ThirdLine Capital

The Case for Private Real Estate Credit

A potentially worthy portfolio addition to support low-volatility income goals

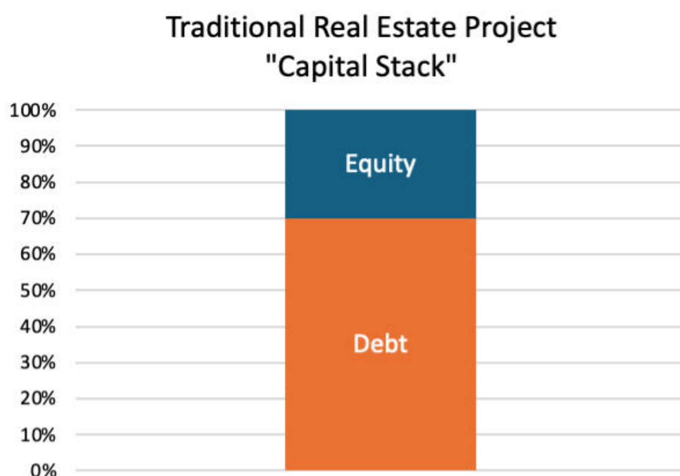
by Charles Hutchens
January 30, 2025

What is Real Estate Credit?

To understand real estate credit as an investment, one must first understand how real estate projects and property acquisitions are typically funded. Securing the funding for a real estate project is performed by a project developer or purchaser (the "sponsor") who also generally oversees the project until the asset is sold. Overseeing the project may involve, among other things, hiring the design and construction teams, and/or hiring the leasing agents and property managers to oversee the leasing and collection of rents. The sponsor generally contributes some cash into the project, but the amount is often a small portion of the overall project cost (e.g., less than 10% is common)[1].

Given that the project sponsor may only be contributing a small amount of the total project cost, they must procure other sources of capital. The investments into a given real estate project may be structured as either "equity" where there is partial ownership of the real estate asset or "credit" where a lender may use the real estate asset and/or equity position as collateral but does not own the asset. The overall pool of capital that is raised to fund a given project is often referred to as the "capital stack." Historically, it was common for the capital stack to consist of only two parts – the equity, contributed by the sponsor and other investors, and a large senior loan (as shown in the figure below).

The Historical Approach vs. The Current Approach

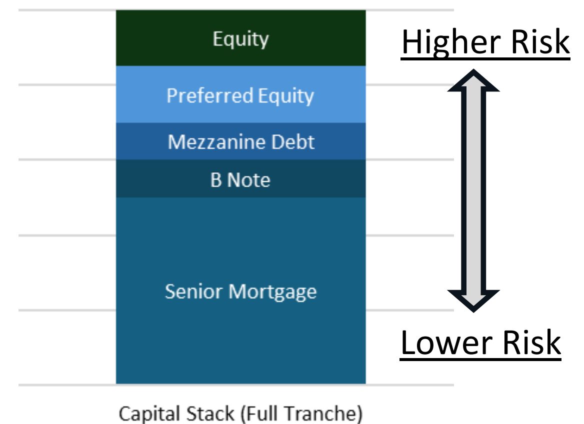


Equity: Collectively, owners of the real estate asset. Equity holders receive all proceeds upon sale after repayment of debt.

Senior Loan: A loan typically provided by a bank or life insurance company depending on the profile of the real estate asset. The loan interest is determined by a spread over SOFR or US Treasury yields.

Recently, a larger percentage of private lenders (e.g., private investment funds, closed-end interval funds, family offices and others) have entered the real estate lending market. In some cases, these participants fully replace a traditional banking relationship and in other cases, they provide a supplemental form of funding. Below is a picture of the capital stack showing structures that are used to fund real estate projects. This diagram is for illustrative purposes to show risk rankings. A single deal may use all these forms of funding, though that is typically not the case.

The additional "tranches" of funding that have become more prevalent recently are generally the result of banks having less appetite for real estate lending. While banks may have previously provided up to 70%-75% of a real estate project's cost, that amount is now more typically in the 50%-60% range[2]. Sponsors have been left to find other sources to fill the gap in funding and, in lieu of additional equity capital, they often choose private lending structures. To delve deeper into the investing opportunity, let's look at some of the key characteristics of the various segments of the capital stack.



