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# NAVIGATING SHIFTS IN THE MARKET:

## Private Credit's Strategic Role in Commercial Real Estate Lending

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# INTRODUCTION

As we conclude 2024, it's prudent to assess the current market conditions and how they impact different investment strategies within real estate. The U.S. economy has shown remarkable resilience despite challenges including high inflation, rising interest rates, geopolitical instability, and ongoing supply chain disruptions. This paper aims to provide actionable insights into navigating the current real estate investment landscape, focusing on opportunities within private credit and resilient sectors like industrial and multifamily real estate. As market dynamics evolve, understanding these shifts is crucial for making informed investment decisions.

**Key Takeaways:**

- Overview of the current economic and market trends impacting real estate investments.
- Deep dive into the private credit landscape and its strategic role in commercial real estate.
- Insights into high-performing sectors such as industrial and multifamily real estate.
- Key considerations for navigating market volatility and identifying investment opportunities.

# ECONOMIC BACKDROP

The current macroeconomic backdrop is one of ongoing fiscal stimulus, labor shortages and heightened geopolitics but generally one of gradual moderation which points to a “soft landing”. In the third quarter of 2024, the U.S. economy grew at an annualized rate of 2.8%, signaling resilience amid global economic uncertainty. Continued growth, increased consumer confidence, and moderating inflation have boosted optimism about the U.S. economy avoiding a recession.

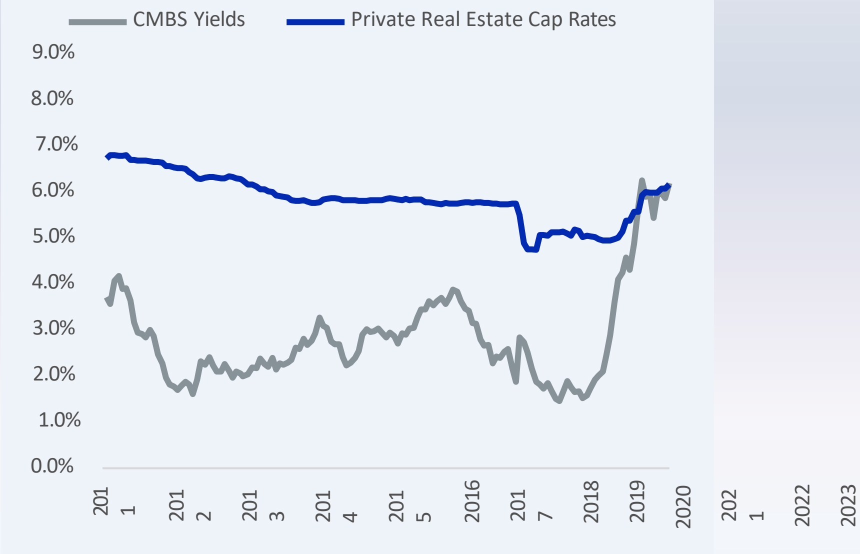
The Federal Reserve cut interest rates by 50 basis points in September and 25 basis points in November, the first cuts since the early days of the COVID-19 pandemic. Core CPI for October came in line with market consensus at 0.3% m/m (3.3% y/y). Overall, investors view this as a constructive report for markets, as it shows that Core inflation is not becoming unglued. We expect more economic clarity over the coming months as we monitor the trajectory of inflation and other economic data.

In addition to macroeconomic considerations, elections typically bring an element of volatility and many savvy investors are focused on interpreting early policy signals of the new administration such as impact of tariffs, increase fiscal stimulus through more lenient tax policies and impact of immigration policies on labor.

Amid market volatility, real estate has consistently served as a safe haven for value preservation, with growing investor interest in real estate credit for its attractive risk-adjusted returns. Per KKR’s Investment Insights from September 2024, investors see real estate credit as a compelling, evergreen opportunity to diversify both real secured equity holdings and the credit component of a portfolio with a high-yielding asset backed by real property and benefiting from a structural decrease in the availability of capital. and Campden Wealth’s November 2023 North America Family Office reports “Adding more to alternatives” is the #1 stated imperative of surveyed family offices going forward and per Nuveen, the ability to offer attractive returns with low volatility, steady income flows, and fixed or floating rate structures make real estate direct lending attractive to a wide swath of institutional investors.

