

CRE: Finding Value In A Misunderstood Market

COMMERCIAL REAL ESTATE (CRE) INSIGHTS – APRIL 2024



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KEY TAKEAWAYS

- > Investors are facing tougher portfolio management decisions as US public markets trade at rich valuations; re-examining market drivers for dislocations between perceived and actual risks could be a benefit
- > We believe the current CRE market is misunderstood by investors, as the secular shift negatively impacting the office sector is not the same headwind other major property types might face
- > Fundamentals remain generally supportive outside of office; lenders have been lowering leverage and tightening covenants on new deals, making it a more attractive entry point to CRE debt
- > Dislocation in the banking sector has caused banks – historically the largest of the four primary providers of CRE debt – to reduce their CRE allocations
- > We believe the middle market within Core Plus Real Estate Debt offers the most compelling opportunity today, but will require broker/borrower relationships and a repeatable, fundamental investment process

Investors face an interesting, and perhaps difficult, landscape as we move deeper into 2024.¹ US public markets have been rallying since the beginning of 2023, raising valuations to historically rich levels. Many investors have sought value in US private markets, but there is perhaps too much money chasing too few deals in private credit while the exit market remains challenged in private equity. Further, the secular headwinds in the office sector are a major headwind for all of CRE.

As a result, an investor will likely have to look deeper to find value. Even richly-valued or troubled asset classes can have idiosyncratic sources of opportunity. This is why bottom-up, fundamental investment philosophies exist. But one lesson we at PPM America, Inc. (PPM) have learned in nearly 34 years of investing on behalf of our clients, is that sometimes the market doesn't understand the entire story.

The CRE market mentioned above is a case study for this lesson today. Yes, the office sector continues to absorb the negative impacts of the work-from-home shift, resulting in excess supply and, in many cases, the inability of borrowers to recapitalize. However, the work-from-home shift has not been a major headwind for the other major property types. Lumping hotel, industrial, multifamily and retail in with office can camouflage potential CRE opportunities for investors.

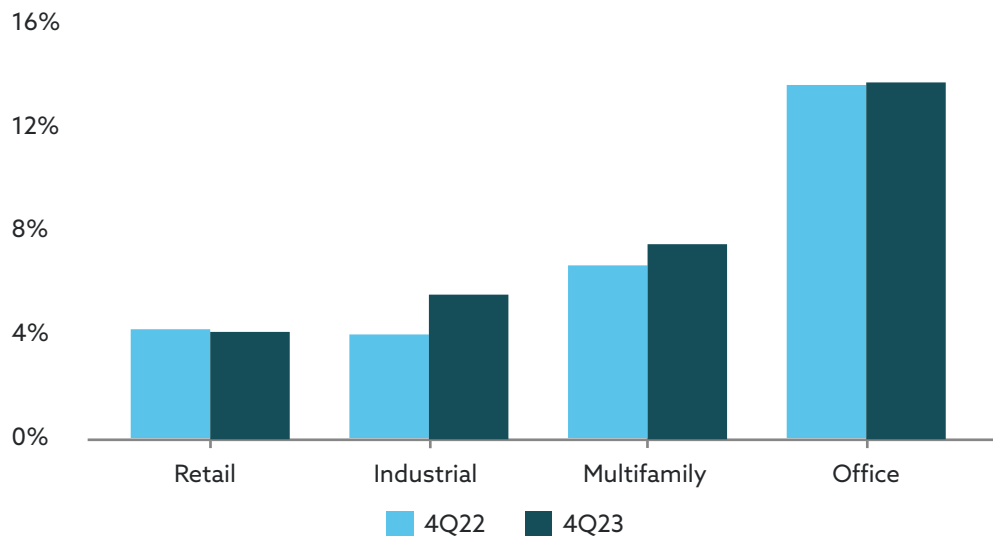
OFFICE VS. EVERYTHING ELSE

For CRE fundamentals, the issue is office, not necessarily everything else. The impacts of higher interest rates have been felt across property types, resulting in declines in Real Capital Analytics' (RCA) commercial property price indices (CPPI) for multifamily (-8.4% YoY through March) and Retail (-1.2%), though Industrial was up 5.7%.² Meanwhile, suburban office has declined 11.4% while central business district (CBD) office has plunged 33.2%. Headlines suggest all of CRE is in a free fall, but we have observed the work-from-home shift primarily affecting office. The other four major property types have seen rent growth slow but largely remain positive. And vacancy levels remain within historical ranges for multifamily and industrial, while retail is near a historical low (see next page).

Industrial and multifamily are still seeing construction, but demand remains and is absorbing the majority of that supply. We believe construction is nearing its peak and a slowdown in supply should boost industrial and multifamily fundamentals in the future. A similar trend played out in retail a decade ago. Investors in the 2010s expected prolonged weakness for retail, which resulted in limited new construction. Today, retail is enjoying stronger fundamentals as limited supply has led to low vacancy levels.

