Finding extra yield potential in real estate mezzanine debt

Exploring the potential for attractive risk-adjusted returns in a misunderstood part of the market

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Mezzanine debt, a significant and growing segment of private credit, offers the potential for elevated yields and historically attractive risk-adjusted returns in a somewhat misunderstood part of the real estate market.

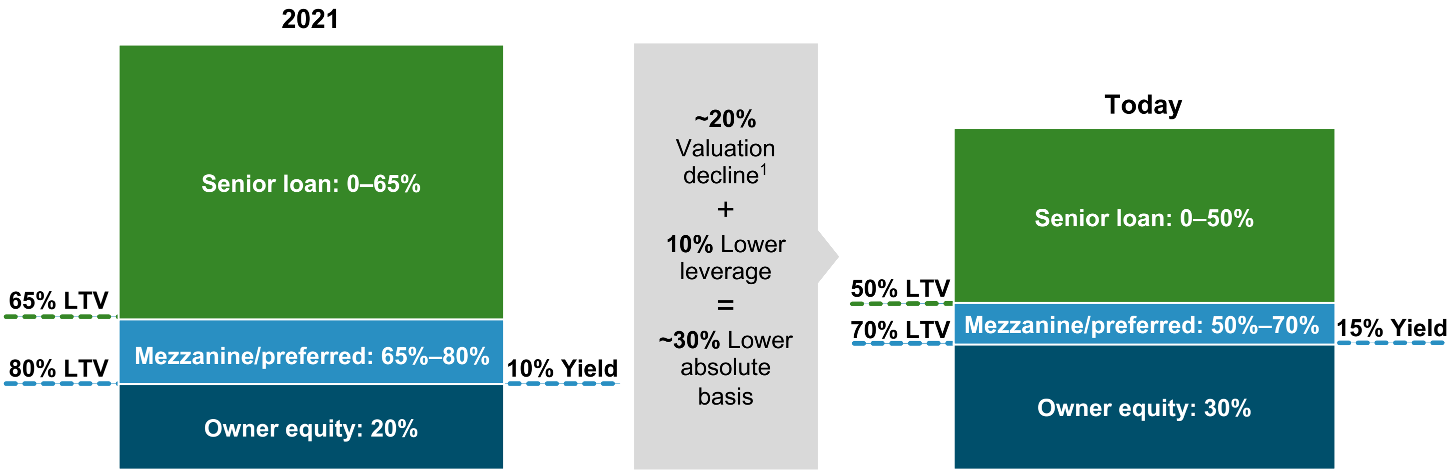
Remember these three things

- There are two main ways to approach the high yield real estate debt market: synthetic mezzanine (levered whole loan), and direct mezzanine (unlevered).
- Synthetic mezzanine structures carry margin call risk. In a Synthetic mezzanine structure, mortgage lenders manufacture high yield returns by setting up leverage facilities with banks in an arrangement called a repurchase agreement. In addition to getting paid interest, the bank also puts covenants in the repurchase agreements whereby they can issue margin calls under certain conditions. Historically, as capital markets volatility increases and economic activity slows down, there is increased risk of banks issuing margin calls which has a detrimental impact on returns for the synthetic mezzanine lenders.
- Direct mezzanine debt has a credit risk profile similar to synthetic mezzanine without the margin call risk. Direct mezzanine lenders shop the market to find the most efficient senior lender. Combining mezzanine debt with the senior loan results in a cost-effective loan for the borrower and yield on the direct mezzanine debt that is higher than the synthetic counterpart.

The short story on the opportunity in mezzanine debt

A roughly 20% decline in property values in recent years has allowed many nontraditional lenders to offer financing in the mezzanine market using less leverage and at a 30% lower absolute basis (see Exhibit 1).

Exhibit 1: A theoretical look at how a valuation decline has made mezzanine financing more attractive



The theoretical look in Exhibit 1 is for illustrative purposes only. Data is subject to change. The analysis is based on indicative pricing and the spread over Secured Overnight Financing Rate (SOFR) as of 6/30/24. Potential downside protection is no guarantee against future losses. (1) Based on Green Street CPPI as of 7/15/24.Source: Green Street CPPI, Bloomberg Finance, L.P., and Fidelity Investments, as of 6/30/24.

Commercial real estate (excluding office space) has looked healthy overall, backed by low vacancy rates, steady rents, and strong cash flows. That said, lower property values in several segments, interest-rate uncertainty, and the desire for banks to lower their leverage ratios have made many traditional lenders choosy about the loans they offer.

