KKR

Market Review

Real Estate
Q2 2023

Crunch Time

How a Real Estate Credit Crunch Could Benefit Investors

2
Executive Summary

4
The Origins of Commercial Real Estate's Tight Credit Conditions

5
Putting Regional Banking Issues in Perspective

7
The Real Estate Opportunity

Crunch Time

How a Real Estate Credit Crunch Could Benefit Investors

Written by:

Ralph Rosenberg
Partner and Global Head of Real Estate

EXECUTIVE SUMMARY

After decades of benign inflation, easy monetary policy, and low rates, we are being reminded what a rate shock means for real estate. The increase in interest rates over the last year has increased the cost of capital for all asset classes, which has meaningful, direct implications for the investment landscape. However, second-order effects of rate increases on real estate values and capital markets are arguably just as important, particularly the sharp decline in availability of debt capital for commercial real estate. In our view, the pullback in real estate debt markets will dictate both outcomes and opportunities for investors in the coming months and quarters.

As we continue to navigate all of the new dynamics of the current environment, we frequently hear a few key questions from our investors. In this letter, we will address these questions based on what our real estate team and KKR colleagues across the firm are observing.

— What are the root causes of the current commercial real estate (CRE) debt pullback?

— What are the second-order effects investors should watch?

— Is the focus on CRE loans on bank balance sheets justified? Are the real estate capital markets as dire as headlines suggest?

— How long could it be until liquidity returns to the market and capital markets resume more normalized functioning?

— What are the best investment opportunities today, and what opportunities will emerge over the course of the next year?

Ultimately, we believe the current market dynamics will create a once-in-a-decade real estate investing opportunity. The environment remains dynamic and complex, and the degree to which commercial real estate lenders are intertwined with one another is likely to complicate and prolong a return to normal liquidity conditions over the next year. We expect banks to remain on the sidelines for some time, in part because regional banks likely face tighter regulations that will curtail their lending activity. We do expect to see an uptick in defaults that will be concentrated in the office sector; however, we do not see office real estate loans or exposures as a systemic risk to banks.

For investors, the opportunity in real estate credit is here. Today's commercial real estate loans have lower loan-to-value ratios (LTVs), better interest coverage on higher interest rates, and more lender-friendly covenants and structures. Non-bank lenders with the strongest relationships are at a particular advantage. In real estate equity, well-capitalized buyers are entering an attractive environment, as forced selling will likely bring high-quality assets to a market where many traditional buyers sit on the sidelines. We expect that many borrowers will need to recapitalize, seek equity infusions, or sell attractive assets as $1 trillion of commercial real estate loans mature in 2023 and 2024.

Key Themes

As we look across today's market, we will cover the following themes:

