Real Estate Mezzanine Debt Outlook

Filling the capital gap

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In Brief

- Although property performance remains relatively healthy, a challenged capital market environment has real estate owners on the hunt for additional sources of financing as both debt and equity become harder to secure.
- Economic uncertainties along with falling asset values and repayment concerns on existing loans have many lenders pulling back on issuance.
- Lenders willing to step in to fill the void are being compensated with elevated rates at lower leverage levels and with favorable terms and covenants.
- Those willing to lend at moderately higher levels are in an even stronger position. Spreads and all-in rates are approaching all-time highs, with only incrementally more risk than senior loans.
- The combination of healthy property cash flows, elevated coupons and lender-favorable terms has the risk/return profile of new mezzanine loans as attractive as they have been in a decade or more.

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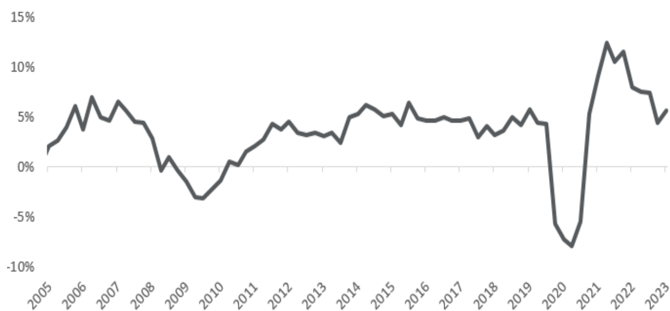
Real estate market background

Real estate markets have been volatile as of late. Rising interest rates and an uncertain economic environment have put downward pressure on asset values, moving market pricing down by as much as 25%. In previous cycles, real estate write-downs have typically come from a combination of deteriorating capital market conditions along with weakening fundamentals. However, this cycle has been different. Outside of office assets, operating metrics across the industry are on relatively solid ground. Vacancy rates are at or below historical averages and rent levels are well above where they were pre-pandemic. This combination of high occupancy and elevated rents means both property NOI and cash flow growth have remained resilient. This means falling values are driven almost entirely by worsening capital market conditions. More specifically, rising interest rates are putting upward pressure on discount rates and downward pressure on asset values. Rates have pulled back from recent peaks, but levels remain well above where they were just a year and a half ago and still represent a headwind for real estate values.

NCREIF Rolling 4Q Same Store NOI Growth (All Sectors)



Source: NCREIF, J.P. Morgan Asset Management; as of 9/30/2023.

Debt availability contracting

This challenging environment has carried over to lending markets as well. Increased economic uncertainty, regulatory pressures and declining asset values have many lenders on edge. As a result, about one-third have decided to pull out of the market until there is more clarity on asset pricing and the direction of interest rates. In addition to this, the lenders that are still in the market have become more discerning in the loans they make. Interest rate volatility, additional regulatory scrutiny, concerns over existing loan paybacks and an overall risk aversion have significantly reduced the amount of funds lenders are willing to put out. As a result, origination volume has been cut by roughly one-half over the last year, leaving a sizeable void in the real estate capital stack.

Net Share of Banks Tightening Standards

Source: Federal Reserve Board, Senior Loan Officer Opinion Survey, J.P. Morgan Asset Management; as of 12/31/2023.

What hasn't changed is the amount of capital needed to pay off maturing loans over the next few years. Estimates are that approximately $1.2 trillion will need to be refinanced in 2024 and 2025, and current levels of lending from the senior lenders will fall well short of the capital that is needed. Additionally, falling values have increased the loan-to-value (LTV) measures across all assets. As a result, even if senior lenders are willing to lend at previous LTVs, the proceeds would still fall short of borrower needs.

