nerej
CELEBRATING 55 YEARS

Opportunities in the mortgage market

October 11, 2012 - Spotlights

Last month I wrote about the risks of leveraged equity real estate in light of eventual interest rate increases and the need for alternative real estate investment strategies at the time of the debt maturity to preserve equity real estate value. While equity real estate has its own challenges in light of current interest rates, there are some very interesting opportunities in real estate debt investments.

For the first time in nearly 40 years, bond investors are experiencing negative yields and are not being compensated for inflation. Specifically, when inflation (CPI) is factored into 5-year treasury yields, a bond investor receives a negative yield. Negative bond yields are a result in periods of deflation or financial repression (the combination of the Fed keeping the short end of the yield curve low and buying long dated treasuries in its quantitative easing program). Given this scenario, it is fair to conclude that treasuries are likely overpriced and, as a result, the market is seeking alternative debt vehicles with more favorable return characteristics. Demand for these assets has created a falling supply of higher yielding assets including mortgages and mortgage securitizations.

At the same time, there are numerous situations where lenders have reduced the amount of mortgage capital available or need to move non-performing loans "off the books." This creates opportunity for others to fill the role of debt capital providers as long as the investment reflects prudently underwritten deals with a focus on underlying value of the real estate. A real estate debt investment strategy can be accomplished through several channels including:

Mezzanine Debt: Investing below the senior tranches in the mezzanine debt tranches. As traditional lenders seek 50% LTV debt originations, there are additional opportunities in the mezzanine space to bridge the gap between senior debt and equity.

Recapitalize Existing Leverage: Typically an opportunity in real estate with opportunity for value increase but currently not appropriately capitalized.

Acquisition of Non-Performing Debt: Lenders will continue to dispose of nonperforming debt positions on a discounted basis.

While the US debt market continues to provide select opportunities in debt investment, additional opportunities exist in the European market. Since Europe is still experiencing banking distress and is in the very early stages of addressing its banking system funding gap, both mezzanine and non-performing loan opportunities are available. Since the region is early in its recovery, underwriting should reflect slow, gradual improvement.

As with all real estate investment today, underwriting discipline is essential as the market will no longer "bail out" a generalist style of investing - the strength and specifics of the underlying real estate is key. Given the backdrop of current interest rates globally, along with the Fed's ZIRP (Zero Interest Rate Policy), real estate opportunities today may offer more value in the debt than equity space - a unique risk adjusted way to think about investing over the next several years.

CRE 2012 Upcoming Events:

* October 14 - 17 - CRE National Convention in Miami.
* November 15 - "Hot Topics" Members Only Luncheon from 12-1 p.m. at Colliers Meredith & Grew (160 Federal St., Boston)
* December 13 - Annual Holiday Reception, Algonquin Club, Boston.

Jill Hatton, CRE, is the 2012 New England/Upstate N.Y. CRE chapter chair, Boston, Mass.