01 The Origins of CRE's Tight Credit Conditions

02 Putting Regional Banking Issues in Perspective

03 The Real Estate Opportunity

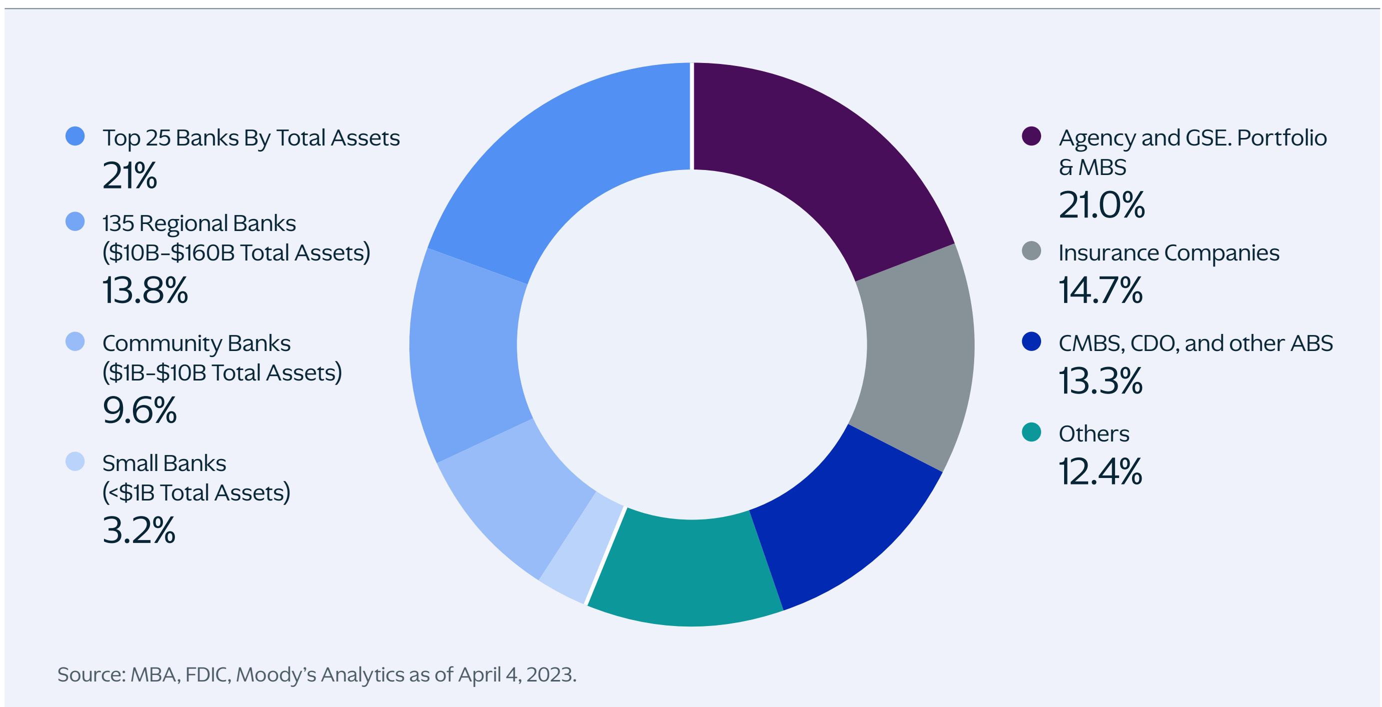
01 The Origins of Commercial Real Estate's Tight Credit Conditions

To understand the root causes of the current credit pullback, we think it is important to understand the types of lenders that comprise the real estate debt market. There is no single precise source of aggregate data detailing the size and composition of the CRE debt market, and a number of reputable research institutions offered differing estimations of the share of CRE debt held by regional banks following the failures this spring of Silicon Valley Bank (SVB), Signature Bank, and then later, First Republic. We believe Moody's has compiled a directionally accurate picture of the U.S. CRE debt market that suggests there is approximately $4.5 trillion in CRE debt outstanding, including multifamily. Approximately 40% comes from banks, including approximately 14% from regional banks with $10-160 billion of assets. Government agencies (the GSEs), insurance companies, CMBS, and non-bank lenders each account for another 10%-20% (Exhibit 1).

Notably, these different lender types rely heavily upon one another. For example:

- Banks originate loans, effectively as bridge and warehouse loan facilities, with the expectation that a CMBS execution will repay that bridge loan over a short timeframe. Thus, CMBS markets impact bank balance sheets.
- Conversely, banks and insurers are some of the biggest buyers and holders of senior CMBS securities, which means that bank balance sheet liquidity also impacts CMBS market liquidity.
- Non-bank lenders tend to rely heavily on warehouse lines of credit provided by banks.
- Large money center banks rely on regional banks as syndicate partners for large loans, so regional banks impact money center bank balance sheets and vice versa.
- The GSEs originate residential loans (and provide a guarantee on the senior securities of these loans), which are then distributed through the securitization market, which has a relationship with the CMBS market. Like banks, GSEs feel the impact when CMBS markets are not fully functioning.

EXHIBIT 1: The Lenders in the Commercial Real Estate Debt Market



Source: MBA, FDIC, Moody's Analytics as of April 4, 2023.

