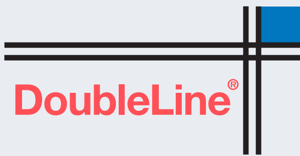


Capitalizing on the Comeback

Why Credit Shines in Today's Commercial Real Estate Landscape

Morris Chen, Robert Stanbrook, Chris Fagan | November 2024

Summary

Commercial Real Estate (CRE) Valuations Have Largely Bottomed

Investor sentiment has improved relative to last year; while negative headlines remain prevalent, we believe the worst is behind us.

As the market enters a cycle of normalization, opportunities have emerged for non-bank lenders to step in and strategically grow market share at attractive entry points.

Transaction Activity on the Rise

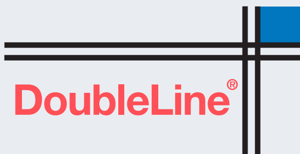
Over the past year transaction activity has increased as lending conditions have gradually loosened.

We believe there will be increased credit availability as the Federal Reserve transitions to rate cuts, leading to improving capital markets and ultimately a further loosening of credit standards.

Opportunities in CRE Whole Loans and CMBS Securitizations

We believe we are entering the most attractive environment for CRE lending since the Global Financial Crisis (GFC) for several reasons: a reset of CRE valuations, improved credit metrics, and a decrease of lending competition as banks are sidelined.

We also see attractive relative value in non-Agency commercial mortgage-backed securities (CMBS), as spreads across the capital structure remain wide of their longer-term averages.



Capitalizing on the Comeback

Why Credit Shines in Today's Commercial Real Estate Landscape

CRE Valuations Have Largely Bottomed

In February, we published a paper on the CRE market titled "It's Always Darkest Before Dawn." The thesis was simple: while higher borrowing costs, lower valuations and economic uncertainty contributed to recession-like conditions in the CRE market, we expected 2024 to mark a turning point in terms of transaction activity, property valuations and investor sentiment.

Our initial thoughts since the time of publishing have mostly come to fruition as several themes have emerged that lead us to believe the worst is behind us:

- Capital availability is improving via non-bank lenders and the non-Agency CMBS market.
- Rate hikes have transitioned to rate cuts, and with the expectation of lower expected borrowing costs, this should provide a backdrop for improved sentiment and greater conviction in underwriting assumptions.
- Property prices appear to have bottomed, and the opportunity to lend at lower valuations combined with generally healthy fundamentals bodes well for transaction activity to increase.

Increased transaction volume has led to greater price transparency and a gradual thawing of lending conditions. At the same time, property level fundamentals, outside of segments of the office market, have remained healthy. These factors coupled with the end of the rate hiking cycle give us confidence that the majority of CRE property values have bottomed. *(Figure 1)*

With property values trading at discounts relative to a few years ago, the risk-adjusted return profiles of loans originated today are particularly appealing. The decline in valuations has forced a rebalancing of capital structures, presenting a compelling entry point for lenders and debt investors as values have reset lower and borrowers are required to have more equity in the deal. *(Figure 2)*

As the market enters a cycle of normalization, opportunities have emerged for non-bank lenders with fresh capital to step in and strategically grow market share. While the normalization of CRE will likely proceed gradually, we believe opportunities will continue to emerge for investors ready to deploy capital. The best investments are often made during or coming out of down-cycles, rewarding those who can actively manage credit exposures when others are fearful.

