buyers of the most subordinated tranche of a commercial mortgage-backed securities deal, for example, get a front-row view of the debt they hold, and those seats have become increasingly valuable.

Buyers of the most junior debt, the B-piece, are in "first loss" position. So the B-piece buyers are first in line when it comes to structuring and monitoring these riskiest pieces of a mortgage-backed security, which are an essential component in securitizing commercial real estate loans. The B-piece investors can "kick out" loans tied to potentially problematic properties, and CMBS pooling and service agreements typically give B-piece holders a key role in monitoring the performance of each loan, in making decisions about problems in the underlying assets, and in appointing special servicers to carry out those functions. By bringing real estate expertise and credit-assessment skill to the investment process, the B-piece buyers are "the market's 'true' gatekeepers," says Joseph Philip Forte, a partner in the New York office of law firm DLA Piper.

The rewards for effective gatekeeping can be substantial. Investors are earning loss-adjusted returns of between 13 percent and 18 percent from securities backed by real property collateral monitored by the investors' agent. That's an attractive investment in today's yield-starved markets. In comparison, U.S. high-yield bonds—essentially unsecured debt—were trading at a 6.1 percent yield in early April, just 10 basis points from the all-time low reached in May 2013, according to Bank of America Merrill Lynch index data. Some seasoned B-pieces have even been upgraded by rating agencies this year as principal paydowns and workouts on riskier properties improve credit quality.

More fund managers have begun to recognize the potential rewards of being last in line, fueling a steady increase in the number of players in the highly specialized field and, in turn, an increase in the value and number of transactions.

New investors began appearing in rankings of B-piece activity in the CMBS market during 2013. In 2013, 11 participants completed 45 B-piece transactions with a value of $53.1 billion, according to Commercial Real Es-

tate Direct, which compiles issuance data and allocates deal credit on the sector. That was up from 27 transactions completed by eight participants, totaling $32.2 billion in deal value in 2012. Activity was on pace to surpass 2013 levels by the end of the first quarter, as CRED recorded 13 transactions by six participants, totaling $14.8 billion in deal value.

Major Players

The most active player in the B-piece sector in the first quarter of 2014, Rialto Capital Management, acquired four deals worth $5.0 billion. Based in Miami, the Lennar Corp. affiliate has consistently been among the market's most active participants. The concentration of B-piece investing talent in Miami reflects Lennar's long involvement with distressed real estate investing and securitization. Rialto was formed in 2007 when Jeffrey Krasnoff rejoined Lennar from LNR Partners. LNR was the original 1989 distressed CRE business of Lennar; it was spun off as a listed company, taken private by a group of funds including Cerberus Capital Management LP, Vornado Realty Trust, and Oaktree Capital Group LLC, and ultimately acquired by Starwood Property Trust in 2013. Along the way, former Rialto executives formed B-piece investing firm Raith Capital Partners, and several LNR executives departed to form Eightfold Real Estate Capital. Rialto did not reply to calls and emails requesting comment for this article.

Rialto, LNR, Raith, and Eightfold hold four of the top five spots in the B-piece league table for the first quarter of 2014. The fifth, Ellington Management Group, partnered with LNR on three of its four deals completed during the quarter. Ellington declined to comment for this article, but confirmed its collaboration with LNR on investments of 25 percent of the B-piece of GS Mortgage Securities Trust 2014-GC18; 85 percent of the B-piece of JPMBB Commercial Mortgage Securities Trust 2014-C18; and 60 percent of the subordinate bonds of GSMS 2014-GC20. Other recent investors include Cerberus Capital Management, Saba Capital Management, Perella Weinberg Partners, and AllianceBernstein.

The credit expertise and service capabilities that come with B-piece firms are becoming strategically critical to the large real estate companies. One major investment bank believes Rialto could be worth more than $800 million and sees it as one of Lennar's affiliated businesses, with the potential to drive the homebuilder's stock about 20 percent higher over the next year. In his results statement for the quarter and year ended Dec. 31, 2013, Barry Sternlicht, chairman and CEO of Starwood Capital Group, said the LNR acquisition was a key part of a "transformative" year for Starwood, the largest commercial mortgage REIT in the U.S. The acquisition "added significant scale to our operating platform, diversified our revenue sources, and provided a proprietary channel of originations," Sternlicht says.

In short, Sternlicht has achieved vertical integration—just as the commercial real estate debt market enters a period of potentially heavy securitization and refinancing that will drive revenue across the businesses acquired from LNR. An estimated $130 billion of CMBS debt is set to mature each year in 2016 and 2017 alone. With LNR now integrated, Starwood Property Trust will have access to pricing of troubled properties in the structuring process, along with recurring revenue from the special servicer business, which is reportedly the largest manager of distressed U.S. commercial real estate loans. By providing clear visibility into the real estate debt scheduled to mature in the next few years—the primary feedstock for CMBS and B-piece issuance—the LNR acquisition has landed Starwood in one of the premium seats, and perhaps created the leading gatekeeper. /

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