Defining Types of Real Estate Investments

- *Senior Debt (A-Tranche)* – As the name suggests, senior debt is in the lowest risk position of the capital stack. Generally, a senior loan holder has several rights that protect it from a loss of capital. For example, the following statements are generally true regarding senior loans:
    - The deed of trust is held as collateral.
    - Upon a sale, default or at maturity, the lender must be made whole (i.e., receive full repayment of the principal & interest) before other investors are paid.
    - Its position in the capital stack cannot be changed.
    - The lender has approval rights over other lenders being added to the capital stack.
    - The loan has a stated interest rate and maturity date.

- *Senior Debt (B-Tranche)* – Often a senior loan will be divided into tranches with different interest rates based on risk (i.e., order of preference in repayment). While these tranches are paid after the "A-Tranche", they are generally still secured by the deed of trust on the asset.

- *Mezzanine Loans* – Mezzanine loans are structured as traditional loans, but they are repaid only after the senior debt lender has been repaid. Rather than being secured by the first deed of trust, they are secured indirectly by the asset value, and the equity investors must lose all their capital before these loans are impaired.

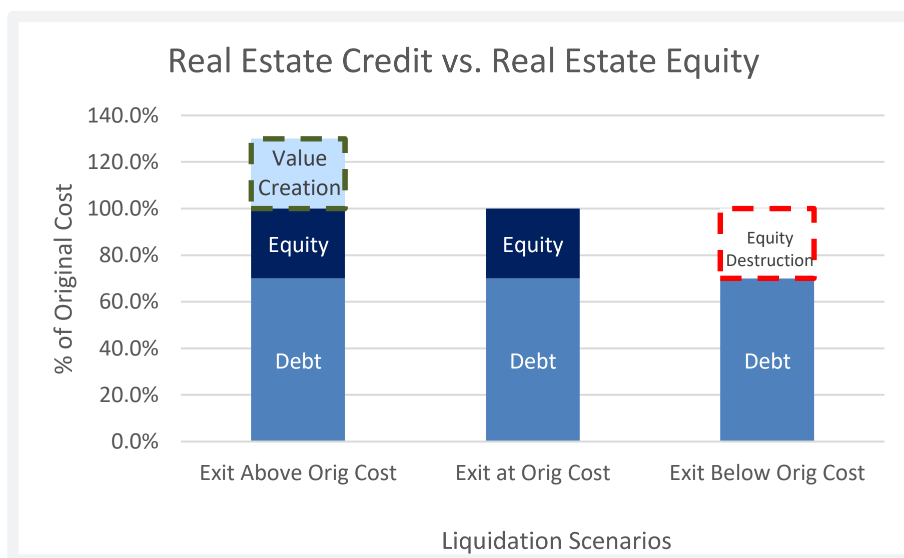
- *Preferred Equity* – Preferred Equity is a priority ownership class that, depending on the terms of the structure, Thirdline Capital considers a form of "credit." Like mezzanine loans, preferred equity investors generally receive an interest payment that is computed as a percentage of the cost basis of the investment. Moreover, these investments can have a maturity date that requires repayment or automatic restructuring. And, like the other credit structures, they have a right to repayment of capital before common equity investors.

- *Equity* – Equity investors generally receive payments after all other investors receive their required payments. Frequently, equity investors require a sales transaction or a significant debt restructuring to realize a return. For this reason, equity returns are frequently "backloaded" with most, or all, of the gains realized upon the asset sale. Unlike other investors, equity investors generally require capital appreciation of the asset to achieve target returns or they need to hold the asset for a considerable length of time.

The dependence on capital appreciation and backloading of the return are key risk factors that, in our view, materially separate equity from credit investing on the risk spectrum.

Real Estate Credit vs Real Estate Equity (Income Focus)

Credit investments are a better choice for investors seeking income and low volatility. We caution investors against cash flowing equity investments selling themselves as income tools, as there can be unappreciated downside risk along with less reliable income generation. Credit investors are mainly seeking a return of capital along with interest payments and the return of capital is backed by a real estate asset that, at the inception of a deal, will always exceed the loan amount. Moreover, credit investors are buffered by the equity investors who must endure a 100% loss of capital before credit investors are impaired. Credit investments can realize their desired returns without the real estate asset's appreciation, and even with project equity losses, therefore a much broader range of deal outcomes can provide the credit investor with its full expected return. To the right is a simple example showing the sensitivity of equity investments to price changes relative to credit. In this simple example, we assume that 30% of the contributed capital is equity.



In all presented cases the debt investor's capital plus interest is returned. In only the upside scenario is the equity returned plus a profit, and in the downside scenario the equity is lost entirely. While we believe real estate equity investing can be a good choice to enhance portfolio growth, real estate credit is a far superior tool for one seeking asset stability and reliable dividends.