When a system is this interconnected, a recalibration in one part of the machine can quickly filter through to all of the others. This is exactly what happened in the current pullback and complicates the path to rebuilding a functioning CRE debt market.

So, where did the pullback begin and how did the dominos fall? In late February 2022, before central banks in developed markets began raising interest rates, Russia's invasion of Ukraine unleashed significant volatility in rates. CMBS spreads widened materially over a relatively short period of time, increasing 70 basis points (bps), or 19%, over the course of February 2022.[1]

Coming off a record year of CRE loan originations in 2021, large money center banks were particularly reliant on the CMBS market to move loans off of their balance sheets. However, wider spreads equated to a higher cost of capital for CMBS loans, which significantly reduced banks' ability to use CMBS markets to repay via securitization what were originally intended to be warehouse and bridge facilities, rather than on-balance sheet loans. CMBS originations declined 36% in 2022,[2] compared to a 19% decline in overall transaction volumes.[3]

The pullback in the CMBS market came alongside a reduction in overall bank capital, as the Fed started to tighten monetary policy in March 2022. Rising rates caused negative marks on banks' CMBS securities books and left banks heavily overexposed to CRE loans. This exposure level quickly triggered regulatory concerns, which in turn suppressed origination volumes. More limited loan availability and higher rates slowed the typical rate of voluntary repayments throughout 2022, further compounding banks' overexposure to CRE loans. Originations slowed further as a result.

02 Putting Regional Banking Issues in Perspective

By early 2023, there were signs of green shoots in the CRE debt markets. Specifically, Single-Asset, Single-Borrower (SASB) CMBS spreads tightened. The very compelling risk-adjusted returns available in CRE debt, most easily observed and accessed through the SASB CMBS market, attracted new sources of capital to the sector and compressed spreads. The failures of Silicon Valley Bank (SVB) and Signature Bank in March 2023, and then First Republic in May 2023, quickly dashed that momentum, however.

Importantly, credit issues did not cause these bank failures, as had been the case in the 2008-09 crisis, but rather a duration mismatch between assets and liabilities: Long-dated assets had a negative mark-to-market (MTM) as rates rose. Interestingly, the issues created by this mismatch took quite some time to come to the fore in the case of the recent regional banking crisis. Rates started rising in early 2022, but the panic around regional bank insolvency didn't materialize until almost a year later, when there was a run on SVB deposits, exposed in part by an only tangentially related cause: the cash needs of SVB's technology-heavy client base. Nevertheless, the collapse of SVB and Signature Bank put a spotlight on the values of MTM securities and loans across regional banks.

A great deal of ink has been spilled wondering why it took so long for management and regulators to recognize and address asset-liability mismatches, but we think the broader lesson is that it takes time for the systemic second- and third-order effects of rate increases to surface. It reinforces for us how important it is to consider what other potential second-order effects could be lurking as a result of the dramatic change in macro conditions over the last 18 months. That, in turn, brings us back to some of the key questions from our investors.

1 Source: Bloomberg. Reflects BBB- CMBS-10YR cash spread from January 28, 2022 to March 4, 2022.
2 Source: Mortgage Bankers Association
3 Source: Green Street Advisors

What is the impact of the regional bank uncertainty on CRE markets?

Regional banks play an important role in financing smaller CRE buyers and development across the U.S. Regional banks also participate in syndications of larger loans and credit facilities originated by money center banks, one of the notable interdependencies among CRE debt providers that we discussed earlier.

As a result of the recent turmoil, we expect tighter regulation for regional banks, such as higher reserve requirements, less leverage, and more oversight in general. Such measures would likely reduce regional bank participation in CRE lending, which would affect smaller loans and development most acutely and add to the liquidity pressures in CRE debt markets. As of now, however, the recent regional bank failures do not seem to have fundamentally changed the capital markets environment for real estate, which was depressed before and remains so now. Instead, the main effect of the regional bank failures to date was to send another shock wave of volatility through the market, stunting the early momentum of a recovery and ultimately prolonging the return of normalized liquidity to the market.

