

CRE DEBT INVESTMENT KEYS TO HGI'S GROWING SEGMENT: HGI WHITE PAPER

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1. INTRODUCTION

Commercial Real Estate (CRE) debt is a pivotal driver of the real estate markets. According to the Federal Reserve, outstanding CRE debt totals over \$5 trillion as of the third quarter of 2023. Owners and developers employ mortgage financing for a host of reasons – acquisitions, recapitalizations, new development and renovation of existing properties. However, the landscape of CRE debt has been anything but stable in recent years. Since 2022, the markets have seen a spike in volatility, driven by rising interest rates, shifting market dynamics, and evolving investor preferences. As the CRE debt market continues to evolve, it is crucial for credit investors to understand the various types of debt instruments available and the risks and potential rewards associated with each, given the current state of the market.



2. TYPES OF CRE DEBT

Commercial real estate financing comprises a multitude of debt instruments catering to different risk profiles of the underlying property borrowers and the risk tolerance of investors. The following sections outline the primary types of CRE debt:

SENIOR MORTGAGE LOANS

Senior mortgage loans are the most straight forward real estate financing. The underlying collateral for the loans are usually stabilized, income-producing properties. These loans, which can range from 5 to 30 years in duration, offer relatively low interest rates due to their senior position in the capital structure.

They are generally non-recourse, meaning the borrower's risk of loss is limited to the property itself. One of the more common property types in the multifamily sector is the garden-style apartment community. These properties provide the most flexibility to people looking for housing at a price that matches their income in a location convenient to their needs.

CONSTRUCTION LOANS

Construction loans are a more speculative form of financing, used to fund the development or significant renovation of properties. These loans typically feature higher interest

rates, reflecting the increased risk associated with new construction, such as potential delays, cost overruns, and uncertainty about future lease-up rates. During the construction phase, these loans are often interest-only, with the principal being repaid upon project completion or refinancing. Given construction loans are not backed by existing, cash-flowing assets, lenders will require a holdback of loan proceeds in the form of an interest reserves to cover monthly interest payments until the property is cash flowing. Construction loans often have an element of recourse to the borrowers as well.

2. TYPES OF CRE DEBT (continued)



BRIDGE LOANS

Bridge loans serve as a temporary financing solution for properties in transition, whether due to renovation, lease-up, or repositioning. These short-term loans are often used by investors who need access to capital but are not yet ready to secure long-term financing. Like construction loans, bridge loans typically come with higher interest rates and shorter terms, reflecting the greater execution risk.

MEZZANINE AND PREFERRED EQUITY FINANCING

Mezzanine and preferred equity financing provides a layer of capital that sits between senior debt and common equity in the capital stack. These instruments are often used to fill the gap when senior debt alone is insufficient to meet a project's financing needs, as well as the equity holders' return thresholds. These instruments offer higher returns than senior debt, but due to the fact they are subordinate to senior debt, this layer of the capital stack is next in line to absorb losses in the event of a default after equity investors.

COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS)

Commercial Mortgage-Backed Securities (CMBS) loans came about following the Savings & Loan Crisis of the 1980s and provided a means for lenders to bundle individual loans into a pool and sell them as bonds to investors. A significant breakthrough in CMBS was the introduction of risk tranching. In CMBS, the cash flows from the underlying mortgages are divided into tranches, with each tranche representing a different level of risk and return. Higher-risk tranches offer higher yields but are first to absorb losses if borrowers default. Lower-risk tranches receive payments first and are more secure. This payment waterfall is referred to as sequential pay.

Within CMBS, there are agency CMBS securities by government-sponsored enterprises such as Fannie Mae and Freddie Mac. The K-Series CMBS are specifically sponsored by Freddie Mac and represent a significant part of the multifamily mortgage-backed securities market.

3. THE CURRENT STATE OF THE CRE DEBT MARKETS

To say the real estate capital markets have been volatile over the last few years would certainly be an understatement. The CRE lending environment has undergone a dramatic transformation, shaped by macroeconomic forces and sector-specific challenges.

Coming out of the COVID-19 pandemic, inflation spiked to levels not seen in the U.S. in forty years. In order to combat this inflation, the Federal Reserve aggressively moved to raise interest rates in 2022, resulting in a profound impact on the CRE debt markets. At the center of impact was the U.S. banking system. Banks hold approximately 50% of the outstanding CRE debt. However, the combination of rising rates and declining property values led to a tightening of lending standards, with over 60% of banks reporting stricter standards for CRE loans by mid-2023, according to the Federal Reserve. This level of caution is reminiscent of the early days of the COVID-19 pandemic and the height of the Global Financial Crisis.