**Fed Funds Interest Rate & Inflation Rate**


**CMBS and Private Real Estate Cap Rate Yields, %**




Data as at March 31, 2023. Source: Bloomberg, Greenstreet, KKR Global Macro, Balance Sheet & Risk analysis.

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# REAL ESTATE PRIVATE CREDIT

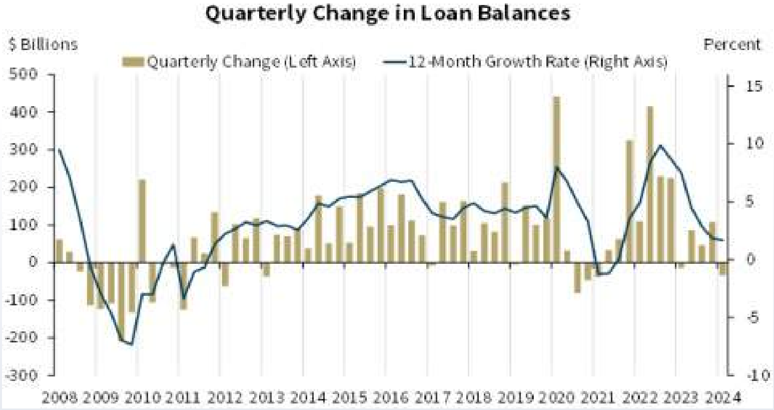
Historically responsible for 40% of U.S. real estate lending, banks have reduced activity due to liquidity constraints and regulatory changes. In our opinion, real estate credit funds will likely have to become more active to maintain an orderly market, as other lenders such as government-sponsored agencies and insurance companies tend to maximize their allocations every year and do not have sufficient capacity to “step into the void.”

The Federal Reserve identifies banking institutions that are potentially exposed to significant CRE concentration risk as those that have total CRE loans which represent 300% or more of the institution’s total capital and a survey taken of 10 large regional U.S. banks showed average exposure to CRE or concentration of loan portfolios that consist of commercial and multifamily mortgages to be 394% as of the 3rd quarter of 2023. Consequently, banks are preserving liquidity and prioritizing existing relationships, thereby providing an opportunity for other CRE debt providers to lend to borrowers that the banks and traditional financial institutions are neglecting.

While U.S. banks are reluctant to lend on their own balance sheets, they are lending to other real estate lenders, including private debt funds and mortgage REITs, through back leverage facilities. For banks, this type of lending is more capital efficient, less time intensive, and may be seen as less risky.

Of the total $4.5 Trillion U.S. debt backed by multifamily and commercial real estate, private lenders as well as other alternative commercial real estate financing sources make up 12.4% of total market share and will now have an opportunity to gain additional share as banks continue to monitor exposure to CRE Loans.

It is important to note that a nuanced approach to lending vis-à-vis asset class, leverage point and geographic considerations are extremely important. The two asset classes that have shown most resiliency through volatile cycles over the past 20 years have been Industrial and Multi-Family.




Source: FDIC


Source: FRED, RCA as of July 2024. Corporate Yield based on Moody's Seasoned Baa Corporate Bond Yield. Commercial Mortgage Rate based on average of commercial and apartment first mortgages with a 7-10-year loan term.

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# INDUSTRIAL SECTOR INSIGHTS

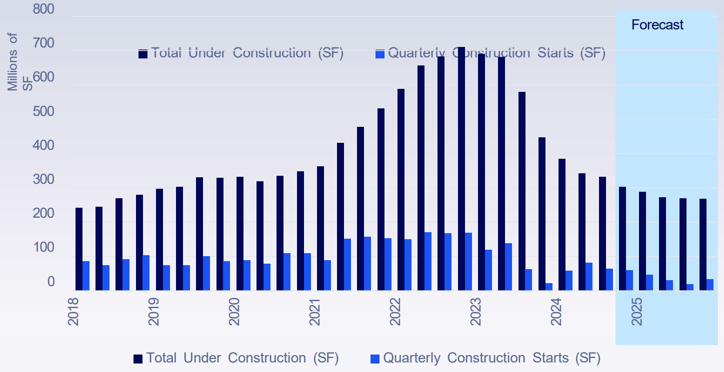
Industrial real estate remains one of the most appealing asset classes for investments. Demand for industrial investments has surged in recent years as the sector evolves to support high-growth industries like e-commerce and advanced manufacturing. The proliferation of e-commerce, internet technology companies, and manufacturing is demanding new industrial spaces to accommodate their growing presence. We will dive into the fundamentals of the industrial sector and highlight what we see as the specific demand drivers in the current market cycle.