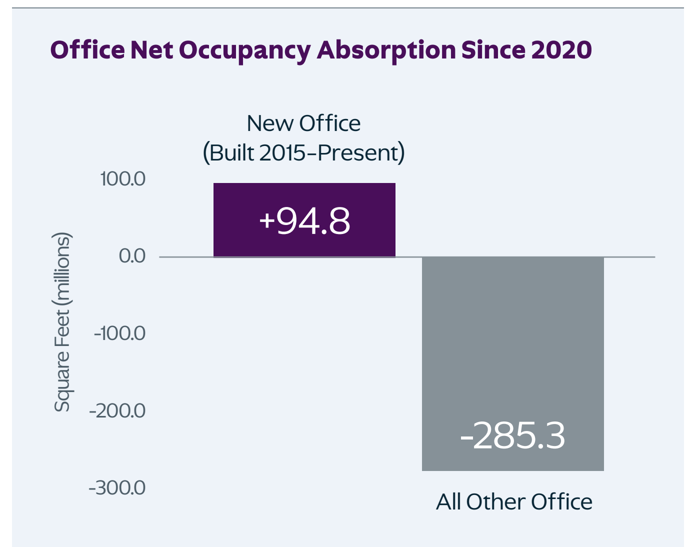
There is a silver lining of the regional bank turmoil for existing real estate owners. We expect fewer new development projects to be funded over the next few years, which should support CRE values as new supply becomes more limited.

Will real estate cause a broader banking crisis?

Credit issues had little to do with the failures of SVB, Signature Bank, and First Republic. That said, credit issues relating to real estate loans, particularly in the office sector, may be the next shoe to drop.

We have already seen a number of high-profile defaults in the office sector, a trend we expect to continue. The secular headwind of lower office attendance combined with higher rates has led to a complete lack of capital markets liquidity in the sector, and we expect continued defaults in office. Within the office sector, the delineation between “trophy” office (newly built, well-amenitized, and environmentally friendly buildings) and “commodity” office (pretty much all other office) is justified (Exhibit 2). Leasing fundamentals are quite strong in the “trophy” sub-segment, while “commodity” office has struggled as companies, sponsors, and lenders question the role that this type of space will play in a post-pandemic work environment. The well-performing “trophy” segment represents just a small part of the office market, representing some 5%-10% of the overall market and less than 20% of the “Class A” stock in most banks’ office loan portfolios. With very little demand from buyers and lenders, we expect some losses to come across bank CRE loan books in the office sector.

EXHIBIT 2: ”Trophy” Office’s Growing Advantage



Source: JLL as of December 31, 2022, reflects 2020-Q4 2022 net occupancy absorption.

However, we think it is improbable that potential office loan losses will lead directly to further bank failures. Let's say that troubled office loans comprise 20% of banks' CRE loan exposure, and CRE loans are 20% of a banks' overall loan book — a conservative assumption compared with Moody's estimate of 16% on average across regional banks. Now assume that half of the troubled office loans default at an average 50% loss severity. That implies total bank capital losses of just 1% of assets.[4] If this scenario played out, it would likely happen over the course of several years rather than playing out immediately. An outcome like this would meaningfully impair bank earnings, but should not in itself cause widespread upheaval on the order of the 2008-2009 Global Financial Crisis.

That said, we do expect an uptick in CRE loan defaults, concentrated in the office sector, which will continue to put pressure on overall CRE debt liquidity for an extended period of time. The interconnected pieces of the CRE debt market are unlikely to heal themselves in the next couple of quarters, so we think the current dislocation and associated volatility is likely to persist at least through this year.

