Bill Maclay

Episode 257: High Yield Real Estate Lending: Navigating the Shifting Landscape

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com Podcast. I'm Stewart Foley, I'll be your host. Hey, welcome back. It's great to be with you again today. We have a really interesting podcast today. Something that we haven't really covered a whole lot of, which is high yield real estate lending. We're joined by Bill Maclay, CFA, portfolio manager at Fidelity Investments. Bill, welcome to the program, and thanks for taking the time.

Bill: Thank you. I'm excited to be here today.

Stewart: I'm looking at our talking points, and this is a great topic. Before we get going too far though, I'd love to know a little bit about you. Which is: where did you grow up? And what was your first job, not the fancy one?

Bill: I grew up in the Bay Area, in the Oakland Hills. I was a huge sports fan growing up. That was a great time to be a sports fan in the Bay Area, because we had the 49ers dynasty with Joe Montana, and Jerry Rice. In baseball, the Giants and the As were quite phenomenal during that time period.

First job? Well, I remember the first thing that I wanted to buy on my own was a Walkman. I didn't have the money at the time. My parents were some of the thriftiest people you will ever meet, so my mother told me I needed to earn the money. When I asked how, she asked if I had a marketable skill. I was only 12 or 13 at the time, and I played soccer growing up. I naively answered, "Soccer." Then she suggested that I become a soccer referee. My first job was as a soccer referee, and I wound up doing that for, actually, quite a few years. To this day, it gave me an appreciation for how difficult that job is, whether it's in professional or youth sports.

Stewart: I think it's so cool. Your mom says to you, at 12, "What's your marketable skill?" That whole concept, there's a lot to unpack there. It tells you something about how she approaches things.

It's an interesting aside. I'm actually going to see my daughter this weekend, at the University of Denver. Hey, Megs. They won the national championship for women's division one hockey last year. We're going to the home opener this year, which ought to be really fun. But what's really interesting is that one of my former students, a guy named Anthony Victor, who works at Missouri Public Teachers, he actually is a ref. He will be reffing this D1 home opener game. When you say you reffed soccer, I didn't really ... I've talked to Anthony a number of times about being an official in these games. I have a much better appreciation for what's involved there.

Bill: Yeah. I think it's a challenging role, but it can be rewarding at the same time.

Stewart: Yeah, absolutely. Absolutely. Super cool. Let's talk a little bit about, everyone knows Fidelity. But I don't think everyone knows your real estate platform, particularly the real estate debt platform. Can you just crank the lens out and give us a high level overview of what Fidelity's capabilities are in real estate?

Bill: Let me start with how I came to Fidelity. I started my career at Clarion Partners, on the acquisition team, long ago. Back then, I was investing in commercial real estate on behalf of institutional investors. Then I joined Fidelity 23 years ago, as part of the real estate debt group. I've been part of the group for the entire time. My role has evolved over time. I've been an investor in both debt and equity, and both on the public and private side. I feel very fortunate that Fidelity has such a broad platform that I was able to gain experience in both the public side and the private side, in just about every flavor of commercial real estate that we offer to investors. Today, I manage all of our dedicated real estate debt funds, which includes our liquid strategies as well as our illiquid strategies.

I think, yeah, you had a great question about Fidelity in relation to commercial real estate. What's interesting is that, at Fidelity, we are expanding our alts efforts, but there's certain capabilities that we've been active in for quite some time, and real estate debt is one of those. Fidelity's real estate debt group was formed 30 years ago. Originally, we were a buyer of the subordinate portion of the RTC securitizations. As the CMVS market formed, we set up dedicated high yield CMVS accounts. From there, we really expanded into all forms for real estate securities, both on the debt and the equities side. Then in 2007, we stood up our private lending strategy, where we've been an active real estate private lender now for close to two decades.

What I think is great about Fidelity is we have a broad platform. We are investing in every flavor of real estate, both on the public and the private side. On the public side, that includes rate equities, rate bonds, CMVS. On the private side, we are buying buildings, and we are originating loans on commercial real estate. If there's something going on in real estate markets, we are seeing it and we are analyzing it.