(1) As of 25 April 2024. Unless otherwise stated, the information presented has been prepared from market observations and other sources believed in good faith to be reliable. Information and opinions expressed by PPM are current as of the date indicated and are subject to change without notice. Past performance is no guarantee of future results. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. (2) Bloomberg. Year-over-year changes of the RCA CPPI Indices. Monthly data through 31 March 2024.

OUTSIDE OF OFFICE, VACANCY RATES WITHIN HISTORICAL RANGES³



We believe CRE valuations outside of office are nearing bottom. As can be seen in the chart below, this backup in valuations has brought with it higher yields for investors.

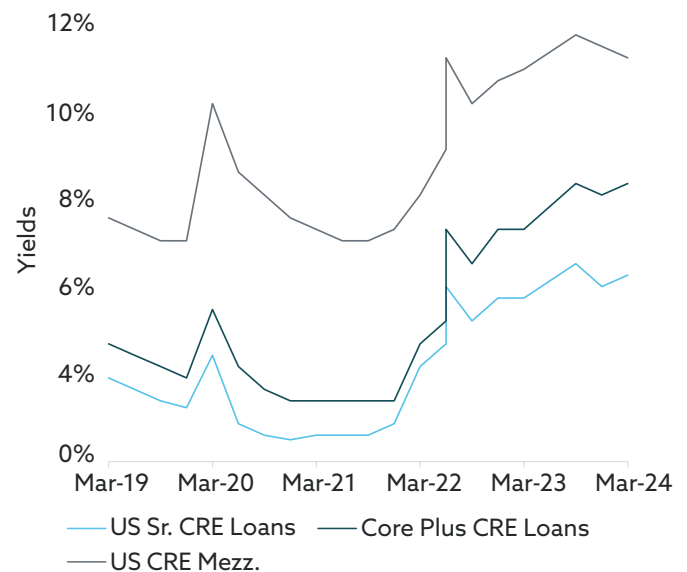
WHY CORE PLUS REAL ESTATE DEBT IN 2024

The combination of cheaper valuations and reasonable fundamentals in hotel, industrial, multifamily and retail make for a compelling investment story in 2024. In terms of return opportunities, CRE equity returns could prove to be higher, but CRE debt often brings lower volatility and overall lower risk due to downside mitigation features. Loans have credit enhancements in the form of sponsorship equity while the physical asset securing the loan may offer a secondary form of repayment in a downside scenario. In recent months, we have witnessed lenders pull back on leverage while getting better loan covenants and structure, making it an attractive entry point.

Given the increasing size of the market in recent years, maturities in 2024 are expected to rival 2023, which was the highest level on record. For borrowers, they face a wall of maturities that need to be recapitalized. But for lenders with money to put to work, these maturities offer a potential investment opportunity. There is over \$500M of debt maturing in 2024 alone (and more than \$2B from 2025 through 2028).

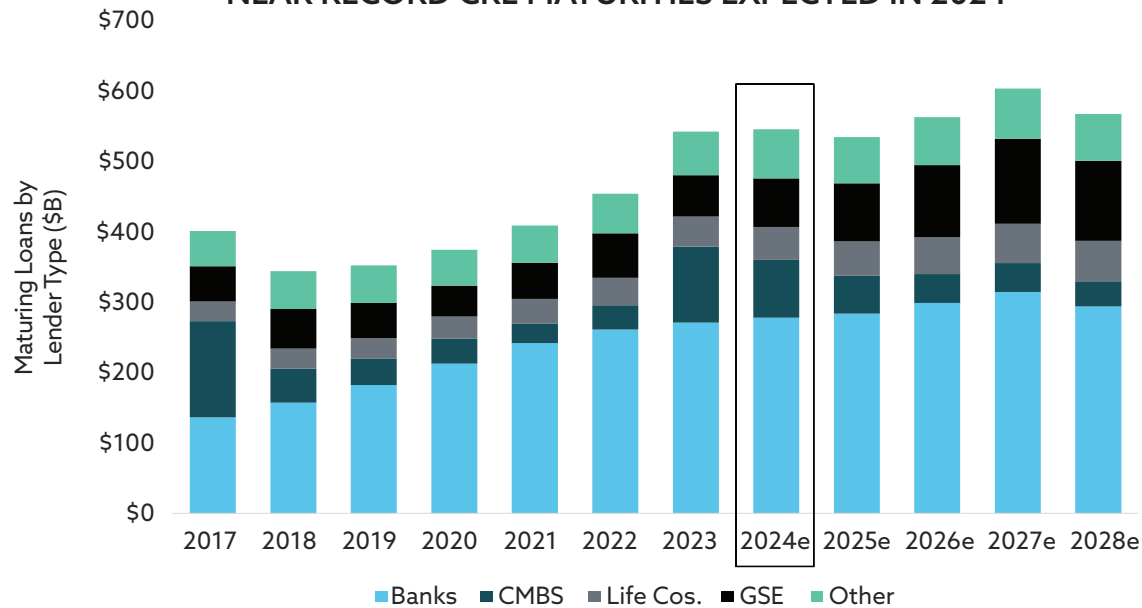
At the same time this maturity wall is generating high levels of demand for CRE debt, the supply side has been affected by potentially increased banking regulations. Regional lenders are facing stiffer regulations following the banking crisis in 2023, limiting the ability of these previously prolific lenders to be as active in the CRE middle market – exactly where PPM likes to operate.