Broad demand drivers insulated industrial real estate from some of the turmoil affecting other asset classes since mid-2022 (when the Fed began raising interest rates). Despite rising rates, consumer confidence and hiring remained relatively strong. Consumers are increasingly dispersed across a broader set of metropolitan areas, while e-commerce continues to expand its market share. Both trends, accelerated by the COVID-19 pandemic, should create upward demand pressure for industrial real estate for the foreseeable future. In a falling rate cycle, this general tailwind may only be strengthened. While the revenue per available square foot projections have come down some from record highs, Investors and operators in the space still forecast stable growth in the sector. Critically, the supply pipeline has thinned considerably, creating less competition for operators and properties in the coming years

## Absorption, New Supply & Vacancy


Source: Colliers

## U.S. Industrial Construction Pipeline




Source: Colliers

# INDUSTRIAL SECTOR INSIGHTS

The U.S. average vacancy rate climbed by 19 basis points, to 6.6%, during the third quarter of 2024, as overall demand decreased by nearly 2% from 2023 to 2024. New supply totaled 76 million SF, the lowest since early 2021, and 54% below the 163 million SF delivered during the third quarter last year. Demand as measured by net absorption totaled 39 million SF, bringing the year-to-date tally to 115 million SF. Quarterly construction completions are expected to decline further, reaching equilibrium as tenant demand rebuilds. Vacancy rates are likely to peak and then decrease across most markets.

While we have examined broad market conditions, it is important to note that a nuanced approach is prudent to investing in this sector and careful consideration to each investment is important. Some of those considerations are as follows: (a) Overall demand decreased by 2% but demand for manufacturing facilities has increased by 20% year over year and is expected to continue to grow and are expected to account for over 19% of demand, an increase from 16% currently. (b) Migration patterns, population growth, labor availability, power resources and land accessibility have contributed to a shift in demand towards the Central and Southeast U.S. with Southeast leading in overall demand. (c) The shift of supply chains from China to Mexico as well as on-shoring of manufacturing sector is drawing attention to border strategies on both the U.S. and Mexican sides. Improving connectivity to port volume and trade routes offers ways to capitalize on this dynamic.

**Key Considerations for Investors:**

Investors in industrial real estate must carefully navigate market dynamics, property-specific characteristics, and lease structures to maximize returns. Key considerations include:

- **Property Features**: Assets with modern specifications, such as high ceilings, advanced logistics capabilities, and energy-efficient systems, modern fire suppression systems, tend to attract premium tenants and support long-term value.
- **Lease Structures**: A thorough understanding of lease agreements, including distinctions between triple net and gross leases, is essential for accurately assessing investment potential and operating expenses.
- **Market Complexity**: Compared to other real estate sectors, industrial investments are often more complex and harder to access, requiring specialized expertise and market knowledge.
- **Technological Adaptations:** The adoption of AI and automation in logistics has heightened demand for industrial properties equipped with advanced infrastructure to support these technologies.

By addressing these factors, investors can position themselves to capitalize on opportunities within this dynamic and evolving sector.