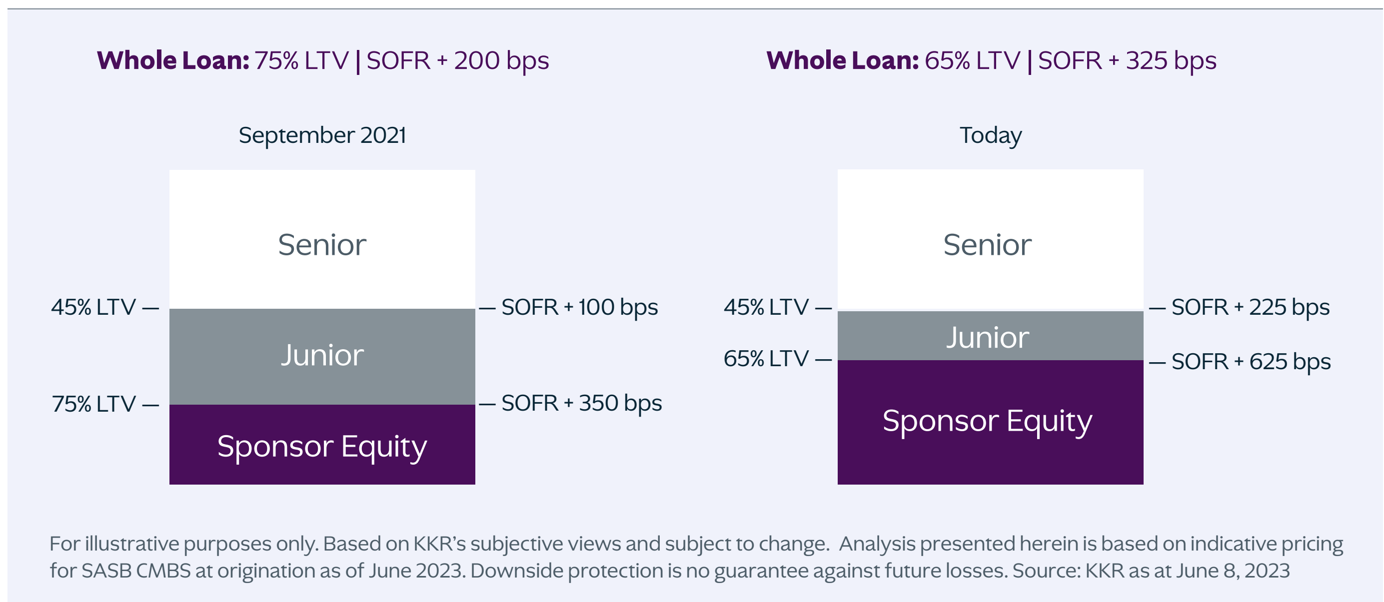
03 The Real Estate Opportunity

In our view, the dislocation is going to create a once-in-a-decade investing opportunity in real estate.

The opportunity in real estate credit is already upon us. In addition to high base rates, spreads have widened meaningfully for new credit originations and loan terms have tightened. Today's CRE loans have lower LTVs, better interest coverage on higher interest rates, and more lender-friendly covenants and structures.

Real estate loan repricing has been dramatic (Exhibit 3). For example, if a whole loan on a stabilized building in a healthy sector and market in the fall of 2021 priced at SOFR+200 basis points (bps) at 75% LTV, that same property might be financeable today at SOFR+325 bps at 65% LTV, and the "V" is likely lower in response to higher rates. The junior tranches of that loan might earn 250 bps or more of incremental spread compared to the fall 2021 market tights (indicatively, SOFR + 625bps today vs. SOFR + 350 bps). Combined with the move in SOFR from approximately zero to approximately 5% over the last 12 months, the overall pricing for these subordinated tranches has moved from low-to-mid single digits to low double digits. At the same time, lenders take substantially less risk given the lower LTVs and better terms.

EXHIBIT 3: CRE Loan Pricing in a Lender's Market



For illustrative purposes only. Based on KKR's subjective views and subject to change. Analysis presented herein is based on indicative pricing for SASB CMBS at origination as of June 2023. Downside protection is no guarantee against future losses. Source: KKR as at June 8, 2023

5 Source: Moody's Analytics as of April 2023, KKR.

The opportunity in real estate credit is already upon us. In addition to high base rates, spreads have widened meaningfully for new credit originations and loan terms have tightened. Today's CRE loans have lower LTVs, better interest coverage on higher interest rates, and more lender-friendly covenants and structures.

