PERE

By: Evelyn Lee
PUBLISHED: 4 April, 2023

MANAGERS

For debt funds, 'most refinancing opportunities are pretty ugly'

With loans maturing and banks retrenching, alternative lenders are seeing more refinancing deals. But 'a lot of them we see just don't work.'

With the banking sector in turmoil over the past month, alternative lenders have seen market conditions shift in their favor.

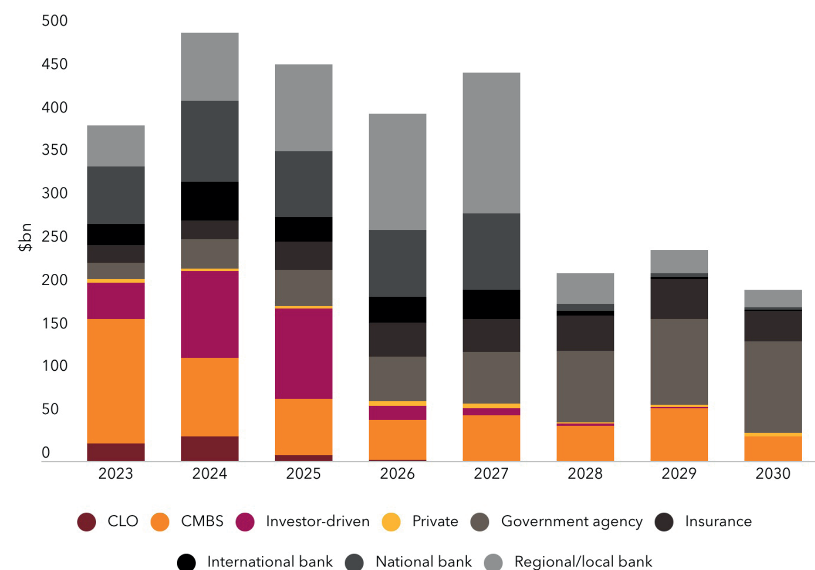
"For private lenders, debt funds like ourselves, we started to see the opportunity set appear pretty dramatically," said Marc Grayson, president and co-founder of Phoenix-based RRA Capital. "While banks are looking at their balance sheets, trying to assess how active they're going to be able to be in the marketplace, it certainly leaves opportunity for private debt funds to fill those gaps."

The potential financing gap left by bank retrenchment is substantial. In recent years, banks have increased their lending allocations to commercial real estate in the US and originated the dominant share of debt coming due in the next five years, according to MSCI's February 2023 US Big Picture report. For example, banks account for more than 50 percent of the loans set to mature in 2026 and 2027, the report showed.

With loans maturing and banks retrenching, debt fund managers have seen more refinancing opportunities land on their desks over the past year. "Pre-Ukraine war, you would never talk to me about one of those deals," said Jim Blakemore, global head of debt at Toronto- and New York-based manager BentallGreenOak. Typically, borrowers in both Europe and the US would refinance their assets using cheap bank financing.

THE WAVE OF LOAN MATURITIES

Banks make up a significant percentage of US mortgages coming due over the next few years.



Source: MSCI

"They would never call us because our margins would have been much higher. But today, we're seeing them because their banks are going struggle with this."

Historically, BGO lent almost exclusively on acquisitions of value-add properties, where the sponsor is investing time and money to improve the asset. Now, the firm has seen refinancing opportunities pick up significantly. Across the US and Europe, "I think some element of refinance, rather than a straight acquisition, will probably be up to 50 percent of what we do this year," Blakemore said. By contrast, refinancings made up just 5 to 10 percent of BGO's lending volume prior to the Ukraine war, he said.

© PEI Group. All rights reserved. Content on this site may not be reproduced, distributed, transmitted, displayed, published or broadcast without the prior written permission of PEI Group or in the case of third party content, the owner of that content. You may not alter or remove any trademark, copyright or other notice from copies of the content. You may download material from this site (one machine readable copy and one print copy per page) for your personal, non-commercial use only.

Blakemore: expects refinancings to represent up to 50% of BGO's lending activities this year

For Related Fund Management, the proportion of refinancing opportunities across its deal pipeline is still low, but higher than it was one or two years ago when interest rates were at historic lows and ample amounts of bank capital remained available, according to Brian Sedrish, portfolio manager for the New York-based manager's credit platform.

"We expect that the percentage of refinancing opportunities relative to new acquisition financings will accelerate over the next several quarters and we expect to be well positioned to capitalize on these opportunities."

Challenges with refinancings

Refinancings, however, involve myriad complications for real estate debt funds and other non-bank lenders. "My personal opinion is most refinance opportunities are pretty ugly," said Boots Dunlap, RRA's chief executive officer and co-founder. Most borrowers are struggling to refinance because although they do not know exactly where cap rates are, the consensus is that those rates are not as low as they were two years ago, he said.

For example, "a lot of the multifamily refinance opportunities are going to be very difficult because they were financed at such a low interest rate," he explained. With interest rates now much higher and cap rates also higher, "I don't know that there's a whole lot of equity left in those deals."