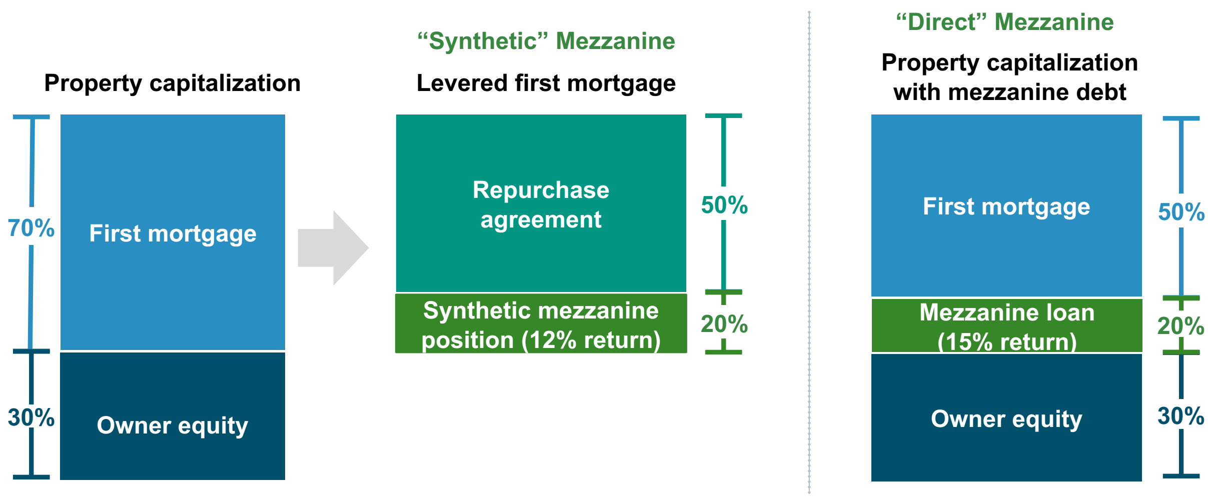
While some have exited the sector, many of the 4,000+ banks in the U.S. remain active along with insurance companies, just at lower leverage levels. This has created an expanded opportunity set for mezzanine debt providers to replace a piece of the capital structure -- and for investors to potentially generate equity-like returns at modest risk.

The two ways to invest in mezzanine loans

Direct approach: Provide an unlevered mezzanine loan in partnership with banks, insurance companies and other balance sheet lenders, who provide the first of two separate loans. With the direct approach, the mezzanine loan can be floating rate or fixed rate. This can be advantageous to lock in current high base rates.

Synthetic approach: Originate a whole loan and finance the loan with another lender, while retaining the "synthetic" mezzanine risk tranche of the loan. This is also called the Levered Whole Loan model. The loan is typically floating rate, and this model is similar to a regional bank business model, where effective management of liabilities (i.e., deposits for banks/secured line of credit for debt funds) becomes more important, especially in market downturns.

Exhibit 2: An overview of the synthetic vs. direct mezzanine structure



For illustrative purposes only. Potential downside protection is no guarantee against future losses. Source: Fidelity Investments, as of 6/30/24.

Why Fidelity has favored the unlevered mezzanine structure

Under both structures, the underlying credit risk is the same. On the risk management side, unlevered mezzanine loans mean there's no margin call risks during times of market volatility (i.e., covid) or large secular change (i.e., office demand decline). On the return side, rather than being forced to choose among a few select lenders, we can partner with the most cost-effective among thousands of senior balance-sheet lenders in the market. The combined economics of such a partnership allows direct mezzanine lenders to keep as extra yield some of the excess economics that otherwise would go to other participants in the capital structure.

A borrower may have strong bank relationships or existing low-cost fixed rate debt in place, and we have the flexibility to be a partner in those situations, too.

Fidelity has been focused on the direct mezzanine investment model for more than 17 years, so we have a strong reputation and origination network within the market. Our ability to engage the entire senior mortgage market and have structural control of our mezzanine loan often provides the most flexible, cost-efficient option to a borrower. In today's de-levering environment, there's also significant opportunity to help borrowers pay down existing loans to modest levels with direct mezzanine loans.

Direct mezzanine debt in the market as of August 2024

Current real estate values are down 20%+ from recent peaks, and it's possible they could decline further. Direct mezzanine debt is positioned to take advantage of current market. This investment strategy has offered equity-like returns, while maintaining 30% equity cushion based on 2024 reset values. Our direct mezzanine structure also avoids financial leverage at a time of uncertainty.

Conclusion

- The broader real estate market de-leveraging is happening as low-rate loans mature into a higher-interest rate environment coupled with banks retrenching.
- There's over $2 trillion of real estate debt that's maturing in the next three years, providing ample opportunities to be selective as an investor.
- While it's difficult to call a bottom in real estate values, a direct mezzanine debt approach isn't reliant on property price appreciation. We believe the current market provides an attractive entry point irrespective of the go-forward trajectory of property values.
- More specifically, we believe an unlevered mezzanine debt approach can offer equity-like returns with modest credit risk.

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