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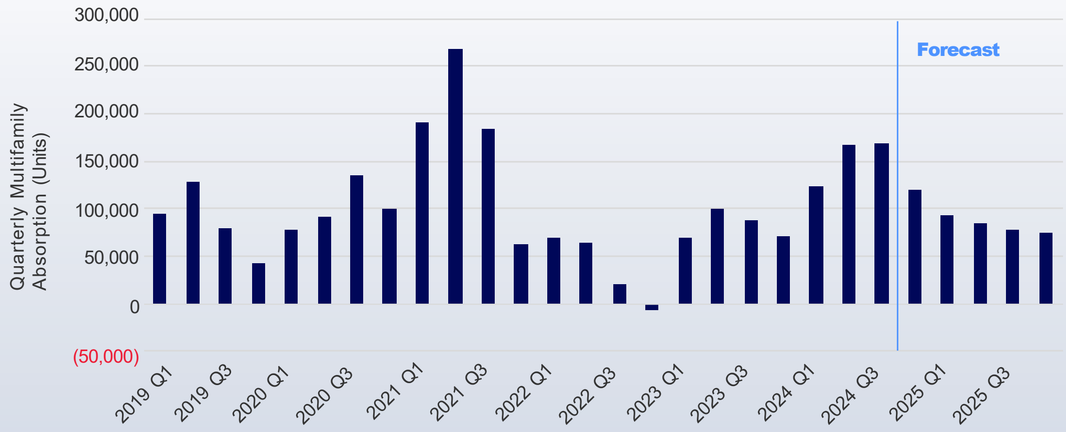
# MULTIFAMILY SECTOR INSIGHTS

Multifamily real estate is typically resilient during economic downturns, unlike retail, office, and hospitality sectors that face more pronounced challenges. However, the demand for housing typically remains stable, as people always require a place to live. A recent report by the National Institute of Building Sciences estimates that the housing shortage ranges from 1.5 million to as high as 5 million units.

Additionally, tighter lending standards during has made it harder for individuals to secure mortgages, resulting in a growing renter population and heightened demand for rental properties. Moreover, financial uncertainty discourages large purchases like homeownership, further expanding the number of renters.

The multifamily market posted year-over-year sales gains for the second consecutive quarter. Preliminary Q3 2024 data indicates that vacancy rates remained steady at 5.8%, with effective rents rising by 0.3% during the same period. Given the sector's continued tailwinds, multifamily looks to remain a robust asset class for the foreseeable future. New deliveries, which are at highest in several decades, have been met with near-record demand.