The Case for *Middle Capital Stack* Real Estate Credit Investments

While credit investments throughout the capital stack are superior income tools to equity, we believe investing in the middle portion of the capital stack provides the most attractive risk-adjusted returns in the real estate credit market. The middle section includes Senior B-Tranche Loans, Mezzanine Loans and Preferred Equity. We point to the following two factors as reasons that the middle of the capital stack is likely to produce the greatest risk-adjusted return.

- *Equity Buffers* – A big driver of risk for real estate credit is determined by a loan's position relative to the real estate asset's value. (i.e., the loss threshold at which a loan becomes impaired). Whether one is investing in the B-Tranche of senior credit, mezzanine loans or preferred equity, these structures can be obtained with loan-to-value ratios, or the investor's "last-dollar-risk" at 50-70% of the real estate assets value, thereby providing a 30%, or more, "buffer" (i.e., required real estate asset value reduction) before the loan investor's capital is at risk. Moreover, if one is adept at vetting real estate assets for valuation stability, they can manufacture less risk than the numbers suggest. While senior loans may have lower loan-to-value ratios, other forms of thoughtfully structured real estate credit can also provide attractive equity buffers that insulate the credit investor from losses.

- *Return Premiums* - Returns in the middle portion of the capital stack are materially greater than returns on senior debt. For example, the spreads on senior real estate exchange-traded loans are generally below 200 basis points[3], while our experience indicates that private mid-capital stack credit structures can generate 500-1,000 basis points above SOFR or US Treasury yields, while maintaining 30%+ equity buffers. We generally believe that thoroughly vetted and well-structured middle capital stack investments provide relatively greater yield increases than risk increases and therefore can produce attractive risk-adjusted returns relative to senior loan investing.

In summary, income seeking investors may be well-served to consider gaining investment exposure to private real estate credit, especially the middle portion of the real estate capital stack. As banks have retreated from real estate lending, bank loan-to-value ratios have fallen thereby providing a compelling opportunity for private real estate lenders. Private deals structures can provide high yield premiums relative to risk thereby creating the potential for attractive risk-adjusted returns. In our view, an increasing number of portfolios may find private real estate credit's return profile supportive of their goals.

About the author

Mr. Hutchens is Co-Founder and Managing Director at Thirdline Capital, an investment advisor and manager of a real estate credit interval fund and other private real estate investments. Prior to Thirdline, Mr. Hutchens spent over 15 years at The Holladay Corporation, a Washington, DC-based real estate investment and development firm, where, in his various roles, he led acquisitions, financings, construction projects, and asset management. He spent the two years prior in Walker & Dunlop's capital markets group.

Notes

1. *The Overland Group, a real estate developer & property manager, reports that approximately 10-25% of the equity commitment is generally made by the sponsor. So, in a deal with an equity investment equal to 40% of the overall costs (a plausible upper bound), this corresponds to a 4-10% sponsor commitment. These figures correspond with Thirdline Capital's own experience.*

2. *This data is supported by the Federal Reserve Bank's Senior Loan Officer survey data which shows significant tightening of CRE lending standards since 2018-2019. Data represents anecdotal observations obtained from Thirdline Capital's own deal experience and market observations, as well as bank loan officer interactions. It is notable that one of Thirdline Capital's directors, Edward Phillips, spent over 20 years in the commercial banking and remains well-connected in the industry.*

3. *Trepp, a provider of data on the CRE lending market, tracks & reports changes in spreads by risk (loan-to-value).*

IMPORTANT DISCLOSURES

This research paper is prepared by and is the property of Thirdline Capital Management, LLC ("TLCM"). No part of this material may be copied or duplicated in any form without the prior written consent of TLCM. This material is circulated for informational and educational purposes only and is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned. There is no consideration given to the specific investment needs, objectives, or tolerances of any of the recipients or, in the case of financial professionals, of their clients.

The investments made by TLCM on behalf of TLCM clients may, and often will, vary from its conclusions discussed herein based on any number of factors, such as client investment objectives, investment restrictions and tax considerations, among others. Investors and financial professionals should consider whether any advice or recommendation in this research is suitable for their, or their client's, particular circumstances and, where appropriate, seek professional advice, including legal, tax, accounting, investment, or other advice.

Past performance is not a guarantee of future results, and it should not be assumed that any of the strategies discussed will be profitable. TLCM makes no representation that any investor will or is likely to achieve returns like those shown. The price and value of the investments referred to in this research and the income therefrom may fluctuate. Every investment involves risk and in volatile or uncertain market conditions, significant variations in the value or return on that investment may occur.