For many property owners, the increase in interest rates has made refinancing existing debt more challenging, particularly for those with loans that are maturing in the near term. The cost of rolling over

debt has risen sharply, and some borrowers have found themselves unable to secure financing on favorable terms. This has led to a rise in loan extensions and modifications, as lenders and borrowers seek to avoid defaults. For the banks specifically, the increase in extensions/modifications may avoid defaults, but not being repaid also leaves less capital to redeploy to new loans causing a tighter lending environment.

In response to the tightening of traditional lending channels, there has been a noticeable shift towards alternative financing options. Private equity sponsored debt funds, mezzanine lenders, and other non-bank entities have stepped in to fill the gaps left by banks. These alternative lenders often offer more flexible terms but at a higher cost, reflecting the increased risk in the current environment. According to Green Street Advisors, CRE debt funds have nearly doubled in size over the last decade to \$125 billion at the end of the first quarter of this year with dry powder of over \$30 billion. While the \$100 billion of gross dry powder is a drop in the bucket compared to over \$1 trillion of CRE debt maturities over the next three years, according to Wells Fargo and Real Capital Analytics. If these funds are strategically focused on

impaired portfolios, and can help get those loans off of banks' books, the benefit could be significant for the industry as a whole.

The challenges over the last two years in the commercial real estate market have been painted with a broad brush. However, the CRE sector is not one size fits all; different sectors have faced varying levels of distress and opportunity. The two most notable sectors to see noteworthy dislocation has been office and multi-family.

- The office sector has been one of the hardest hit, as the rise of remote work has led to declining occupancy rates and reduced demand for office space. This has put pressure on property values and made it more difficult for office landlords to refinance existing debt.
- In multi-family, fundamentals remain sound, however, there has been dislocation in the markets stemming from acquisitions at the peak of the market with low interest rate debt. As the debt on these properties roll or interest rate swaps burn off, more properties are likely to see debt service coverage drop materially setting up a need to restructure the capital stack.





4. HGI'S CREDIT PLATFORM

Harbor Group International has leveraged its multi-decade track record of success as an owner and operator of multifamily and office investment real estate throughout the United States, to become a premier debt investor across commercial real estate. Given the current flux the market is in, it is more important than ever to employ a thoughtful underwriting process to understand the risk.

HGI's portfolio of credit and alternative investments fill out the entire capital stack, with an array of holdings, including:

- Agency Bonds
- Whole Loans
- CLOs
- Non-Agency CMBS Bonds
- SASB Bonds
- Preferred Equity
- Mezzanine Loans

With more than \$5 billion in these types of assets, HGI ranked no. 31 on Private Equity Real Estate's 2023 Real Estate Debt 50 list.*

Additionally, HGI leverages its credit platform to access data on more than 700,000 multifamily units throughout the U.S., helping the company inform decisions when it comes to both debt investments and direct equity.

HGI began diversifying into alternative forms of real estate and credit investments leading up to the financial crisis of 2008 with preferred equity investments and, during the crises, acquisition of CMBS bonds. When economic conditions tighten the market for direct equity, debt investment becomes a key alternative strategy that allows firms like HGI to participate in investments

on properties acquired by sponsors with qualified business plans.

HGI continues to expand its holdings in these segments, including credit investments in both multifamily and commercial properties, using its track record as an owner and operator to capitalize on what we believe to be the best opportunities available.



*Source: PERE Real Estate Debt 50 on May 2, 2023, based on the amount of capital raised for the purpose of real estate debt issuance by firms between January 1, 2018 through December 31, 2023.

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HARBOR GROUP INTERNATIONAL, LLC

HGI and its affiliates control an investment portfolio of ~\$20 billion¹ including 5 million square feet of commercial space throughout the United States and the United Kingdom and 58,000 apartment units² in the United States. In addition to its corporate headquarters in Norfolk, Virginia, HGI maintains offices in New York City, Baltimore, Los Angeles, and Tel Aviv.



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Certain statements made herein reflect the subjective views and opinions of HGI and its personnel. Such statements cannot be independently verified and are subject to change.

¹Total capitalized value of underlying assets of \$20 billion includes direct real estate and private funds as of 12/31/2024. AUM represents the total capitalized value of underlying assets, which includes direct and indirect real estate and real estate related investments, and the AUM of HGI's affiliate, HGI Capital Management, LLC.

²Multifamily units total includes multifamily preferred equity investments.