But what I think is really helpful is that we have a steady flow of CEOs coming into Fidelity every day, from every industry. These companies are users of commercial real estate. All those meetings are open here at Fidelity. What is great about that is I can go in and ask a tech company, how are they thinking about their real estate needs? Or I could ask a retailer how they're thinking about their brick-and-mortar space versus selling through the e-commerce channels. These are just a couple data points, but it's the aggregation of all these data points over time that helps us understand the changes in the underlying demand for commercial real estate. It's really great to have all these resources here at Fidelity. That's really why I've been here for more than two decades.

Stewart: That's really interesting and helpful. One of the things that, when we had David Gaito on, I think it was episode 205, on your private credit capabilities. He made a point to say that Fidelity had not acquired an existing platform, that it was built internally, and that that was important to keep the culture consistent. Is the same true for real estate?

Bill: That's, I think, in all parts of Fidelity, that the culture is very important. I think that's pretty evident in the real estate debt group, where we have a 30-year history. Part of that is we've been very consistent with our investment process over that entire period of time. That really goes to culture. I think David Gaito made a lot of great points.

Stewart: What is the current state of the real estate debt ecosystem right now?

Bill: Yeah. Let's start with who the largest holders are of commercial real estate debt. Banks hold about 50% of the outstanding commercial real estate debt. GSCs, like Freddie Mac or Fannie Mae, hold about 17%. And insurance companies in CMVS each hold about 12%. Banks have the largest exposure, and are a very important piece of the commercial real estate debt ecosystem.

Now, there's been, I think, plenty of headlines about banks lending less. That's mostly true. That is what we're seeing live in capital markets. You can also see that in the Senior Officer Lending Survey done by the Federal Reserve, which shows the current time period has one of the highest percentages of banks tightening their lending standards for commercial real estate. There's really only a few other times that it's been this extreme. One was during COVID, which was a pretty brief period of time. Another was during the great financial crisis, back in 2008. Then for the third example, you have to go all the way back to 1990, during the savings and loan crisis.

Banks have tightened their lending standards and are looking to reduce their commercial real estate exposure. There's really two reasons for this. Their shareholders are pushing to reduce commercial real estate exposure. And regulators are also encouraging banks to reduce exposure.

Now, like most things in life, it's not completely uniform. Exposure to commercial real estate varies across all the different banks. The largest banks actually have less exposure to commercial real estate, compared to regional banks. If we break up that commercial real estate exposure by bank sizes, what we see is the very largest banks that are classified as globally systemic, important banks, are about 17% of the bank commercial real estate exposure, while regional banks are actually 30%.

The large banks also benefit in that they have a natural exit for very large loans on trophy properties through the CMVS market. That is what we're seeing in the marketplace, where we're seeing loans refinanced off balance sheets of money-center banks into the CMVS market. These are high quality, trophy quality properties that capital markets can easily absorb. If you're a client of a money-center bank or have access to the CMVS market, you have pretty decent access to capital. But for the more modest size borrowers that are clients of regional banks, you have less choices.

Now what's interesting, is at the same time, there's approximately $2 trillion of commercial real estate debt that's maturing over the next three years. There definitely looks like there's some imbalance between the need for debt capital, and then the supply of debt capital.

One thing that's actually pretty unique about the current commercial real estate cycle is that over- lending has not been an issue. In the last 40 years, there's only been really two other points in time that commercial real estate prices have experienced a material drawdown of values like they have recently. Those two times were the great financial crisis back in 2008, and then the S&L crisis in the late '80s and the early '90s. In both cases, over-lending was an issue. When I say over-lending, what I mean is that the leverage in the marketplace is too high.

Just as an example, if we use a dataset from Real Analytics, which is a real estate data provider. The average loan to value in the commercial real estate debt week was north of 70% back in 2007, going into the great financial crisis. Post the great financial crisis, it did reset lower, and then it actually continued to trend lower. Real estate lenders clearly did not want to get burned again. If you look at the last five years, using that same dataset, the average loan to value has only been about 60%. That's materially lower, and that's good because it allows the plumbing of the financial system to remain in good working order. For the most part, the banks that are over-exposed to commercial real estate can just lend less and let their current exposure drift down.