Why are CRE lenders able to earn these outsized risk-adjusted returns today?

We've discussed the implications of higher rates and how they have contributed to a pullback in CRE lending. On the demand side, more than $1 trillion of real estate loans are due to mature in 2023 and 2024 at a time when rates are at a multi-year high (Exhibit 4). When less debt capital is available, lenders gain pricing and negotiating power and can be far more selective about which assets and sponsors they lend to.

We expect the "lender's market" dynamic to persist, at least until real estate debt markets and rates fully stabilize. A path to stabilization is complicated given the combination of 1) the likelihood of continued defaults, which we believe will be concentrated in office loans, 2) the additional strains on bank balance sheets outside of CRE, and 3) the interdependencies across the CRE debt market. Those who are able to navigate these risks and complexities should enjoy an extended period of attractive lending dynamics.

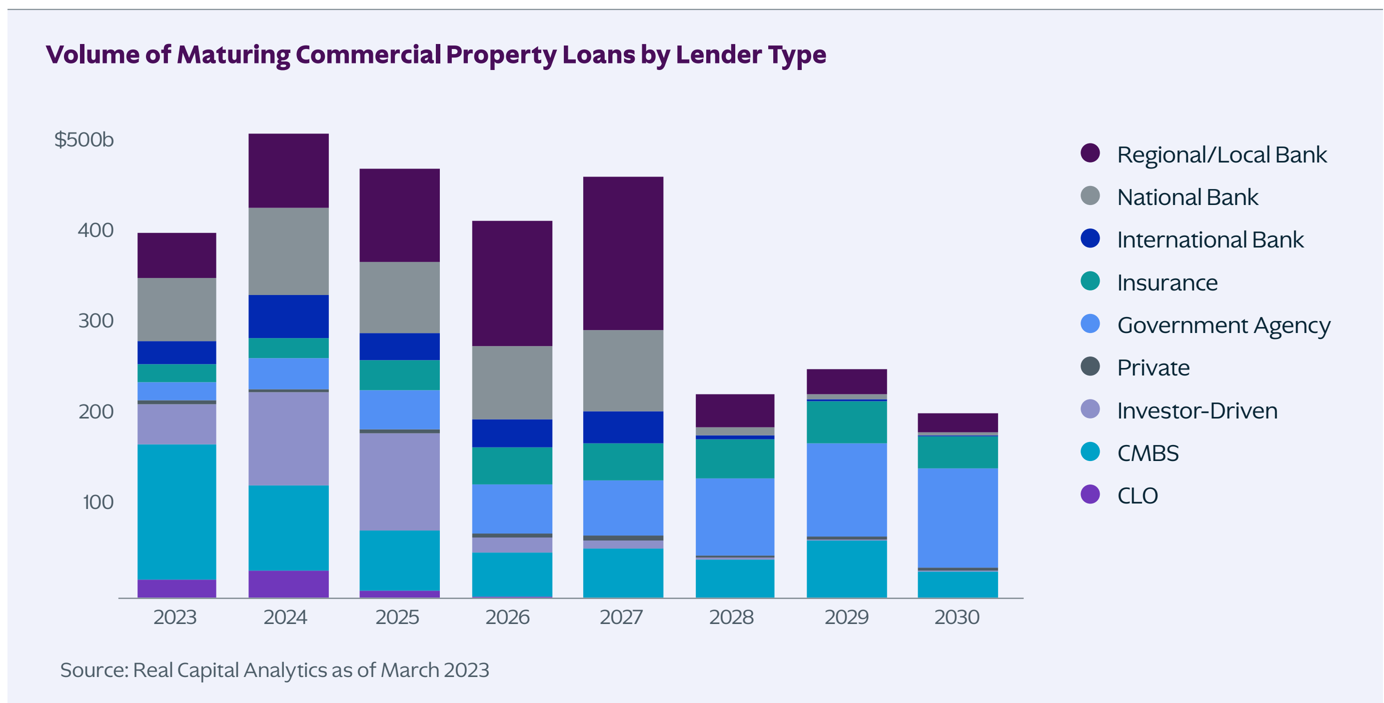
Insurance capital is beginning to get more aggressive in response to the attractive opportunity in real estate credit, bringing down whole loan pricing for certain in-favor property sectors at lower leverage points. However, their lending is not nearly sufficient to fill the gaps in real estate credit markets. This leaves a meaningful amount of high-quality real estate credit opportunities at very attractive yields available to non-bank lenders.