"For me, what's more interesting is new acquisitions," particularly those involving hard closing dates with forced sellers such as REITs having to purge assets or borrowers unable to refinance, Dunlap said. "We're seeing lenders that are telling borrowers who still have equity, 'you have to sell because the cap rate environment tomorrow could be substantially higher,' and those borrowers that couldn't necessarily get refinanced are having to sell. I think those are the interesting opportunities."

One of the reasons RRA has been more cautious on refinances was because the business plans for the underlying assets often were not completed. Grayson said that prior to the Fed rate hike cycle, the firm would be approached by borrowers seeking a bridge-to-bridge loan after failing to execute the initial business plan within the timeframe of the original bridge loan. "We would look at deals and if they didn't execute on their business plan, then they needed another bridge loan to do it. And so that was usually not a great look for a refinance."

In today's marketplace, "we are seeing some deals where borrowers are willing to bring cash to recapitalize the deal," Grayson noted. "That's a better sign for us to want to refinance."

Another challenge with some refinancing deals is the increased cost of debt, both in terms of base rate and spread. "In general, with the low yields that some of these assets were purchased on, there's not excess cashflow that you can use to amortize the loan to reduce your loan basis," Blakemore noted.

"So I think the challenge is making sure that you're lending on collateral that you really like long term. And that's the tricky thing with the refinance." Whereas an acquisition involves a definite plan to improve the building, the improvement to an asset with a refinancing is less clear. "You hope that the rent is correlated with inflation. But other than rental growth, there's often no kind of business plan to add value to the assets."

With refinancing opportunities, "a lot of them we see just don't work," he said. But given the size of the US real estate market, "we're more likely to find refinances that work in the US than in Europe."

Dunlap: prefers new acquisitions to refinancings

Related has also not seen many compelling refinancing deals thus far. "To date, the refinancing opportunities that we have looked at have either been collateralized by assets where the long-term viability is questionable or where the maturing loan balance exceeds loan-to-value targets," Sedrish noted. However, he expects more attractive loan refinancing opportunities to emerge over the next one to two years.

"In the early part of a moderating cycle, borrowers are less inclined to adjust expectations for their asset values or what they consider acceptable pricing for their loans," he explained. At the same time, existing lenders are less likely to accept a discount to their loan balances. Additionally, the firm expects the quality of

© PEI Group. All rights reserved. Content on this site may not be reproduced, distributed, transmitted, displayed, published or broadcast without the prior written permission of PEI Group or in the case of third party content, the owner of that content. You may not alter or remove any trademark, copyright or other notice from copies of the content. You may download material from this site (one machine readable copy and one print copy per page) for your personal, non-commercial use only.

Grayson: more likely to refinance if borrowers bring cash to the deal

collateral to improve, since the first deals to come to market typically have values that are most in question.

"As the cycle matures, we expect borrower/incumbent lender expectations and asset collateral quality to change such that the volume of refinancing opportunities will increase materially," Sedrish added.

Refinancing outlook

Dunlap does not believe there will be as many available refinancing opportunities for alternative lenders as expected. Instead, he anticipates banks facing potential loan losses will grant a lot of extensions over the next two years. "I do think a lot of lenders are scared right now. And I think a lot of lenders are willing to extend the maturity dates on their loans, because it doesn't really cost them a whole lot, it allows them to maybe have the markets correct and feel more comfortable about where they are."

Meanwhile, most borrowers know the interest rates on their current loans are much lower than the rates at which those mortgages would refinanced, he added: "So I think a lot of shrewd borrowers are already going to their lenders looking for rate modifications and term extensions."

Blakemore, however, believes borrowers with maturing loans can expect one of three outcomes: a loan extension, with the lender making concessions; a refinancing; or a default. During the global financial crisis, the first option was very common. "My expectation today is that may be less common in this cycle, just given the interest rate environment, just because some of the deals may struggle to pay debt service, which was not the case in coming out of the GFC. That was more of a valuation issue where this is both debt service and valuation."

RRA is currently in the market with its third real estate debt fund, RRA Real Estate Debt Fund 3, with a $400 million target and a $500 million hard-cap, according to PERE data. Michael Tussie, who leads Americas real asset institutional capital raising at UBS Private Funds Group, is advising the firm on the fundraise.

Meanwhile, BGO is raising three real estate lending funds in the UK and Europe, PERE data shows: BentallGreenOak European Secured Lending III, which has a €2 billion target; BentallGreenOak Europe Tactical Lending II, with a €500 million equity goal; and BentallGreenOak UK Secured Lending IV, with a £2 billion target.

© PEI Group. All rights reserved. Content on this site may not be reproduced, distributed, transmitted, displayed, published or broadcast without the prior written permission of PEI Group or in the case of third party content, the owner of that content. You may not alter or remove any trademark, copyright or other notice from copies of the content. You may download material from this site (one machine readable copy and one print copy per page) for your personal, non-commercial use only.