Stewart: That's super helpful. You mention this imbalance, this supply/demand imbalance. Can you expand on that? And in your mind, is that a concern, or an opportunity?

Bill: I think it's a great opportunity if you're deploying capital. It's a chance for private capital to step in and fill the void created by banks. The market share for private lenders could increase, and the market share for banks could decrease. That is what happened in the corporate bucket, so it would not be surprising for real estate to follow a similar pattern. Now I mentioned earlier, there's a difference in the commercial real estate exposure for large banks versus regional banks. A key piece of the market to fill is in the middle market. That's the land of the regional bank. Regional banks accounted for about 9% of all commercial real estate loans back in 2011. By 2022, regional banks accounted for 29% of all commercial real estate originations. Now last year, that decreased to 22%, and it would not be surprising to see that to continue to fall over time. There's a decent sized hole in the financing market, in the middle market.

What is exciting about the middle market in commercial real estate is that there's so much real estate that falls into that size range. And it's the property types where the fundamentals are solid. When I'm saying middle market, I'm thinking about properties that have values of, say, $50 million to $150 million. And properties that are larger, that have a value of, say $150 million or greater, I would consider the high end in the market. I'm excluding the properties that have values less than $50 million, just to try to capture the institutional quality assets.

If we look at the sales transactions over the last five years for properties that are over $50 million in value, the size group of $50 to $150 million accounts for 90% of all of those transactions by count, but only two-thirds by value. Above $150 million, that's 10% of the transactions by count, but one-third by the total value. The point here I'm trying to make is that there's a lot of commercial real estate in that middle size range, which means there's a lot of opportunities to make loans. What is also very interesting is, if you break that out by property type, the $50 to $150 million value group includes many apartment buildings, warehouses, self-storage, grocery-anchored centers. These are the property types that we're focused on, as they have good on the ground fundamentals with rising rents and good occupancy. For the properties that have values greater than $150 million, office buildings are actually a pretty big piece. I think that makes sense, because when you think about the types of buildings that are very large, central business district office buildings tend to be really big buildings. Now I enjoy working in office building, but I'm not so excited to finance them.

Again, the point is there's lots of buildings that will need financing that are in the middle market. Now, because there's a greater need for capital, today lenders can be a little bit more choosy about which properties to lend on. It also means that we can charge more. In our high yield lending strategy, we're seeing yields in the mid-teens, which is several hundred basis points higher than what we saw a few years ago.

Stewart: Obviously, property type matters. It sounds like the mix of property types that are available are different in the middle market than in the upper end of the market. Can you talk about that? Am I asking a dumb question? I don't know this market well enough, it but seems like what property types are available would be relevant here.

Bill: Absolutely. Again, I mentioned by property type. Again, we can focus on the property types that have good underlying fundamentals. I think it's somewhat fortunate that the middle market has those property types that have those fundamental tailwinds. On the larger side, it tends to have some office buildings. Malls tend to also be on the larger side. I don't feel bad about missing out on lending on central business district office buildings or regional malls.

The other point to make for how high yield real estate lending works is the type of loan. In high yield real estate lending, the majority of the time, the sponsor has a business plan to create some kind of value. A very common approach to real estate private lending is bridge lending. That's where a sponsor or borrower wants to reposition a property, so they need shorter term financing. Examples of that, of a business plan, might include renovating a Class B apartment building into a Class A apartment building to achieve higher rents. Another example could be repositioning a retail center to higher quality tenants that will pay a higher rental rate. The business plan usually entails upgrading a property to achieve a higher rental rate, which would then increase the value of the building.

Now, bridge loans tend to be floating rate, with a cred spread that ranges between 300 and 400 basis points over SOFR. The term is usually about two years, with three one-year extension options, so a fully extended term of five years. One of the challenges with bridge lending is it's expensive financing, so the borrowers want to refinance into a lower rate sooner than later.