DEMAND REMAINS STRONG

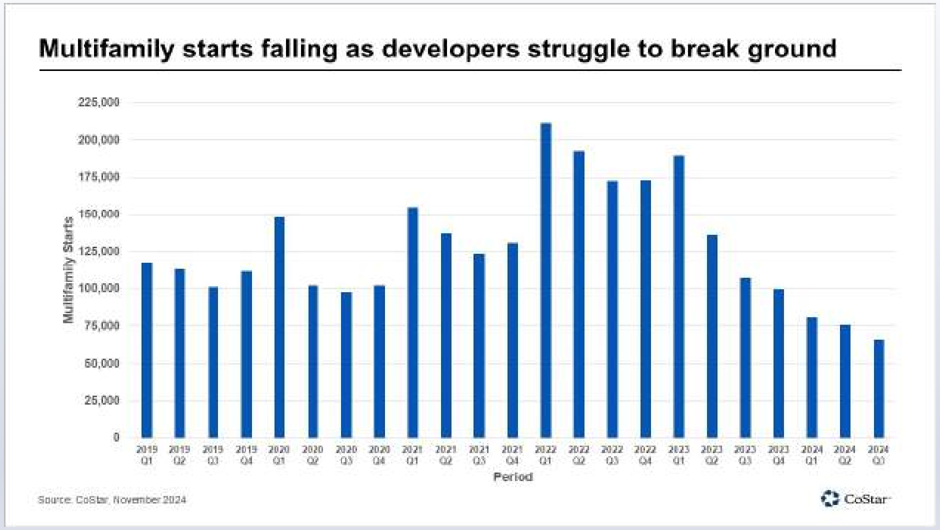



Sources: Colliers, CoStar

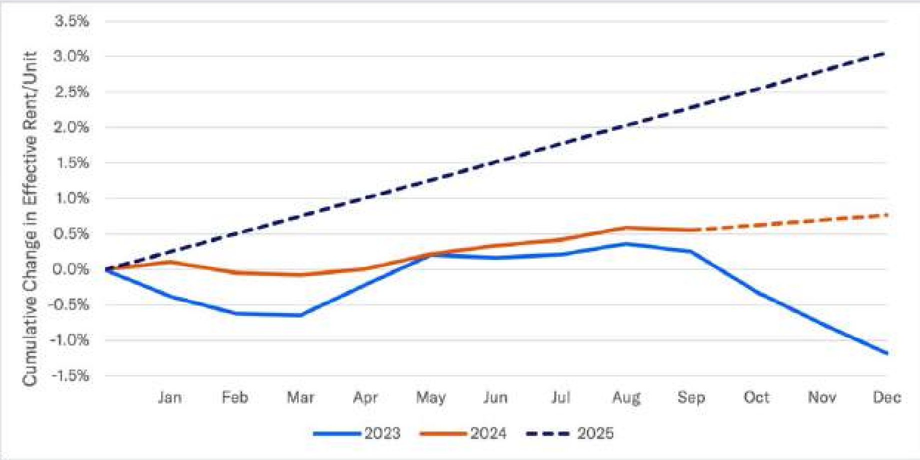
Though occupancies have slipped, the extent of such decrease is less than expected given the supply-side pressure. Supply-side pressure is expected to decrease. April 2024 saw the fewest new multifamily project starts since April 2020, when the COVID-19 pandemic halted construction in many markets. This is mostly a function of capital markets conditions rather than a response to decreased demand. Rising interest rates and tightened lending from mid-sized banks have complicated financing for developers and operators.

# MULTIFAMILY SECTOR INSIGHTS

Transaction Volumes remain healthy, supported by continued household formation and stabilized expenses. We expect the multifamily rent growth to accelerate in 2025.




Multifamily Effective Rent Growth by Vintage




**Key Considerations for Investors:**

Investors in the multifamily sector should adopt a nuanced approach, taking into account a variety of critical factors to optimize investment outcomes, including:

**1. Population Growth and Migration Trends**: Analyze regions with robust population growth and favorable migration patterns, as these drive long-term demand for rental housing.

**2. Barriers to Entry**: Evaluate markets with high barriers to entry, such as zoning restrictions or limited land availability, which can support rent growth and asset appreciation.

**3. Governmental Regulations**: Consider the impact of local policies, including rent control measures, property tax laws, and development incentives, on both profitability and operational flexibility.

**4. Supply-Demand Dynamics**: Assess the balance between new construction and tenant demand, ensuring the market is not oversupplied.

**5. Capital Market Conditions**: Stay informed about financing availability, interest rate trends, and the cost of debt, which directly affect acquisition and development feasibility.

**6. Property-Specific Features**: Focus on assets with modern amenities and energy-efficient systems, which are increasingly favored by tenants and can reduce operating costs.

**7. Macroeconomic Factors**: Monitor economic indicators such as employment growth, wage trends, and inflation, as they influence renter affordability and rental demand.

By carefully evaluating these factors, investors can position themselves to capitalize on opportunities in a dynamic and resilient asset class.

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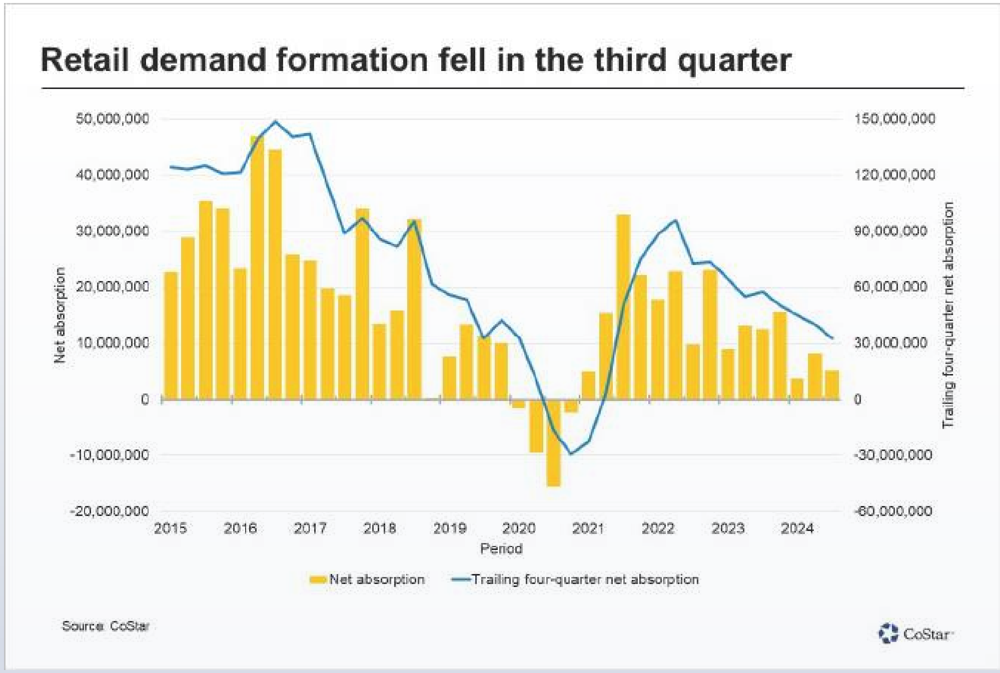
# RETAIL SECTOR INSIGHTS

