

## KEYNOTE INTERVIEW

# Discipline and innovation: The future of CRE debt



*Real estate debt investing is evolving to tackle market pressures and challenges, say Kayne Anderson's **Albert Rabil** and **Lee Levy***

Since the global financial crisis, real estate debt has undergone a fundamental transformation. The landscape once dominated by the world's biggest banks has evolved into a sophisticated market of well-capitalized investment managers.

Albert Rabil, Kayne Anderson CEO and co-founder of Kayne Anderson Real Estate, and Lee Levy, head of real estate debt, break down how the post-GFC regulatory environment has fueled a more disciplined, efficient and resilient debt market. Sponsors who own over-levered assets that are also constrained by debt service payments are increasingly relying on innovative deal structures from alternative lenders

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like Kayne Anderson to recapitalize their deals.

**Q How has real estate debt investing evolved over the past decade, and what are the most significant structural changes you have seen?**

**Albert Rabil:** The primary thing is the institutionalization of real estate debt markets. It's a massively larger asset class that has become not only accepted but highly sought after by large institutional investors in the form of private

equity and in private credit fund managers. We've also seen market share of direct real estate lending shift to alternative lenders from banks, a trend that will continue. Those are the two largest changes.

**Lee Levy:** The regulatory changes that occurred post the GFC created a structural change in direct lending for commercial real estate. Much of that stems from the Dodd-Frank Act, which pushed banks to carry increased amounts capital to provide liquidity in times of market dislocation. The Act, along with Basel III, has had the intended effect of moving direct lending off bank balance sheets.

Over the last 10 years, we have seen banks shift from being primarily focused on direct lending to indirect lending to alternative lenders. That's spurred an influx of capital into private equity, with banks stepping in as shadow lenders – effectively lending to the lenders. This has enabled private equity funds access to back leverage, helping drive strong risk-adjusted returns while keeping the risk off the balance sheets of banks.

## **Q You mention being in a post-GFC world. How does today's environment compare with previous cycles?**

**AR:** It's not a static environment. Look at the delinquency for the banking sector, which sits at 2 percent today versus close to 10 percent during the peak of the GFC. A wall of maturity lies ahead, but it's unlikely to reach 10 percent thanks to greater investor discipline. Private equity has filled the void through creativity, not by pushing LTV, but by satisfying what sponsors are looking for, while having appropriate risk-adjusted returns.

LPs are increasingly focused on the capital stack. Over the past three to five years, many have found debt investments to be more compelling than equity – and for good reason. The same trend is evident in private credit, where strong LP demand has created a natural pull toward debt markets. This isn't just private equity platforms making the shift; it's also LPs signaling clearly that debt is where they want to be.

The summary is that we are in a far better place than pre-GFC. It's almost apples and oranges. The sophistication and the way things are structured, combined with the historical perspective, have helped make this business far more efficient.

**LL:** The kind of sponsorship that owns real estate today is different than the days when many institutional owners were public REITs with limited access to new capital. There is currently over

## **Q What innovative financing structures or strategies are gaining traction?**

**LL:** We're seeing more structures with payment-in-kind (PIK) components. Debt service is an issue for sponsors who financed their assets with floating rate debt. We can defer some of that interest and are making a bet that when the asset stabilizes that we're at a comfortable LTV and debt yield when accounting for our stepped-up basis from the PIK structure.

It's kind of a throwback. It's about getting creative around loan structure and economics to take the pressure off the asset today and bet on its property level performance in the future. You end up getting paid more but shifting when you receive those dollars. Often sponsors are contributing fresh capital which provides us with an alignment of interests while providing flexibility for the sponsor to complete their business plan.



\$300 billion of dry powder in closed-end real estate funds spanning equity and debt. That is three times the size it was 10 years ago.

You now have a well-capitalized investor base with a tremendous amount of dry powder versus the capital formation that existed pre-GFC. When you have that type of liquidity and scale, you can do more things. We're financing newly built assets that are in various stages of lease-up as well as new development projects given our in-house development expertise. Leverage levels remain well below what we saw before the GFC.

