Real Estate Capital USA

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NEWS & ANALYSIS

PGIM Real Estate's McDonnell sees pivot toward shorter-term loans

The firm expects rates to stay higher for longer, bringing more creative financing opportunities over the next 18 months and beyond

PGIM Real Estate is seeing more commercial real estate borrowers opt for shorter-term loans due to uncertainty over the direction of interest rates and their ability to execute on business plans for properties in today's volatile market, according to Bryan McDonnell, managing director and head of the US debt business at the firm based in Newark, New Jersey.

"The biggest trend we are seeing is that borrowers are all moving shorter on the yield curve," McDonnell said. "It used to be that we would have a smattering of three-, five-, seven- and 10-year financings. But five is the new 10 in terms of where borrowers want to commit because they don't know what is going on in their business plan. They want to shore things up now, figure it out later."

The phenomenon is occurring as the commercial real estate market debates the potential for interest rate cuts this year. While the Federal Reserve has signaled rate cuts of about 75 basis points, there is a part of the market that is hopeful for more substantial decreases.

"We at [PGIM Real Estate] have been in the camp for the higher-for-longer outlook on rates," McDonnell said. "We have not been a buyer of the idea that we're going back to a 3 percent Treasury and the Federal Reserve is going to cut rates very quickly."

The firm's view is that the Federal Reserve will err on the side of keeping rates higher for longer to be certain inflation has been removed from the system and is starting to see borrowers make decisions around the future of their properties, McDonnell added.

"Frankly rates, historically speaking, are not that bad and we are seeing more borrowers engaged in making decisions," McDonnell added. "There is more [dealflow], but it is still lighter than it has been historically. And it won't be until we see many sales going on that the market opens up."

McDonnell believes the tilt toward shorter-term loans will ease in the coming months. "People eventually will get to a place where it will settle down and people will get a more normal maturity profile. It is a global phenomenon," he added.

As the commercial real estate market navigates an estimated $1.5 trillion of maturities over the next two to three years, PGIM Real Estate sees opportunity to make structured investments in properties and projects with solid fundamentals that also have distressed capital stacks. The firm estimates that there are roughly $235 billion of loans with a funding gap that could mature over the next two years.

"These deals can't cover on their existing loans and need some sort of sub debt or new equity to come in," McDonnell said. "Maturity walls never end up hitting fully because some loans will get solved and others will get kicked down the road. But some of these will need to be addressed and we are starting to see those play out in different ways."

There is a further factor affecting the current situation – banks need to de-risk their balance sheets.

"Even if there is nothing wrong with a property, banks are saying, 'We need to take your property from 75 to 50 or 60 percent LTV,'" McDonnell said. "These are situations in which PGIM could come in and offer mezzanine loans or just a preferred equity slice to bridge some of the gaps as banks are under pressure to lighten up their balance sheets. There are cooperative situations with senior lenders where we can come in and support it."

There is a strong element of creativity to these transactions, with McDonnell citing a situation in which the firm is working with a lender that has a senior loan on the property and wants to finance a second property for the sponsor. But because of the way capital charges work, the lender needs to first de-risk its first position.

"We could come in and do a mezzanine loan on both properties so the lender can do a new financing with the sponsor. This would allow the lender to de-risk on the first property and keep in a safe position on the second," McDonnell said. "It is a co-operative play that is accretive for the banks."

McDonnell estimates that this

investment window will last about 18-36 months as capital structures need to get sorted out.

"Banks need to sort situations and there are also CMBS loans coming due that will have some issues," McDonnell said. "But longer term, every time you go through a disruption, you have to remember that the US has very sophisticated capital markets. There are a lot of players from the debt funds to life companies to the GSEs to CMBS."

He continued: "There will be an immediate push over the next 24 months and, with Basel III end game playing out, you'll see the non-bank lenders continue to play this role in the market around at-risk capital. This will keep the banks in a well-capitalized space and force the private markets to take the risk."

Distressed capital structures are a more serious issue for the market than distressed properties, which is a shift from the global financial crisis when the script was flipped, McDonnell said.

"Last cycle, what we saw was underlying properties were so stressed that it made it a more difficult financing story. The properties here, there is largely nothing wrong with them. It is just the capital stacks and that gives us more creative options on how we play," McDonnell said.

Additionally, there is an issue for sponsors with maturing construction loans. At the time of origination, when rates were at historic lows, these loans were made at a 60 or 70 percent loan-to-cost. But as rates have risen and valuations have dropped, these LTCs are now closer to 100 percent, McDonnell said.

McDonnell sees a future in which alternative lenders, which began to gain significant market share because of post-GFC legislation around de-risking banks, will experience a similar period of growth.

"If you break down commercial real estate lending, there are CMBS lenders, banks, life companies, debt funds and GSEs. PGIM Real Estate is an amalgamation of all of those," he said. "We manage a lot of life company capital and are a major GSE player and that is more of an evolution of a full-scale commercial real estate capital market.

"The market is becoming more sophisticated, and our pitch now is that we are trying to create solutions for borrowers and try to match them with capital for investors. The more solutions we have for borrowers and options we have for investors, the more valuable we are to them."