The retail sector, which faced significant challenges with the rise of e-commerce, has shown signs of stabilization. Improved consumer sentiment, driven by a more subdued inflation environment, has contributed to this recovery. Expanding retailers continue to outpace announced closures, with strong competition for premium locations. With new retail space deliveries at decade-low levels, retailers seeking to expand are increasingly targeting vacated spaces for opportunities.

Demand for well-located retail spaces has driven the strongest rent growth environment since the Great Recession in 2008. A key driver of this trend is the maturation of leases signed 5 to 7 years ago during the downturn, which are now being reset at higher rates. Sun Belt markets have particularly benefitted from robust in-migration, tenant demand, and rent gains, resulting in above-average rent spreads. In contrast, metropolitan areas such as San Francisco, Boston, and New York have seen rent declines.

However, rent growth is beginning to decelerate, reflecting limits on tenants' willingness to absorb higher costs as consumption growth slows. Construction starts remain at record lows, with availability 210 basis points below the historical average of 6.8%. Prohibitive construction costs continue to hinder new development, likely keeping supply constrained until equilibrium is reached between rent increases and building costs.



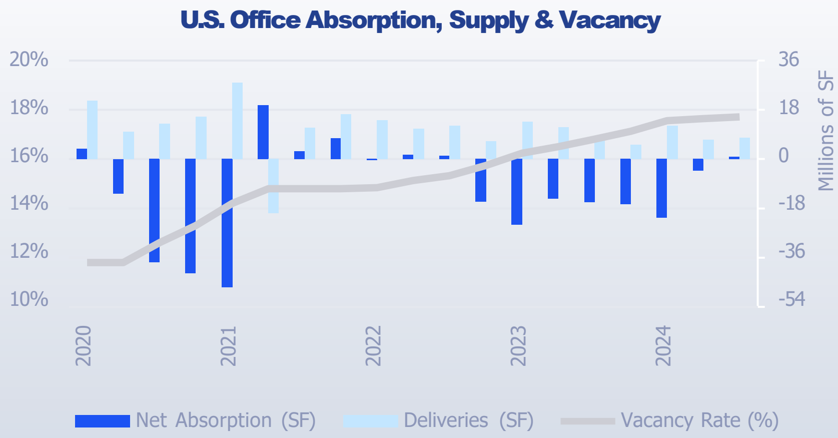

While overall demand for retail space remains positive, the pace of growth has significantly decelerated compared to prior years. Over the trailing four quarters, net absorption—or the net change in occupancy—dropped to just 32.9 million square feet, marking its lowest level since 2021. This slowdown in demand aligns with an uptick in store closures, as numerous large retailers, including Walgreens, Family Dollar, and Big Lots, have been reducing their footprints. Although the specific drivers behind these closures vary, the breadth and depth of the announcements collectively highlight the challenges currently facing the retail sector. Nevertheless, landlords remain optimistic that the freestanding boxes typically occupied by drugstores can be re-tenanted by expanding categories such as discount retailers and fitness centers.

# OFFICE SECTOR INSIGHTS

The U.S. office market is showing signs of recovery as leasing activity and tenant demand increase across most major markets. High-profile return-to-office mandates have garnered attention in recent months, particularly in September, contributing to a rise in office visits and boosting confidence in the long-term outlook for the office sector. While many tenants are reducing their overall space usage, the office remains a crucial hub for collaboration, creativity, and culture.

