PIMCO®

The Case for Private CRE Debt

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Introduction to Commercial Real Estate Debt

Commercial real estate (CRE) is a large, evolving market that offers ongoing challenges and opportunities for owners, operators, and lenders through each cycle. Traditionally dominated by large institutions such as banks, the lending landscape is shifting as these institutions reduce origination activity, allowing private lenders to step in. Private credit investors can aim to capitalize, benefiting from an asset class that may offer predictable cash flows, downside mitigation, diversification, and attractive risk-adjusted returns.

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- How this landscape is changing

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- Where CRE debt fits within the capital structure
- A range of debt profiles designed to meet sponsor and borrower needs
- Investment options across the risk-return spectrum
- Spotlight on transitional lending

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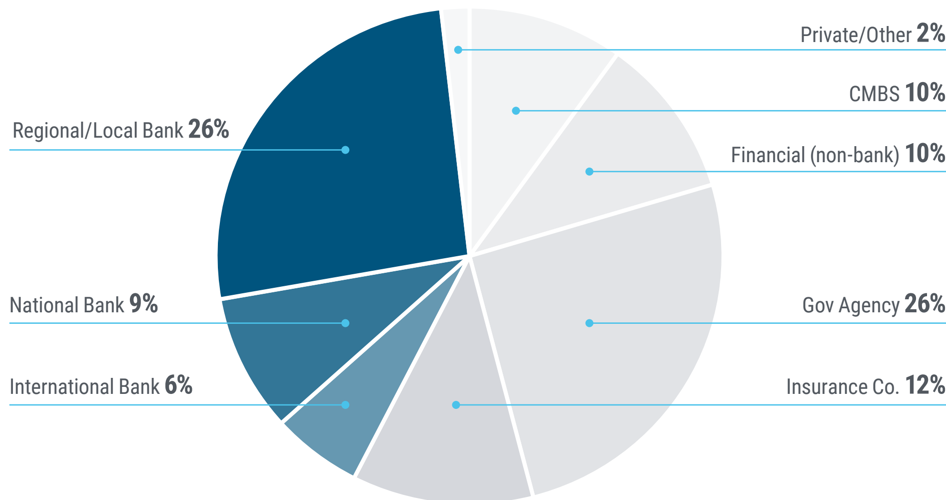
- Seeks superior risk-adjusted returns and diversification
- Comparative advantages over direct lending
- Robust market potential driven by persistent opportunity
- Historical stability across cycles

The CRE Debt Market

A LARGE, EVOLVING, INSTITUTIONAL MARKET

U.S. CRE debt is a roughly **$5.9 trillion market**[1] with a diverse composition of lenders. Following the Global Financial Crisis, from 2010 through 2021, loose monetary policy **fueled a 4.6x increase in CRE transaction volume**[2] **significantly boosting the demand for real estate credit** to finance this increased transaction activity, which included ground-up developments and acquisitions of existing assets, across different property types.

U.S. Commercial Real Estate Lender Composition, 2023



Source: Morgan Stanley Research

HOW THIS LANDSCAPE IS CHANGING

Throughout this period, the primary lenders have been banks of varying sizes, ranging from large national and international institutions to smaller regional and local banks. Notably, regional banks have significantly increased their private lending capacity, accounting for **63% of all bank exposure to CRE**[3]**.**

While banks still comprise a material percentage of the market in 2024, they have scaled back exposure with **the rate of new originations down over 58% from a year ago as of December 2024**[4]**.**

This recent decrease in bank activity can be attributed to several factors, including tighter monetary policy, capital and liquidity limitations, heightened regulatory scrutiny, and a rise in troubled loans that are now consuming a larger portion of bank resources. Challenges faced by these institutions include:

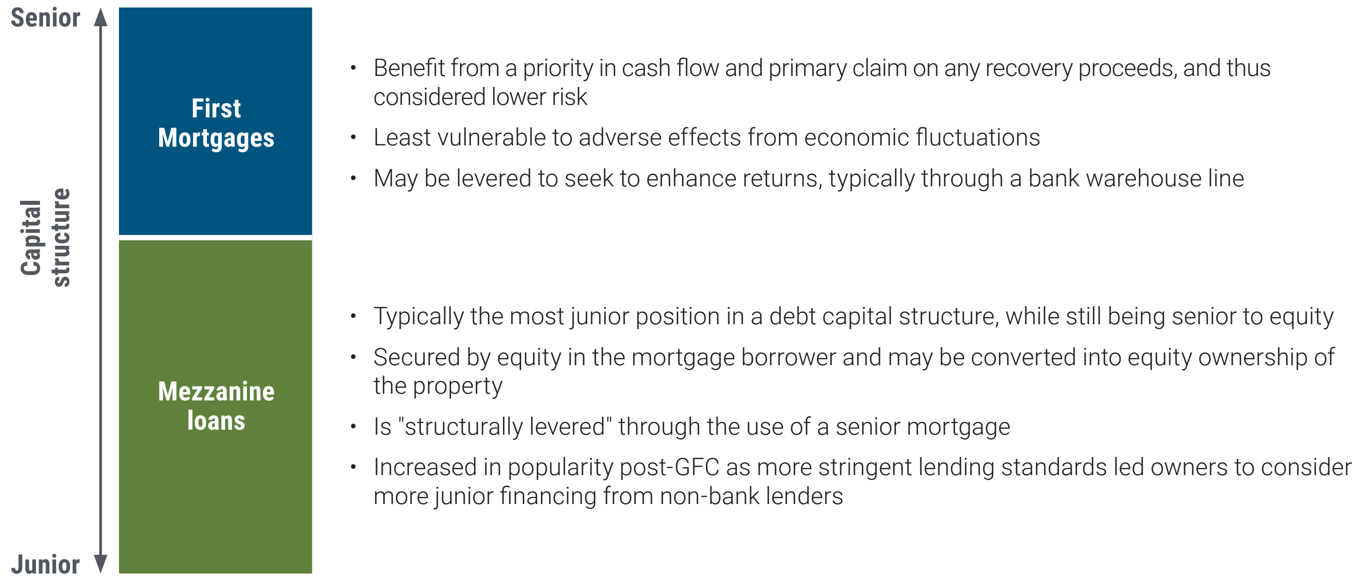
- Adjustments to the capital-to-risk weighted assets ratio for banks
- Various requirements designed to mitigate excessive risk taking in the aftermath of the Global Financial Crisis
- Accounting changes affecting the loss reserves banks must maintain on their balance sheets
- Gradual increase in banks' non-performing loan ratios, due largely to the extension of troubled loans during period of high interest rates and value declines beginning in 2022[5]

1 Tepp, Q4 2023.
2 MSCI Real Capital Analytics ("RCA").
3 Morgan Stanley Research.
4 Federal Reserve Data.
5 Federal Reserve Staff Paper: "Extend-and-Pretend in the US CRE Market," November 2024.

Key Features of CRE Debt

CRE debt can broadly be categorized based on its position within the capital structure, which determines the order of payment from the property's cash flows. Senior, first mortgage holders receive their payments first and have priority in taking ownership of the asset in the event of a borrower default (i.e., the "first lien"). Subordinated debt holders, such as those holding mezzanine debt, have a lower priority and are compensated with higher returns to account for the increased risk.

WHERE CRE DEBT FITS WITHIN THE CAPITAL STRUCTURE



Source: PIMCO. **For illustrative purposes only.**

A RANGE OF DEBT PROFILES DESIGNED TO MEET SPONSOR AND BORROWER NEEDS

CRE debt is often segmented into various profiles based on the borrower's financing needs and the state of the underlying real estate. Each of these senior loan profiles differs in terms of typical interest rates and loan-to-value (LTV) ratios.