Now if it's a light renovation, a sponsor can get it done in 12 to 18 months, and the typical pre-payment protection is about 18 months, so for projects that go well, we get refinanced after a year-and-a-half. If you're getting your money back after 18 months, or a year-and-a-half, you have to be constantly originating just to keep your current exposure. It's kind of like running on a treadmill. Now a risk of that is eventually, your portfolio could be reflective of the current credit environment. Today, that's fine because we have the wind at our back from a credit perspective, since we've had a reset in values recently. With banks pulling back, it's less competitive, so we can put more structure in covenants into our loans.

But when we do bridge lending, we work really hard to find ways to keep our loans outstanding longer, to avoid that treadmill effect and credit creep. One of those ways is the type of sponsor that we want to lend to. The typical sponsor or borrower for us as a large regional developer or owner. What we like about that type of sponsor is they should be an experienced owner with organizational structure. What they are really good at is knowing their property, and knowing their market. What they want from a lender is a fair deal. What we've noticed is that those loans tend to stay out longer. They want to make their money by owning the right assets and managing them very well. They're less focused on financial engineering.

Now, another way that we find to keep our loans outstanding longer is doing more than just bridge loans. Construction loans are also a key piece of the market. We're fans of construction lending. What we've found is when we partner with an experienced developer, we can reduce the construction risk. When the project is complete, we have the newest building in the market, well below replacement costs. For construction, we mainly focus on multifamily, which is apartments, or pre-leased warehouses. We find those much easier to underwrite, and taking speculative lease up risks, say for an office building. We're also not big fans of office buildings.

The other thing we like about construction lending is it tends to stay out longer. It does take roughly two years to build an apartment building, and then it takes another 12 to 18 months to lease it up. Construction loans tend to stay outstanding longer than bridge lending.

The last area I want to mention is gap financing. Now, this is a chance to finance stabilized properties. This is where a borrower is looking to refinance an asset, but first mortgage proceeds are lowered due to the current environment. Say a bank is willing to provide a new first mortgage, but the prior mortgage had a 70% loan to value, and the bank is only willing to lend a new loan at a 50% loan to value. That's where subordinate financing and some new equity can come in and fill the gap. It's possible we could see a need for a good amount more of gap financing in the coming years, due to the variety of factors that we've talked about. The commercial real estate values are down from a few years ago, banks are lending less. The lendings standards have heightened. And there's $2 trillion of debt maturing over the next three years, so it seems like gap financing should be needed even more than in the past.

Stewart: Let me just ask maybe, I don't know, a naïve question. But when you're using the term sponsor, or owner, or borrower, can you help me identify who each one is? Is that the same entity with interchangeable names? Can you just talk me through that?

Bill: Absolutely. It's the latter. We refer to them as sponsors, but they're borrowers, or they're owners. All those people are the same entity. We think about them as a partner. We want to be there to help them achieve their business plan. When we lend money, we truly think of it as a partner. That's not to say, if there's an issue, we wouldn't exercise our rights or remedies. But during the process of them renovating the property and going through the business plan, we want to be a partner to them.

Stewart: That's super helpful. Is it possible to create high yield returns from a first lean position?

Bill: Yeah. An important side of high yield real estate lending is the financing side of the business. Investors generally expect a return of high single digits to low double digits. But as I've previously mentioned, a first lien bridge loan may typically have a credit spread of 300 to 400 basis points. Even with SOFR at an elevated level today, you don't get there with enough yield.

The way you get there is with leverage. What I mean by that is the high yield lender needs to somehow have exposure to the junior portion of the debt, and a lower cost to capital needs to have exposure to the senior portion of the debt. There's really three ways that I think about to achieve that. They are, one, using a line of credit. Two, CLO financing. And three, using a mezzanine loan structure. Each of those ways, the leverage at the asset level should be the same. But the method for creating that subordinate position is different.