Green Street CPPI®: All-Property Index | As of Aug. 31, 2024

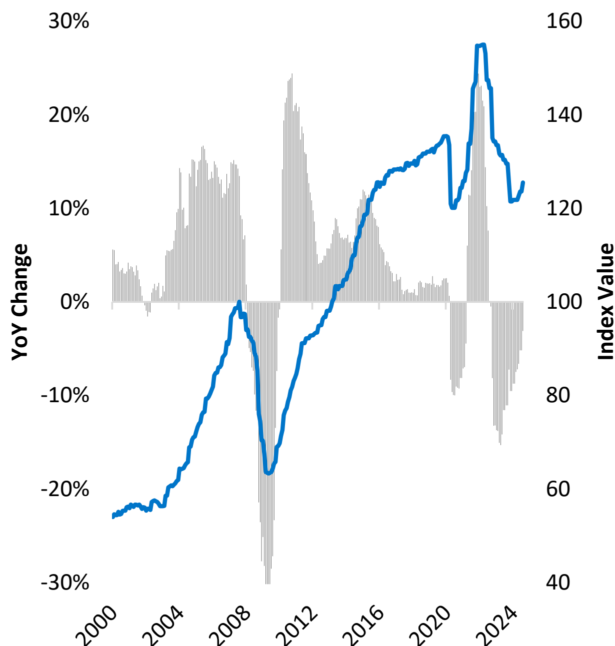


Figure 1
Source: DoubleLine, Green Street

CRE Debt and Equity Values | As of May 31, 2024

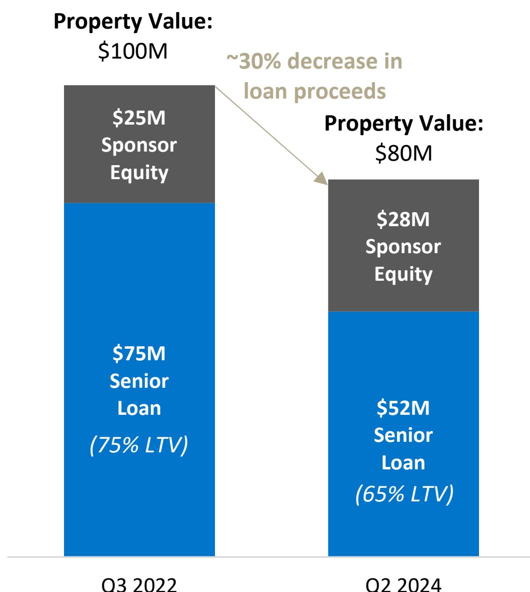
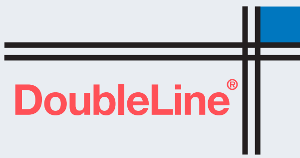


Figure 2
Source: DoubleLine. Information provided is for illustrative purposes only, subject to change. Figures presented are estimates.



Transaction Activity on the Rise

The increase in interest rates beginning in 2022, coupled with regional bank stress and tight lending conditions contributed to anemic transaction volume in 2023. However, we believe transaction volume has now bottomed. Interest rate cuts, and more importantly, lower borrowing costs and potential interest rate stability, provide a backdrop for greater conviction in underwriting assumptions for both lenders and borrowers. As a result, although lending conditions remain tight relative to pre-pandemic levels, we are seeing an increase in financing capital availability and a narrowing of bid-ask spread between buyers and sellers. *(Figure 3)*