The hybrid work model continues to be widely adopted and is expected to remain steady, though companies are still evaluating how it affects their space requirements, including at headquarters. Another factor influencing tenant decisions is the growing role of artificial intelligence (AI) in business operations. While the timing and extent of AI's impact on office space and employment remain uncertain, companies are preparing for its eventual influence.

The office market remains highly segmented, with trophy and A-plus properties consistently outperforming broader inventory. Well-located, modern properties with strong on-site and nearby amenities are experiencing robust demand and leasing activity, partly due to their ability to offer competitive concession packages. In contrast, properties that lack these advantages are facing increased financial strain, as owners may struggle to meet the elevated concessions now common in many markets.




Source: Colliers

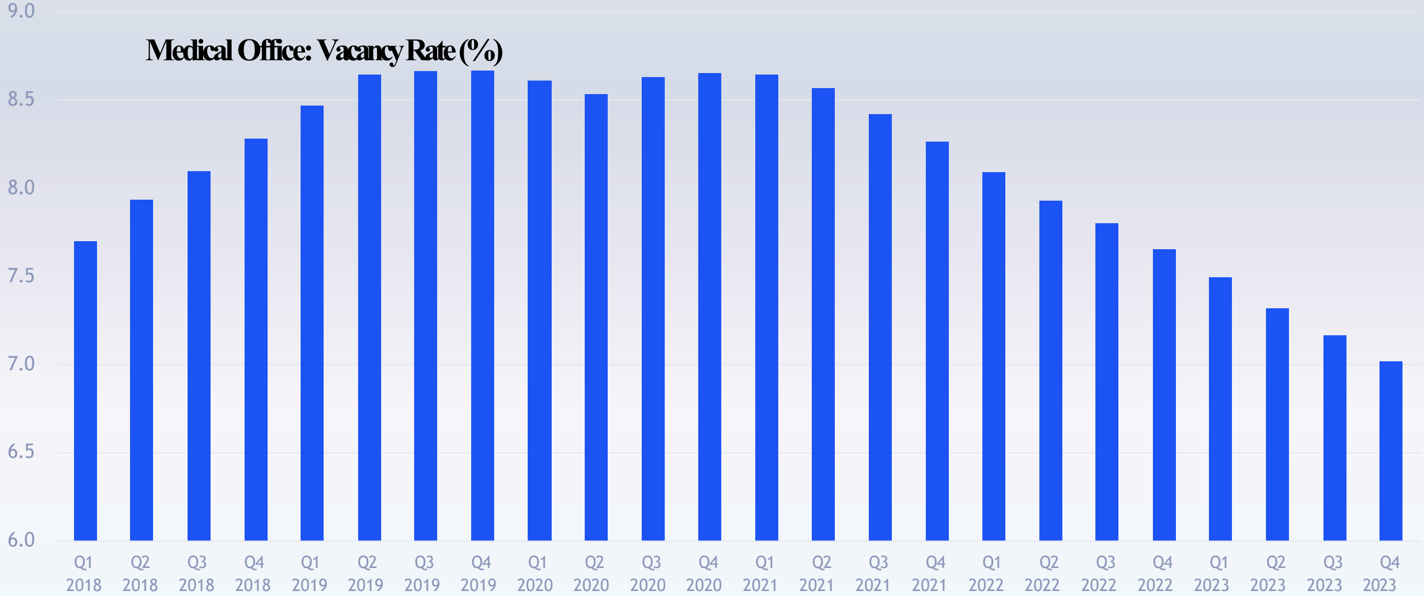
Despite the uncertainties surrounding the future of portions of the office sector and the potential impact of AI, niche segments like medical and private education continue to demonstrate resilience and are expected to remain robust. We will further examine the medical office segment.

# MEDICAL OFFICE SECTOR INSIGHTS

The medical office sector remains strong, with low vacancy rates and record-high rents. Demand continues to outpace supply, though high construction costs have slowed new development. The sector has felt the effects of the Federal Reserve's rate hikes, with sales volume declining in 2023 as higher cap rates and pricing pressures widened the gap between buyers and sellers.
Despite these challenges, the long-term outlook is positive. Growing healthcare demand, driven by population growth and aging population, will support continued strength in the sector.