## **Q What is driving the institutional capital toward real estate credit, and**

## **how sticky is that demand?**

**LL:** It's sticky. I think institutional LPs view real estate credit as not only an alternative to core equity investing but as another fixed income sleeve with which they can invest in. We are delivering 400-500 basis points over risk-free rate, in a senior secured first lien position in the capital stack with 20-30 points of subordinate equity capital.

That's very compelling from a risk/reward perspective. Real estate credit is now well understood by LPs and it's an asset they want to be in when compared to other fixed income products or core equity.

## **Q How is that capital being allocated and which regions or sectors are**

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### presenting the most attractive risk-adjusted opportunities?

**AR:** Generally speaking, our focus is on medical office, senior housing, student housing, light industrial and multifamily. There are lots of pockets of returns in these sectors. We also like a multi-sector approach and, with the exception of multifamily, we look at focused alternative sectors.

Part of the reasoning is that we have deep, strategic expertise in these asset classes. They’re differentiated, not commoditized – and we’re still in the early stages of capital rotating into our sectors of expertise.

It’s a challenging market. Tariffs, construction costs and interest rates

create uncertainty, which creates a challenging environment. That said, we are in demographically driven sectors that are supply constrained with excess demand and relatively few competitors.

There are far fewer players and less interest in alternative sectors. I say that I want to be able to be 10 percent wrong and still be right, and you do that by being in high growth sectors that we invest in.

Take healthcare, for example. Today and over the next 20 years we will continue to see a massive aging population, and since most healthcare needs occur later in life, demand is escalating far faster than supply. In senior housing the average stay is just 22 months – this isn’t a 20-year net lease, it’s a 24/7 business. Underwriting those dynamics requires differentiated operating capabilities and having that expertise creates a stronger chance of generating outsized risk-adjusted returns.

**LL:** On the credit side, we take the same approach as on the equity side in terms of the sectors we invest in. For multifamily, one of the areas we focus on are the Sunbelt states, though there’s a clear bifurcation.

Some markets, like Austin, have strong long-term fundamentals but have seen rent growth wane due to recent oversupply. Other markets we invest in have weathered new supply with outsized tenant demand.

In student housing, we focus on universities with growing enrollment at large primary state schools targeting assets that are walkable-to-campus. The sector continues to exhibit resilient and countercyclical performance.

### On the flip side, where do you see the biggest risks?

**LL:** The oversupply of office is the easy answer, and it started before covid. The conversions to creative office were a way to address the shrinking of traditional office footprints, and then came coworking. Office owners handled the

oversupply of office by recreating traditional office space into something else. This came to a head in the pull back in tenant demand post covid.

The life sciences market similarly has suffered both from an excess of new supply drive by new entrants into the sector and a material slowdown in tenant demand leaving many life sciences markets with substantial vacancy and an inability to push rents.

The other thing is multifamily built or acquired at height of the market between 2021 and the first half of 2022. Many of the assets from this vintage are over-levered and are under debt service pressure. We’re seeing stress both in the broader market and among sponsors with undercapitalized balance sheets. Owners and operators are being stretched to meet margin calls, buy rate caps or pay down loans, and this subset of the multifamily market are showing cracks.

### Looking ahead, what does the next chapter in CRE debt investing look like?

**AR:** I see private equity continuing to grow market share. Despite the fact that we are experiencing a more business-friendly regulatory environment, I don’t see banks regaining their previous positioning due to private equity being more responsive and having plenty of dry powder.

**LL:** We’ll continue to see growth in single-asset single-borrower commercial mortgage-backed securities as an effective way to finance public companies and financial sponsors who seek the efficiency of the securitization markets. Life insurance companies will continue direct lending and increasing their exposure to real estate debt as LPs in debt funds. Their regulatory framework makes that valuable for them.

Ultimately, real estate debt platforms like ours will continue to capture market share while providing flexible solutions to sponsors and delivering durable risk-adjusted returns to investors. ■