Core / stabilized	Light transitional	Moderate or heavy transitional	Construction
Typical LTV: < 65% Rate Type: Fixed or Floating	Typical LTV: < 70% Rate Type: Floating	Typical LTV: < 80% Rate Type: Floating	Typical LTC: < 70% Rate Type: Floating
Secured by fully leased, or near-fully leased, cash-flowing real estate	Secured by projects undergoing modest changes pre-stabilization, such as light renovations or lease-up	Secured by projects undergoing more substantial repositioning pre-stabilization. Typically lent at higher LTVs relative to light transitional loans	Used to fund the development of new real estate, these loans typically follow a delayed draw schedule with additional funding incurred after incremental construction and development milestones are reached

Source: PIMCO. **For illustrative purposes only.**

INVESTMENT OPTIONS ACROSS THE RISK-RETURN SPECTRUM

The loan profiles described previously vary in risk-return potential, which is another lens through which to evaluate CRE debt. Lenders may pursue a variety of loan types in any given strategy, and this variation in risk profiles offers investors a wide range of yields.

In addition to core, transitional, and construction senior debt, investors can also explore special situations and distressed debt. These profiles represent the most opportunistic types of debt, involving both senior and subordinated structures. They aim to either capitalize on unique situations with compromised real estate, liquidity constrained sponsorship, or both. They may take a longer, riskier, and more involved route to property stabilization, and/or end in the ultimate goal of owning the property. They may also involve acquiring loans from a previous lender at a discounted price or new origination to fill a gap in the capital structure.

Special Situations

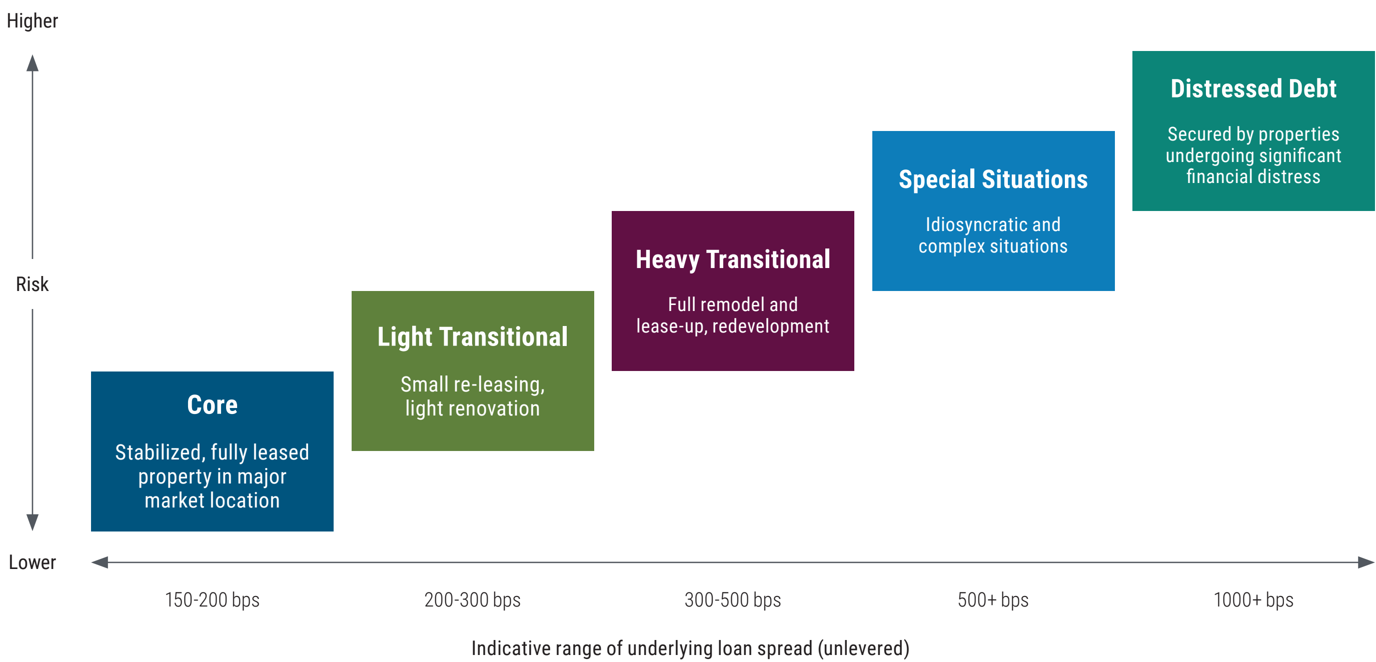
Special situations in CRE are complex, often time sensitive, investment opportunities that offer potential for outsized returns for investors who can leverage property expertise, structuring capabilities, and deep counterparty relationships.