AMID OFFICE-LED VALUATION DECLINE, CRE DEBT OFFERING HIGH YIELDS^{4,5}



(3) National Association of Realtors. 3 January 2024. (4) Bloomberg. Year-over-year changes of the RCA CPPI Indices. Monthly data through 31 March 2024. (5) As of 31 March 2024. CRE yields are calculated by PPM using third-party sources including Cushman & Wakefield.

NEAR RECORD CRE MATURITIES EXPECTED IN 2024⁶



WHY PPM

The current opportunity set in CRE debt brings the potential to invest at historically elevated yields and low loan-to-value ratios with tighter loan covenants. But we believe that elevated loan maturities require bottom-up due diligence to deliver potential investments benefits from fundamental drivers. To do this, an institutional investor can benefit from partnering with a manager that has the experience and capabilities to invest at this point in the cycle.

PPM has a 29-year track record of investing in commercial mortgage loans through multiple cycles.⁷ Our senior leadership team averages 26 years of real estate experience, complemented by long-term broker and borrower relationships in more than 50 markets. Our streamlined credit process has attracted middle-market relationships which have facilitated repeat business with borrowers (62% of new business over the last 10 years has come from repeat borrowers).⁸

Within our Core Plus Real Estate Debt Strategy (Strategy), we typically leverage middle-market loan sizes of \$10-50M to limit competition and generate additional yields. As part of our relative value philosophy, the Strategy focuses on primary and secondary growth markets with unmet financing needs due to disconnects between perceived and actual risks.

In a similar vein, we attempt to compete for CRE debt opportunities, whenever possible, on what we refer to as non-economic terms – structural flexibility, certainty of execution and speed of close. Said another way, we provide borrowers items that may add spread on the

investment without meaningfully increasing the risk. First, our experienced loan originators are able to offer borrowers flexible/creative deal structures. Second, with our entire CRE team based in Chicago, we can socialize investment opportunities with all key decision makers early in the due diligence process, leading to more certainty of execution and speed to close that we feel are among the best in the industry.

Finally, PPM has the DNA of an insurance company, having been founded by an insurer and with decades of experience managing a large general account.

- > A primary output of this DNA is heightened surveillance of Core Plus loans to identify macro and property-level risks.
- > A primary characteristic of the Strategy is overweight positions in defensive sectors such as multifamily, industrial and necessity-anchored retail. We favor these loans because they are often less capital intensive and tend to have more stable cash flows, leading to lower loss experiences over time.
- > We also aim to augment portfolios with hotel loans and what could be seen as recession-resistant property types – including self storage, student housing and life science – that can provide diversification and incremental yield.

We feel this defensive positioning and heightened surveillance will prove especially pertinent in today's CRE market. The current cycle brings high interest rates, a troubled sector (office) and the possibility of a US economic slowdown, but also great opportunity.

(6) Trepp, Inc. Based on the Federal Reserve's Flow of Funds data through Q3 2023. (7) As of 31 December 2023. (8) Average last 10 years ending 31 December 2023.

ABOUT PPM AMERICA

Our mission is to be seen by clients and their advisors as a consistently reliable partner to help them achieve their long-term value goals.

PPM is a US-based institutional asset manager with \$73.11 billion in assets under management as of 31 December 2023.⁹ Established in Chicago in 1990, PPM exists to consistently support institutional clients in achieving their

long-term value goals. We offer our Midwestern mentality of hard work, straight talk, full transparency and humility. Our success is supported by a team-based culture that encourages debate, collaboration and consistency. At the center of our belief is the fact that our best ideas to date have and can come from any team member anywhere in our firm. We believe the success of our investment culture is best demonstrated by the strong retention of our clients and investment professionals.

Past performance is no guarantee of future results. Investments involve varying degrees of risk and may lose value.

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(9) AUM includes committed but unfunded capital for PPM's private equity and commercial real estate businesses.

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