Lending and Transactions | As of Jun. 30, 2024

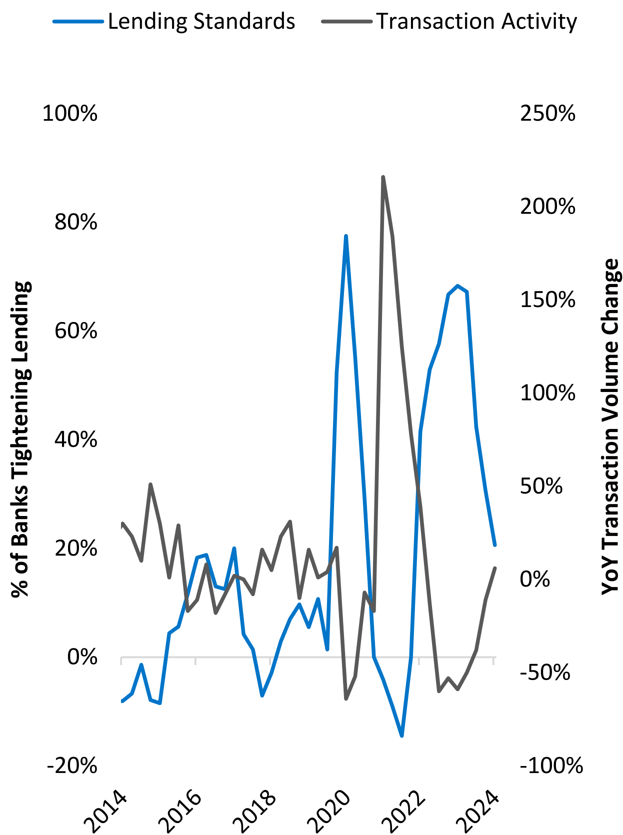


Figure 3
Source: DoubleLine, RCA, St. Louis Fed

We believe higher quality property types will be the first to trade, including industrial, higher-quality multifamily, trophy office, necessity-based retail and certain segments of lodging. As valuations for these higher-quality properties become clearer, we believe transaction activity will increase across a broader range of property types. Conversely, we expect non-trophy office to continue to trade by appointment with a more protracted path to normalization as differing views in valuations between buyers and sellers remains wide and price transparency remains uncertain.

As the interest rate outlook becomes clearer over the intermediate term, transaction activity should pick up and allow more borrowers to refinance. This should give investors a better feel for valuations, forming a feedback loop that begets additional transactions and, subsequently, greater clarity, which should lead to increased capital market activity and, ultimately, an easing of lending standards. Additionally, with approximately $2.8 trillion of loans maturing over the next four years, we believe this dynamic will force a significant subset of borrowers "off the sidelines" and into sales or refinancings.[1]

Examining the lender composition, banks, which have historically accounted for approximately one-third of CRE lending in the United States, are largely still on the sidelines.[2] While banks will likely remain active participants in the market, we expect their overall share of CRE lending to continue to decline driven by higher capital charges, tighter regulatory environment, and decline in loan payoffs within their loan portfolios. Similarly, many mortgage real estate investment trusts (mREITs) have remained on the sidelines driven by legacy issues and an inability to raise new equity capital.

Given this backdrop, we believe private lenders and the CMBS market can gain market share at attractive entry points, providing another avenue for loan availability, with active lenders in a position to potentially dictate more favorable terms.

Opportunities in CRE Whole Loans and CMBS

We believe we are entering the most attractive environment for CRE lending in over a decade for several reasons:

- Banks are pulling back from CRE lending, with loan growth having slowed to its slowest pace since 2015. Lenders now have more control over pricing and structure, positioning themselves as "makers" rather than "takers."
- Commercial mortgage rates remain near their highest levels since 2010, allowing lenders to achieve some of the highest yields in over a decade. *(Figure 4)*
- Lending standards have tightened significantly, with lenders now taking far less risk than they have in any period outside of the GFC and the COVID pandemic.
- CRE valuations have reset lower, creating a compelling entry point for investors as collateral values have adjusted downward. Borrowers are also contributing additional equity to rebalance capital structures.
- Transaction activity is restarting as the potential range of future interest rates narrows, leading to borrower capitulation at current mortgage coupons.
- A looming maturity wall presents an opportunity, as loans originated in the previous low interest rate and cap rate environment may struggle to refinance through traditional lending channels.

We also see attractive relative value in non-Agency CMBS. Spreads across the non-Agency CMBS capital structure remain wide of their longer-term averages. *(Figure 5)* We think senior portions of the non-Agency CMBS capital structure could continue to see modest tightening. Down in credit quality, we see the potential for spreads to narrow more meaningfully, particularly if borrowing costs continue to decline and CRE fundamentals exceed expectations. For more-seasoned bonds, mezzanine conduit paper could also enjoy meaningful spread compression, particularly to the extent lower yields translate into better refinancing prospects, less punitive extension assumptions, and more-benign losses.