The opportunity is neither limitless nor available to every non-bank lender, however.

First, origination volumes are down significantly given the higher cost of financing, as many borrowers choose to delay refinancing where possible. Second, many real estate credit funds rely upon first lien financing (loan-on-loan leverage), which is very limited with banks on the sidelines. Only groups with the strongest relationships can acquire scarce first lien leverage and access the double-digit return potential in subordinate traches of directly originated loans.

While constrained, CMBS markets remain open and offer another avenue to the double-digit return potential in subordinated tranches of CRE loans. As on the direct origination side of the real estate credit market, groups with strong relationships and underwriting expertise have distinct advantages.

EXHIBIT 4: Approximately $1 Trillion of CRE Debt Matures in 2023-2024



Source: Real Capital Analytics as of March 2023

Real estate debt funds and mortgage REITs also have the potential to catalyze deal flow. Approximately 120 real estate debt funds and mortgage REITS have credit lines that could be a source of fragility and recapitalization opportunities. These leverage facilities typically provide 60%-80% (in the range of 1.5:1 to 3:1 debt-to-equity) loan-on-loan financing for performing loans. If a loan tied to one of these facilities defaults, the fund typically has a short window of time to remove the defaulted loan from the credit facility and find capital to delever. This delevering capital typically represents two-to-four times the size of the fund's initial investment. If these vehicles begin to experience defaults in their portfolios and cannot bring their loan-on-loan borrowings back into balance, we may see an increase in sales of both performing and non-performing loans. We are watching the space closely, particularly as the "wall of maturities" plays out over the next two years.

The Developing Real Estate Equity Opportunity

We expect this kind of forced selling to play out more broadly, too. This leads us to the coming opportunity in real estate equity. The $1 trillion of CRE loans maturing in 2023 and 2024 will create financing needs beyond what the current CRE debt markets can provide. Some borrowers will be able to rebalance capital structures with new, more expensive loans, but others will need to turn to equity or hybrid capital solutions. In many instances, sponsors will need additional equity to delever and correct their capital structures for the new macroeconomic regime, in which rates and inflation are likely to remain higher for longer. This dynamic, which our Global Macro & Asset Allocation team has written about extensively, supports collateral-based cash flows and real assets.

The need for liquidity and recapitalization should extend well beyond the office sector, where we have already seen the first significant defaults. We do not foresee a repeat of the GFC or broad systemic distress in commercial real estate, but overlevered capital structures exist across property types. The recent changes in the cost of money have impacted even on-trend sectors. The durable, long-term forces supporting both rent growth and property values in these sectors are still attractive over the medium term. However, markets are resetting in response to higher interest rates in a largely mechanical way, with cap rates and discount rates widening as policy and benchmark interest rates increase. While there have not been many trades, we have begun to see a price floor developing that is approximately 10%-20% lower based on gross asset value than before rates began to rise.

Existing borrowers and sponsors with conservative capital structures and/or capital reserves to help delever any near-term maturities will have distinct advantages until real estate debt markets stabilize. Liquidity-constrained borrowers with near-term loan maturities may be forced either to recapitalize, seek equity infusions, or sell attractive, on-trend assets to support capital needs elsewhere in their portfolios. These sponsors will face a vastly different capital markets environment than when they originated the loans. While some loans may be refinanced or extended, we believe that a meaningful proportion of upcoming loan maturities will result in assets coming to market across property types and under very different market conditions than in 2021 and earlier.