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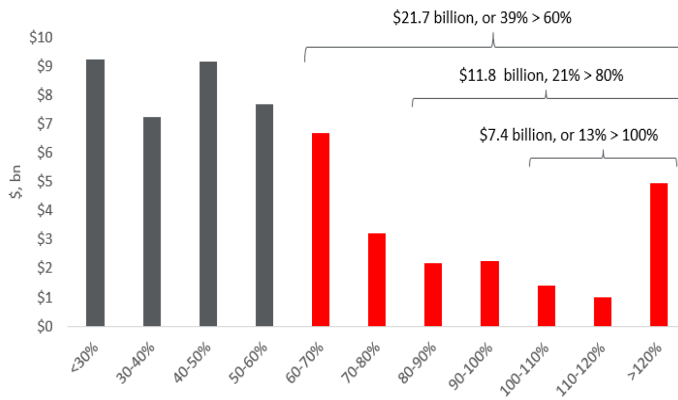
Estimated LTV for Conduit CMBS 2023-2024 Maturities



Source: CMBS Research, J.P. Morgan Asset Management; as of 9/30/2023.

Opportunity for willing lenders

In as much as this creates a challenging environment for real estate equity, it is a boon for lenders with money to put out. The lack of debt capital means that those willing to lend have their pick of assets and can negotiate for much more favorable terms than they could just a few years ago. Spreads and all-in rates are as high as they have been since the global financial crisis, and lenders can get these higher rates at lower LTVs and with more attractive covenants than they have in years. Additionally, because value declines are driven by capital market changes and not operating fundamentals, the properties securing the loans are generating as much, if not more, cash flow than before. Due to this, debt yields are higher and debt service coverage ratios are still healthy despite the rise in rates, leaving lenders in a more protected position.

When it comes to mezzanine lending, everything mentioned previously still holds, but the effects on loan proceeds at more elevated LTVs are even worse. The combination of senior lenders reducing the LTVs they are willing to go to and falling asset prices compound on each other, making the basis on new loans or refinancings below what they were previously. This means most borrowers looking to purchase an asset or refinance an existing loan have a sizeable gap in their funding that needs to be filled. Without this additional capital, many borrowers are at risk of defaulting on maturing loans, which could mean losing the buildings and, as a consequence, all of their equity as well. Due to this, borrowers have little negotiating leverage, and lenders that are willing to step into this modestly higher LTV range are at even more of an advantage than those issuing senior mortgages. By stepping up just 10% to 15% in LTV above the mortgage loan, mezzanine lenders can get spreads that are essentially double what senior lenders can charge. This non-linear increase in lending rates makes for a much more attractive loan profile, as the risk increase is only marginal.

Improved risk-adjusted returns

Wide lending spreads and elevated base rates mean, depending on the asset, returns for new mezzanine loans are in the low to mid-teens. This is a return range traditionally in line with core plus to value-add equity investments but is now being achieved with greater downside protection via the increased equity cushion behind the loans and stronger covenants. Additionally, this return is coming entirely from current income as opposed to appreciation, providing elevated yields that many investors need while also making for a more durable return profile.

Risks can be further reduced through asset selection. Top-quality buildings continue to perform better than commodity products and, as such, have lower vacancy rates, higher rent levels, better growth prospects and less capital needs. However, despite the better operating performance, these assets can still face challenges with securing financing. Lenders with enough experience to identify these projects can incorporate even more downside protection into their portfolios, further enhancing the risk/return profile.

Attractive entry point

We are in a unique period for mezzanine lenders, where a confluence of events has created a particularly attractive entry point. A challenged capital market environment has all-in lending rates near all-time highs. Falling asset values and an increasingly risk-averse senior lender pool mean attachment and detachment points for mezzanine lenders are lower than they have been in over a decade. Sponsors are putting more equity into deals, giving mezzanine lenders a sizeable equity cushion to help absorb any

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further pricing volatility. Additionally, although capital markets are challenged, operating metrics are, for the most part, healthy and asset cash flows are growing. In short, although mezzanine loans are now providing return levels in line with those historically seen with higher-risk real estate equity, the risk profile for these loans continues to improve. As a result, not only are coupons near all-time highs, but lenders also have their pick of the market when it comes to assets. As such, risk-adjusted returns look to be at the highest levels in some time, setting up what may be a once-in-a-generation entry point for mezzanine lenders.

Next steps

For more information, contact your J.P. Morgan representative.

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