Commercial Mortgage Rate | As of Aug. 31, 2024

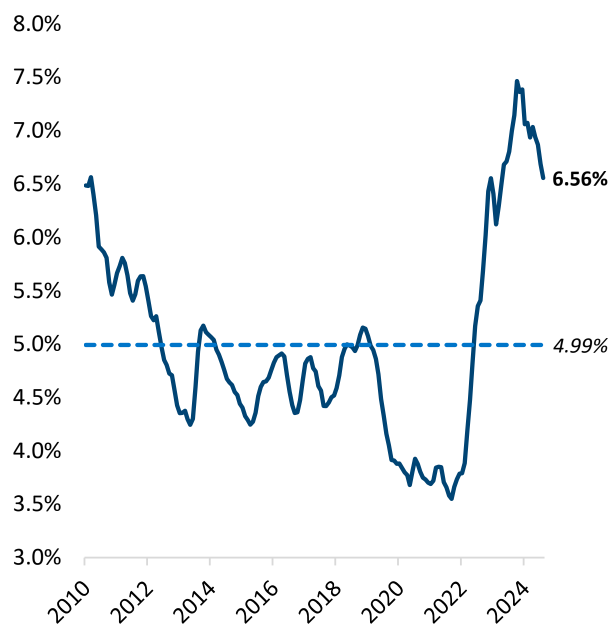


Figure 4
Source: DoubleLine, Real Capital Analytics.
Dashed line represents the average commercial mortgage rate.

Non-Agency CMBS Spreads | As of Oct. 31, 2024

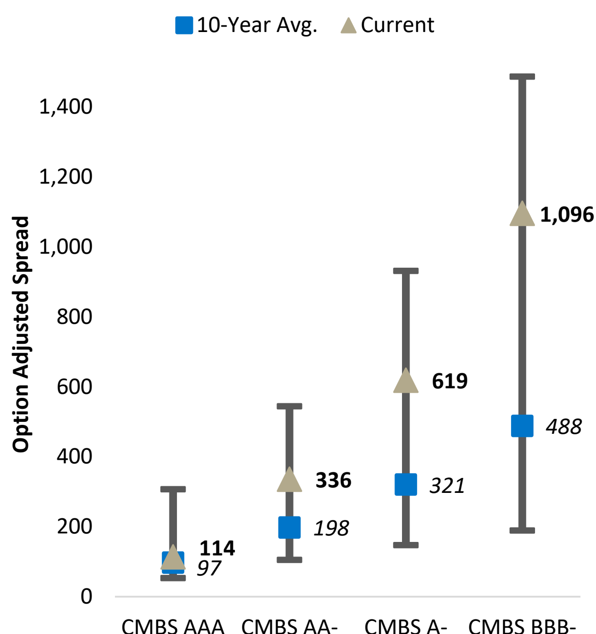
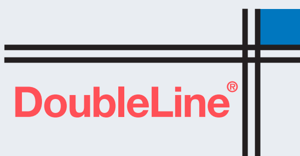


Figure 5
Source: DoubleLine, Bloomberg.
Black bars represent the range from Oct. 31, 2014 through Oct. 31, 2024.



Capitalizing on the Comeback
Why Credit Shines in Today's Commercial Real Estate Landscape

An Experienced CRE Team

DoubleLine's CRE investment team comprises experienced professionals with deep credit backgrounds spanning investments, originations, asset management, servicing and workouts. The credit expertise of our professionals is incorporated into the management of portfolios, providing extensive lending experience, in-house asset management, and investing across the capital structure and across all property types and domestic markets. The team believes that this insight and knowledge is a critical advantage that differentiates it from other investment managers and affords our team the ability to underwrite at a granular level and compare opportunities to manage portfolios through active investment selection.

DoubleLine's CRE team members have an average of 17 years of CRE experience and manage approximately $7.5 billion in CMBS and CRE debt in CRE-dedicated and multisector investment strategies and portfolios. DoubleLine's CRE team invests across the credit spectrum and capital structure; participates in CRE direct originations; and maintains deep working relationships with the industry's top CRE lenders, owners and operators. ■

About the Authors

Morris Chen
Portfolio Manager, Structured Products, CMBS

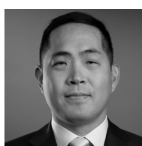
Mr. Chen joined DoubleLine at its inception in 2009. He is a Portfolio Manager, leading the CMBS/CRE Debt Investment team and CRE New Investment Review team, and is responsible for the oversight and management of all CRE debt-related investments at DoubleLine. Mr. Chen is a permanent member of the Fixed Income Asset Allocation and Structured Products committees, providing valued insight into the CMBS sector. He is also an active participant and speaker at CREFC events. Prior to DoubleLine, Mr. Chen was a Vice President at TCW, where he was responsible for CMBS credit analysis and trading from 2004 to 2009. He holds a B.S. in Business Administration with concentrations in Business Development and Finance from the University of California, Riverside.