We have already seen this trend building. Some of the early examples of impending loan maturities creating motivated sellers for high-quality, on-trend assets have been developers with maturing construction loans on newly built assets, a notable source of deal flow for us thus far in 2023.

Just as lenders can benefit from the general pullback in lending activity, well-capitalized buyers can benefit from reduced risk appetite among certain of their peers. Many of the traditional lowest-cost-of-capital buyers, namely REITs and core funds, are on the sidelines, creating another layer of liquidity constraints. This type of buyer often has perpetual capital, which tends to be pro-cyclical since there are demands on liquidity (or they trade at a discount to NAV) at the moment there is dislocation. For levered buyers, as we have discussed, reduced risk appetite from a smaller roster of lenders has made leverage less available and led the fewer active lenders in the market to be more selective. This is creating a very attractive buying environment for well-capitalized sponsors with access to liquidity, such as committed capital in drawdown structures and/or strong lender relationships.

Conclusion

History tells us that some of the most attractive vintages for real estate have come in the aftermath of a shock. We believe we are coming into a very attractive vintage for real estate. The outsized risk-reward in credit is likely to persist for multiple quarters, but the opportunity in equity is just beginning, with pressures on undercapitalized sponsors starting to mount. This environment warrants patience and discipline, but for prudent investors, we believe 2023 and 2024 will be exceptional investing vintages.

We often get questions about when exactly the bottom will be. In our experience, trying to time the bottom of any market cycle is extremely difficult. Furthermore, there typically isn't much investment activity at the brief moment of the "bottom." Our approach to optimizing results during periods of dislocation, like what we are experiencing today, is to stay true to our thematic convictions, focus on the best real estate, invest at an attractive basis or detachment point, and emphasize conservative capital structures, focusing on duration and durability. We believe that this strategy, combined with measured pacing of capital deployment over the next two years, offers the best odds of generating attractive risk-adjusted returns, rather than trying to time the market.

We welcome your thoughts and look forward to speaking with you soon.

DISCLOSURES:

The views expressed in this material are the personal views of Ralph Rosenberg and the Real Estate Team of Kohlberg Kravis Roberts & Co. L.P. (together with its affiliates, "KKR") and do not necessarily reflect the views of KKR itself. The views expressed reflect the current views of Mr. Rosenberg and the Real Estate Team as of the date hereof and neither Mr. Rosenberg and the Real Estate Team nor KKR undertakes to advise you of any changes in the views expressed herein. In addition, the views expressed do not necessarily reflect the opinions of any investment professional at KKR, and may not be reflected in the strategies and products that KKR offers. KKR and its affiliates may have positions or engage in securities transactions that are not consistent with the information and views expressed in this material. This material has been prepared solely for informational purposes. The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this material has been developed internally and/or obtained from sources believed to be reliable; however, neither KKR nor Mr. Rosenberg and the Real Estate Team guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. This material should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy. The information in this material may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this material, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Performance of all cited indices is calculated on a total return basis with dividends reinvested. The indices do not include any expenses, fees or charges and are unmanaged and should not be considered investments. The investment strategy and themes discussed herein may be unsuitable for investors depending on their specific investment objectives and financial situation. Please note that changes in the rate of exchange of a currency may affect the value, price or income of an investment adversely. Participation of, and discussions with, KKR private markets personnel, KKR Capital Markets and KKR Capstone personnel, Senior Advisors, Industry Advisors and, if applicable, RPM and other Technical Consultants, in KKR Real Estate's investment activities is subject to applicable law and inside information barrier policies and procedures, which can limit or restrict the involvement of, and discussions with, such personnel in certain circumstances and the ability of KKR Real Estate to leverage such integration with KKR.

KKR

Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
212-750-8300

www.kkr.com