REAL ESTATE

Uncovering Private Commercial Mortgage Syndication

Discussion

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Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with Michael Hofheinz, Head of Real Estate Capital Markets and Syndications at MIM, to understand liquidity conditions for commercial real estate.

Guy:* *I understand what a commercial mortgage is, but you run MIM's commercial mortgage syndication desk. Can you tell me what that is?

Michael: Thanks, Guy. The concepts are not so different. A commercial mortgage is simply a mortgage loan secured by commercial property. In this sort of transaction, there might be one party buying a property and one party acting as a lender or debt investor. Within our syndications platform, we originate commercial mortgages, and then make different pieces of the loan available to a number of investors with different risk appetites. In a mortgage syndication, there might still be only one party buying a property, but two, three or more parties acting as debt or preferred equity investors in that property.

MetLife Investment Management

Guy: ***I imagine that role offers you a broad perspective on real estate capital markets. What is the state of markets today?***

Michael: Interest rates have risen quickly as you know, while at the same time regulators have restricted bank lending. Other nonbank lenders have also increased capital reserves—essentially their rainy day funds—in anticipation of a weaking economic environment. Therefore, I'd partially characterize the real estate capital markets today as being in a liquidity crunch. I believe such a backdrop can be favorable for mortgage debt investors, but many have limited buckets of capital that they would like to diversify across multiple transactions. This is especially difficult considering institutional-quality mortgages are generally large assets that can typically exceed $50 million per transaction.

Guy: ***It sounds like commercial mortgage investors are being offered attractive returns today, but the size of institutional-quality assets is keeping capital sidelined.***

Michael: I think that is partially true. Commercial mortgage investors are certainly being offered among the highest yields we have seen in decades. In 2021 and 2022, coupons on low-risk senior mortgages were in the 3% to 4% range, but assets with a similar risk profile in the market today are pricing in the 6% to 8% range. I wouldn't say capital is "sidelined" necessarily, but there are new challenges in the current market. Like I mentioned, debt investors have limited capital today. You are naturally more selective if you know your capital is limited and you will only get one bite at the apple due to few transactions in the marketplace. Another challenge is matching mortgage investors with the right risk/return profile for their investments in an environment where fewer properties are trading.

Guy: ***Can you give an example of how mortgage investors are facing challenges finding the right risk/return profile on their investments?***

Michael: Sure, in a healthy market with a normal amount of transaction activity, mortgage investors have a wide menu of assets to choose from. They can select assets from a variety of cities across the U.S., and across different property types. They can also choose which part of the capital stack they would like to invest in, from senior loans and subordinate debt to preferred equity depending on gaps they would like to fill in their portfolios. For example, that investor may normally have $300 million to deploy in a year to diversify across these selections.

Today, that investor might only have $150 million to deploy, and fewer deals are coming to market to choose from. That investor might see an $80 million apartment mortgage in Atlanta but might not want to increase exposure to that market by such a significant amount.

Guy: ***Interesting, so investors are trying to manage portfolio diversification, but their "toolbox" is limited. How is this being addressed by the market?***

Michael: Yes, that is fair to say. One way MIM is addressing this is through commercial mortgage syndications. In other words, MIM can originate a commercial mortgage loan, but break it into two or three different pieces that have varying risk/return profiles. For example, an $80 million mortgage on a $100 million property might be broken into three different debt instruments. These three pieces could include a low-risk senior mortgage that might fund up to $40 million of the total $100 million property value. A second piece could be a $20 million medium-risk mezzanine loan that would fund the capital stack between $40 million and $60 million. Finally, the third piece could be a $20 million high-risk subordinate mezzanine or preferred-equity investment that would fund dollars between $60 and $80 million, with the common-equity investor or "borrower" funding the rest.

In my prior example, we have now expanded the tool kit available to investors constructing mortgage portfolios by creating three debt investments with different risk profiles. We have also simplified things for the borrower by creating a "single lender" execution.

Guy: ***Are many borrowers facing that challenge today, having to manage gap financing in addition to securing senior mortgages?***

Michael: Yes, this has become a significant challenge for borrowers today both due to the limited availability of capital and declining values of properties.

Traditionally, institutional-quality commercial mortgages follow an interest-only or partial amortization schedule, where a portion of the principal may be paid down during the life of the loan, followed by a balloon payment at maturity. In normal market conditions when values are growing during the life of a loan, refinancing with lenders like banks or insurance companies is uneventful, and borrowers expect to have little trouble sourcing a new 60% or 65% loan-to-value (LTV) loan at maturity.

However, properties that were worth $120 million at the time of loan origination a few years ago may only be worth $100 million today. Now, a borrower who must refinance an $80 million loan is faced with a challenge. Few senior mortgage lenders are willing to lend up to 80% LTV ($80/$100), so the borrower must source a senior loan for $40 or $50 million and either put more money into the investment or search elsewhere for the remaining capital, such as a debt fund that originates mezzanine loans.

Guy: ***The syndications structure sounds similar to the commercial mortgage-backed securities (CMBS) market. Is that the case?***

Michael: No, CMBS is a different structure with different considerations. CMBS pools typically include many senior mortgages that underlie tranches of bonds backed by those pools. The different tranches typically have varying risk/return profiles. MIM's syndication team selects individual assets to split into tranches of varying risk profiles. Underwriting CMBS risk is based on understanding the risk profile of 75 predominantly senior mortgages whereas what MIM is doing includes understanding the structure and risk profile of loans that are subordinate to senior mortgages. This is an area we feel especially competent in. Earlier this year, MIM's real estate research team wrote a couple of articles on subordinate mortgage risk and pricing for the Pension Real Estate Association (PREA) Quarterly magazine.

Guy: ***Turning back to the big picture, where do you see real estate capital market conditions headed in the next year, and will syndications continue to be an important factor for commercial real estate debt markets?***

Michael: I think the good news for real estate capital markets is that a major driving force behind limited transactions is uncertainty around what the Federal Reserve will do, and these days there is a lot more agreement on the path forward for interest rates. Think back to mid-2022: Market participants were debating whether there would be two, five or 10 rate hikes. Today, we see there is some disagreement on the margin around what's in store from the Fed, but a lot more agreement around what the future looks like. We think this will help close the wide bid-ask spread that still remains among buyers and sellers and allow for real estate capital market conditions to begin normalizing, hopefully sometime toward the middle of next year. Broadly, anytime markets are dislocated as they are today, well-capitalized investors can dictate terms more effectively and uncover attractive relative value opportunities. We believe, syndications will play an important role in unlocking many of these opportunities over the next year.

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