Real Estate Debt Funds Aim to Be Players on Opportunistic, Distressed Strategies

The path is paved for real estate debt funds to get into the mix with more opportunistic plays, including in the office sector.

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With trouble roiling the banking sector, attention has turned to real estate debt funds to pick up market share. And indications that some of the funds will focus on opportunistic and distressed plays, which could be a welcome source of capital for office owners that may struggle to find alternative refinancing sources.

In all, 78 real estate funds closed and raised $20.6 billion in the first quarter, according to Preqin, down 42.6 percent and 64.5 percent, respectively, from the prior quarter. In all, 26 percent of closed-end private real estate fundraising used real estate debt as its primary strategy, and debt made up of 17 percent of closed-end private real estate assets under management, according to Preqin. In addition, 38 percent of real estate investors in a PERE survey said they will target real estate debt over the next 12 months, an increase from 18 percent in the first quarter of 2022. In all, real estate debt funds focused on North America have raised over $111 billion since 2018, according to Preqin.

“This suggests some real estate debt funds are targeting distressed real estate vehicles with higher default risk,” said Alex Murray, vice president of research insights at Preqin. “Many of these higher return-targeting debt funds will be conscious of the possibility of securing assets at discount, if equity subsequently walks away.”

Austin-based Palladius Capital Management, a diversified real estate investment manager with around $600 million in assets under management, is one of those players hoping to provide a solution to those in need of financing while expanding its debt business.

In September 2022, the firm announced it is seeking to raise $300 million for real estate debt investments across the United States. So far, the firm has raised around $100 million and hopes to reach its target over the next 18 months, according to Marko Velazquez, senior managing director at Palladius.

“Right now is actually the perfect time to be in this business because of the negative headlines that you're seeing out there in the mainstream media—part of it is actually true,” Velazquez said. “And so, you want to be able to step in when the larger

institutions and/or the regional banks are unable to underwrite rescue capital situations, which is where we come in."

"The loans the firm are seeking typically have a return of at least 9 percent, according to a source familiar with the firm. It is raising capital from HNW individuals and family offices and structured under rule 506b

The office sector is the target of many of the negative headlines these days, as workers in the U.S. have not returned to their cubicles and commutes in droves post-pandemic. The tech sector has also seen waves of layoffs in recent months, and many employers have cut back on their office leases.

At the moment, that stress has not worked itself through the system yet and there hasn't been an opportunity to resolve it, noted Stephen Buschbom, research director at research estate data firm Trepp. Partly, that's been because the market is waiting for the resolution of the lingering bid/ask gap that led to a major slowdown in transactions in recent quarter.

"At the end of the day, one thing is abundantly clear: it's going to take capital, recapitalization for some of these properties to get to the other side. But nobody wants to commit capital without knowing where values are headed because we're still a very long way off, is the general consensus, from the trough," said Buschbom.

Not everyone has run away from the office sector

Boca Raton, Fla.-headquartered Morning Calm Management, a fund sponsor and an operating company that focuses on industrial and office assets, is one firm that sees troubles in the office sector as a potential opportunity.

The company recently announced it launched a $500 million joint venture to target office financing deals, specifically in larger metro areas and valued at $25 million and up.

"Our view is things always get thrown out with the bathwater," said Mukang Cho, CEO and managing principal of Morning Calm. Of course, not every office loan will be able to secure refinancing or find a buyer, Cho noted. "But I think that we, having been in the business for many, many years and having owned millions of millions of square feet of office assets in 10-plus states, our view is that we've got the experience and the expertise to be able to assess, underwrite, mitigate and manage risk better from the standpoint of office."

However, while some firms might be waiting to capitalize on office distress, it's multifamily properties that are likely to experience more interest from the debt funds, according to Buschbom. He doesn't expect to see a large volume of distress in that sector, but "what pockets you do see in the multifamily space I would suspect are going to be very attractive opportunities because, by and large, the asset class is forecast to perform very well," he said.

The vehicle is a JV between the firm and a global investment manager with $50 billion in AUM.

Nuveen, the asset investment management arm of TIAA, has shifted its tactics, particularly as the markets have become less liquid and interest rates remain high.

“At a high level, tactics change,” Hernandez says. “But strategy doesn’t.”

While last year, Nuveen looked at deals in the range of $75 million to $200 million, Hernandez says now it’s looking more at the $30 million to $75 million space, which means targeting more alternative asset classes—like manufactured housing and self-storage deals—that can be aggregated.

Still, the full fallout from the collapse of Silicon Valley Bank and cost-cutting measures ahead of an impending recession have yet to be felt in full, making uncertainty the name of the game for the time being.

“There's still a concerningly large percentage of the market that I think will be pulling back from commercial real estate lending. And that impact has really yet to be felt in full,” Buschbom says.

And it’s unclear what effect this all will have on commercial real estate valuations, particularly in the challenged office space.

“I think we'll continue to see this trend of loans coming to maturity, being unable to refinance and some just ‘extend to pretend,’ a holding pattern purgatory, if you will,” Buschbom says. “What will be very critical to watch as we enter the back half of the year is some of the distress that come into the system once we start getting revaluations that take a couple of months.”

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