Just to unpack that a little bit more. If we're using a line of credit, we would start by, say originating a first mortgage at a 70% loan to value. Let's say the spread is SOFR plus 400. We then go to a credit line provider, that's typically a money center bank, and pledge that loan as collateral, and then borrow against it. You might have an advanced rate of, say 75% of that loan balance, at a rate of SOFR plus 200. Just as an example, if you had a property that was worth $100. We'd originate a first mortgage of, say $70, so 70% loan to value. You then pledge your $70 loan to the bank. It provides $50 from the line of credit. The high yield lender is only providing $20. The provider of the line of credit has the senior exposure, and the high yield lender has that subordinate exposure. The high yield lender will earn a mid- teens return on that $20 of invested capital. Through financial leverage, you've really created a synthetic subordinate position that is high yielding.

One of the risks with this strategy is that you could have a margin call, or make it need to have liquidity to remove the loan from the credit facility for a variety of reasons, such as a workout scenario. A benefit though, is that this method is very efficient. It works well for lending at higher volumes.

I mentioned that second way is to use a CLO financing vehicle. That's where the high yield lender would accumulate loans that are, again, let's say a 70% loan to value. And then, they're deposited into a trust. That trust is then taking to a rating agency that rates the different tranches or classes, based on the seniority in the structure, and then assigns a credit rating anywhere from triple-A, all the way down through single-B or unrated. The senior portion in the structure are the investment grade bonds. Those are sold to bond investors. The high yield lender retains the subordinate portion that includes those low investment grade bonds. It's really the capital markets are bond investors that have the exposure to the senior portion, and the high yield lender has the subordinate portion.

Again, the high yield lender will earn a similar mid-teens return on that subordinate portion. An advantage of this method is that you have structural leverage. That limits your risk of margin calls from a line provider. But there is a risk, because you're relying on capital markets' execution to distribute and price those senior bonds.

Now, a third way is to partner with a bank or an insurance company that has a lower cost of capital. They originate a low leverage first mortgage, so say a 50% loan to value. The high yield lender simultaneously originates the next 20% of the capitalization as a mezzanine loan, bringing your total leverage up to the 70%, or the same as the prior examples. Sticking with that example that I mentioned earlier, you have a property worth $100. The total debt would be $70, but the bank or insurance company would have the first 50, and the next 20 comes from the high yield lenders.

The leverage point, again, is the same at the asset level as the other ways, but the method is through structural leverage created at the time of origination. This really eliminates their risk of a margin call, but it also eliminates the capital markets risk.

Each of these methods has benefits and drawbacks. My personal preference is to use the mezzanine structure, as there's no financial leverage. It's structural leverage, which means you can get called out during times of volatility. It's during those times of volatility that we really want to focus on deploying capital, and not worry about the risk of a margin call. Now to be fair, one of the drawbacks is it is more difficult to do those mezzanine loans in higher volume.

Stewart: That's super helpful. Here's, I guess, my final question, and it's not an easy one. How do you create alpha?

Bill: Yeah. I think that's really important for the underlying LPs or investors. When I think about how to create excess return, or alpha, I think there's five things that come to my mind.

As with all debt investments, you can only get back par, so credit is most important. We have managed real estate debt funds through many cycles, including LTCM, the bursting of the internet bubble back in the early 2000s, the great financial crisis, COVID, and certainly today. Understanding credit risk is deeply embedded in our culture. That's point one.

Point two is being very selective. The top of our funnel is very wide to start. We're getting all the packages from the mortgage brokers. We have many, many direct relationships with sponsors. We're combing through billions of dollars of opportunities. But we say ‘no’ a lot. Our general goal is to do about 20 loans per year. We have a very focused effort on our best ideas. Each time we do a loan, we're really excited by that opportunity.

The third thing is we look for parts of the market that are less competitive. We've talked a little bit about how sponsors looking for larger loans have more options, whether it's the CMVS market, money center banks, or insurance companies. We've also been talking about how the middle market has a big hole to fill. We think, in the middle market, it's less efficient and we really like that niche.