Robert Stanbrook
Portfolio Manager, Structured Products, CMBS

Mr. Stanbrook joined DoubleLine in 2019. He is a Portfolio Manager responsible for the CRE loan platform as well as DoubleLine's CRE CLO portfolios. Mr. Stanbrook is also a CRE sector specialist on DoubleLine's Responsible Investment team, overseeing and monitoring the Responsible Investment integration framework for the CMBS/CRE team. Prior to DoubleLine, he was a Principal and Chief Credit Officer with Narrative Capital Management. Prior to that, Mr. Stanbrook was a Vice President at Colony Capital with day-to-day oversight of origination and underwriting for a $3 billion bridge lending platform. He began his career in Origination & Acquisitions roles at Karlin Asset Management/Calmwater Capital. Mr. Stanbrook holds a B.A. in Business Administration from Loyola Marymount University.

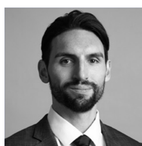
Christopher Fagan, CFA
Director, CRE Credit, Structured Products, CMBS

Mr. Fagan joined DoubleLine in 2016 as a CMBS/CRE Analyst and was later promoted to Director, CRE Credit. Prior to DoubleLine, he was a Vice President in the Real Estate Structured Finance group at Bank of America Merrill Lynch. Prior to that, Mr. Fagan worked in restructuring at Mesirow Financial and Seneca Financial. He holds a B.S. in Commerce with concentrations in Finance and Accounting from the University of Virginia. He is a CFA® charterholder.



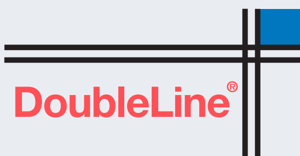
Mark Cho
Portfolio Manager, Structured Products, CMBS

Mr. Cho joined DoubleLine in 2013. He is a Portfolio Manager responsible for the CMBS credit platform and is part of the CRE New Investment Review team. Prior to DoubleLine, he was an Investment Associate at H/2 Capital Partners, covering a broad range of real estate credit opportunities. Prior to that, Mr. Cho worked in real estate acquisitions as a Director at Jamison Properties. He began his career as an Investment Banking Analyst at Lehman Brothers. He holds a B.A. in Economics from Stanford University and an MBA from the Wharton School at the University of Pennsylvania. Mr. Cho is a member of the Founder's Circle of Stanford Professionals in Real Estate (SPIRE).



Phil Gioia, CFA
Client Portfolio Manager

Mr. Gioia joined DoubleLine in 2018 and serves as a Client Portfolio Manager. In this capacity, he is responsible for communicating DoubleLine's macroeconomic views and portfolio positioning via client engagement, published market commentary and dedicated strategy content, with a focus on DoubleLine's Securitized Product strategies. Prior to DoubleLine, Mr. Gioia was an Investment Product Manager for Fidelity Investments. He holds a B.S. in Financial Management and Business Administration with a minor in Accounting from Salve Regina University, and he earned a certification for the Applied Data Science Program from the Massachusetts Institute of Technology. Mr. Gioia is a CFA® charterholder and holds the FINRA Series 7 and 63 licenses.



Capitalizing on the Comeback

Why Credit Shines in Today's Commercial Real Estate Landscape

Definitions

Agency – Refers to mortgage-backed securities (MBS) whose principal and interest are guaranteed by a U.S. government agency such as Fannie Mae (FNMA) or Freddie Mac (FHLMC).

Commercial Mortgage-Backed Securities (CMBS) – Securitized loans made on commercial rather than residential properties.