**Key Medical Office Trends**

- **Vacancy:** vacancy rates dropped 63 basis points to 7.0% in 2023, while broader office sector vacancies rose to 16.9%.
- **Absorption:** Net absorption climbed to 16.5 million square feet in 2023, up from 15.8 million in 2022.
- **Rents:** Average asking rents hit $24.37 per square foot, a 2.3% increase year-over-year.
- **Construction:** 10.8 million square feet of new MOB space was delivered in 2023, up from 10.3 million in 2022.
- **Sales:** MOB investment totaled $7.3 billion in 2023, down 62% from 2022, with prices falling from $329 to $292 per square foot. Cap rates rose 80 basis points to 6.8%.




*Source: Revista *Top 100 Markets*

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# IMPLICATIONS FOR BEB'S INVESTMENT PLATFORMS

Experienced platform:
BEB, together with its affiliates has 40 plus year track record of investing in Real Estate. Coupled with its multi-disciplinary platform BEB has navigated through various market cycles.

Capitalizing on market dislocation:
Increased exposure to CRE lending from traditional banking sources has created a significant opportunity for private lenders to capture market share.

Focus on Core Sectors:

Primary Focus on industrial, multi-family, mixed-use and medical office assets.

Stable Valuations and attractive risk adjusted returns:
With favorable LTV ratios, CRE loans provide an attractive investment opportunity.

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# KEY CONSIDERATIONS FOR INVESTORS

1. **Market Dynamics and Resilience**
   - Understand the implications of macroeconomic trends, such as slowing rent growth, decelerating inflation, and subdued construction starts, on the commercial real estate (CRE) market.
   - Focus on sectors demonstrating resilience, such as industrial and multifamily, while monitoring potential opportunities in retail and office segments.
2. **Geographic Diversification**
   - Consider markets with strong population growth and tenant demand, which continue to outperform in terms of rent growth and absorption rates.
   - Be cautious with investments in areas facing downward rent pressure.
3. **Asset Class Selection**
   - Prioritize asset classes with proven stability which are less susceptible to economic downturns.
   - Focus on well-located properties with strong tenant demand and high occupancy rates, particularly in areas with limited new supply.
4. **Supply and Demand Imbalances**
   - Evaluate the impact of constrained new development due to rising construction costs, which may create supply-demand imbalances and opportunities for value growth in existing properties.
   - Assess lease structures, where lease resets may provide upside potential in high-demand areas
5. **Alternative Lenders' Role in CRE Financing**
   - Private credit funds and alternative lenders are well-positioned to capitalize on the liquidity gaps left by traditional banks.
   - Monitor the competitive landscape for CRE debt providers and seek partnerships with experienced operators who can navigate regulatory and market constraints.
6. **Tenant Quality and Adaptability**
   - Conduct thorough due diligence on tenant creditworthiness, business models, and long-term adaptability.
   - Target properties with tenants from expanding industries such as discount retail, fitness centers, and experiential businesses.
7. **Risk Management and Forward-Looking Strategies**
   - Hedge against potential economic downturns by maintaining a balanced portfolio with exposure to both fixed and floating-rate structures.
   - Stay informed on forward-looking economic indicators such as interest rate movements, inflationary pressures, and consumer confidence metrics.
8. **Emerging Trends**
   - Leverage opportunities from emerging trends such as reshoring of manufacturing, migration shifts, and the evolution of e-commerce impacting logistics and retail needs.
   - Stay agile to pivot investment strategies as new growth opportunities or challenges arise.

# CONCLUSION AND KEY TAKEAWAYS

In summary, we are optimistic about the current environment for real estate credit investing and believe that the market for CRE-based private credit is poised to grow. A growing number of commercial real estate transactions should increase the number of opportunities to lend, while the dearth of bank capital should keep yields attractive and spreads relative to corporate credit elevated which we believe can offer investors attractive risk-adjusted returns while providing downside protection and low market correlation.

Investments require careful considerations of numerous factors, some of which have been stated in this paper. Investors should carefully consider their investment goals, risk tolerance, and other factors.

More than ever, experienced fund management is crucial in navigating the current market.

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