The fourth thing, and I spoke a little bit about this earlier, is keeping the loans outstanding for as long as possible. We work hard to put in as much pre-payment protection. We try to mix the different loan types beyond just bridge lending. We also look for sponsors that are focused on real estate rather than financial engineering.

The last point that I would like to make is avoiding fund level risks. When I think about that, I really think about financial leverage. I think it's really important to not have too much financial leverage, as it could create liquidity risks. Looking way back, during the great financial crisis, we saw funds get into trouble from loans defaulting. But some funds also got themselves in trouble, just from having their financing lines pulled. Keeping fund level risks to a minimum I think is also important.

Stewart: A question that occurs to me, and you mentioned this hole, this supply demand imbalance. What is the likelihood that that hole doesn't get filled and it creates a dislocation? Is that risk on your radar screen?

Bill: Yeah, I think that's always a risk. One of the things I mentioned is that the plumbing of the financial system is in good working order. I pointed to the difference between what happened during the great financial crisis or the S&L crisis. I do think we're in a more fortunate position than times have passed. That's always a risk, but I think it's less than some of those other circumstances.

Stewart: Super helpful. I've just gotten a masterclass on high yield real estate lending. I really appreciate it, Bill. Thanks for coming on. I've got a couple of fun ones for you out the door, if you'll entertain them?

Bill: Absolutely.

Stewart: I just got done speaking to a class at LSU. I was with about 50 students. It was actually Rip Reeves' class at LSU. This was Monday evening. This is Wednesday, October 16th, and this was the Monday evening. Those students are seniors, and they're getting ready to graduate. I surveyed the room and asked them how many had jobs already, and a couple did, but many did not. What advice would you give that room, if you had the opportunity?

Bill: This is advice that I give my daughters all the time. To be clear, this is personal career advice, this is not how we invest capital.

Stewart: Okay, good deal. Okay. Important distinction.

Bill: Two points here. Venture out of your comfort zone. That is the way that we learn and grow, is by trying new things. Then the second is embrace failure. I have never met anyone that succeeds every time they try something new. It's part of the learning process. If you have failed, then you've never gotten out of your comfort zone.

Stewart: Yeah, I think that's great. I think it was Henry Ford that crafted the quote, "Failure is the opportunity to start over with better information."

Bill: That's a great quote.

Stewart: You learn the most when you fail. If everything's click-in, you're like, "Wow." But when you fail, you learn. I got the scars to prove it. That's great advice. Okay, final fun one. Lunch table for four, you're one of them. You don't have to have four, it could be up to four. Who would you most like to have lunch with, alive or dead?

Bill: Yeah. I'm going to make it five, but there's going to be one real guest. I mentioned I'm a soccer fan. I have three daughters, so we watch a lot of women's soccer. The person I would like to have lunch with is Emma Hayes. For those of you who don't know who she is, Emma is the current US Women's National Soccer Team coach. I'd like three more seats, because I want to invite my three daughters for this lunch.

Stewart: That's a super cool choice. I know who she is, I just didn't know her name. Can you give us a little bit of the background on Emma Hayes?

Bill: Yeah, absolutely. Emma is the current US Women's National Soccer Team coach. Before that, she managed Chelsea in the Barkley's Super League, where her team won the last five league championships, and the last seven of nine championships. Then she joined as the US Women's coach after the 2023 Women's World Cup, where unfortunately the US Women's National Team had its earliest exit ever in their history. Now, her first big challenge was at the Olympics in Paris this past summer. With Emma as the head coach of the US Women's National Team, they turned it around, and they took home the gold medal. She is clearly doing something right. She clearly knows soccer. But she also must know how to get the best out of people and run a complex organization.

Stewart: Absolutely, absolutely. It's been a lot of fun to have you on. I've gotten a great education today. Thanks for coming on, Bill. We really appreciate you.

Bill: Thank you. I enjoyed being here.

Stewart: We've been joined today by Bill Maclay, CFA, portfolio manager at Fidelity Investments. Please rate us, like us, and review us at Apple, Spotify, or wherever you listen to your favorite shows. My name is Stewart Foley. I'll see you again next time, on the InsuranceAUM.com Podcast.