Conduit Loans – Type of loans, also known as commercial mortgage-backed securities (CMBS) loans, that are commercial real estate loans pooled together with similar commercial mortgages and sold on the secondary market. On the secondary market, conduit loans are divided into tranches based on risk, return and loan maturity.

Green Street's Commercial Property Price Index® (CPPI®) – This index is a time-period-specific series of unleveraged U.S. commercial property values that capture the prices at which commercial real estate transactions are being negotiated and contracted.

High Yield (HY) – Bonds that pay higher interest rates because they have lower credit ratings than investment grade (IG) bonds. HY bonds are more likely to default, so they must pay a higher yield than IG bonds to compensate investors.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as high yield (HY) or "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.

Loan-to-Value (LTV) Ratio – Assessment of lending risk that financial institutions and other lenders examine before approving a mortgage. Typically, loan assessments with high LTV ratios are considered higher-risk loans. Therefore, if the mortgage is approved, the loan has a higher interest rate.

Mezzanine Financing – Since commercial mortgage-backed security (CMBS) loans typically prohibit second mortgages, some borrowers use mezzanine financing to fill in the gap. Mezzanine financing, unlike a traditional second mortgage, is a hybrid of debt and equity that permits the lender to convert their debt into shares in the borrower's company in the case of a loan default. Therefore, the mezzanine lender sits between the CMBS lender and equity shareholders in terms of repayment priority, and is junior to the CMBS lender's claim on the company's assets.

Option-Adjusted Spread (OAS) – Measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option. Typically, an analyst uses U.S. Treasury yields for the risk-free rate. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.

Spread – Difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings or risk.

Endnotes

[1] Trepp

[2] BofA Global Research

Important Information Regarding This Material

Issue selection processes and tools illustrated throughout this presentation are samples and may be modified periodically. These are not the only tools used by the investment teams, are extremely sophisticated, may not always produce the intended results and are not intended for use by non-professionals.

Yield to maturity (YTM) does not represent return. YTM provides a summary measurement of an investment's cash flows, including principal received at maturity based on a given price. Actual yields may fluctuate due to a number of factors such as the holding period, changes in reinvestment rates as cash flows are received and redeployed, receipt of timely income and principal payments. DoubleLine views YTM as a characteristic of a portfolio of holdings often used, along with other risk measures such as duration and spread, to determine the relative attractiveness of an investment.

DoubleLine has no obligation to provide revised assessments in the event of changed circumstances. While we have gathered this information from sources believed to be reliable, DoubleLine cannot guarantee the accuracy of the information provided. Securities discussed are not recommendations and are presented as examples of issue selection or portfolio management processes. They have been picked for comparison or illustration purposes only. No security presented within is either offered for sale or purchase. DoubleLine reserves the right to change its investment perspective and outlook without notice as market conditions dictate or as additional information becomes available. This material may include statements that constitute "forward-looking statements" under the U.S. securities laws. Forward-looking statements include, among other things, projections, estimates, and information about possible or future results related to a client's account, or market or regulatory developments.

Important Information Regarding Risk Factors

Investment strategies may not achieve the desired results due to implementation lag, other timing factors, portfolio management decision-making, economic or market conditions or other unanticipated factors. The views and forecasts expressed in this material are as of the date indicated, are subject to change without notice, may not come to pass and do not represent a recommendation or offer of any particular security, strategy, or investment. All investments involve risks. Please request a copy of DoubleLine's Form ADV Part 2A to review the material risks involved in DoubleLine's strategies. Past performance is no guarantee of future results.

Important Information Regarding DoubleLine

To receive a copy of DoubleLine's current Form ADV (which contains important additional disclosure information, including risk disclosures), please contact DoubleLine's Client Services or visit our website at DoubleLine.com.

CFA® is a registered trademark owned by CFA Institute.

DoubleLine Group is not an investment adviser registered with the Securities and Exchange Commission (SEC).

DoubleLine® is a registered trademark of DoubleLine Capital LP.

© 2024 DoubleLine Capital LP

(813) 791-7333

DoubleLine.com

@DLineCap

DoubleLine-Capital