Examples include recapitalizations, stalled projects, debt maturity defaults and modifications, and note financing and purchases.

Distressed Debt

Typically involves loans secured by properties experiencing significant financial difficulties from factors such as declining property values, reduced rental income, or broader economic challenges. Outcomes may include discounted payoffs or foreclosure on the property to gain equity ownership at an attractive basis.

Examples include acquiring a non-performing loan, where the sponsor cannot service the debt due to insufficient property cash flows. The purchaser of the loan may then foreclose on the property, with the goal of taking direct ownership of the property and better managing it to a stabilized state.



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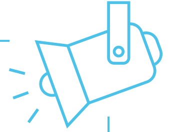
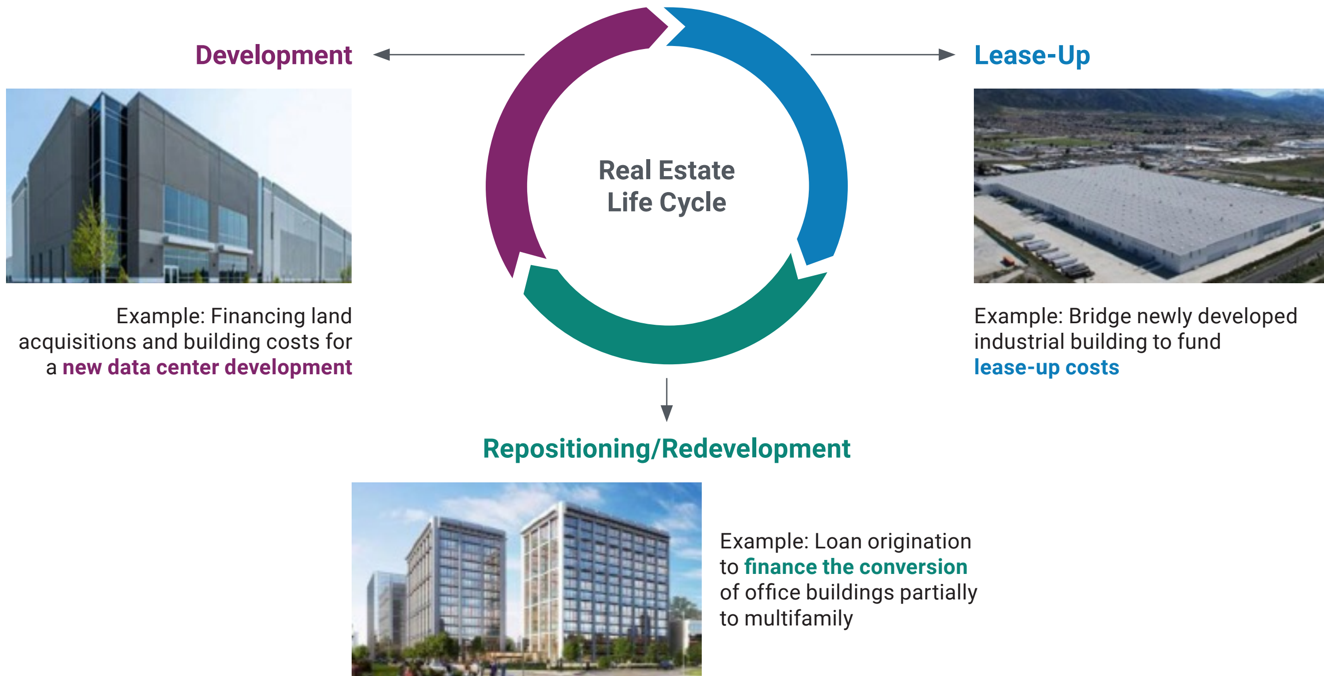


SPOTLIGHT ON TRANSITIONAL LENDING:

We view transitional lending as a persistent opportunity

By nature, real estate is ever-changing and undergoes a perpetual cycle, consistently requiring new financing during these transitions.

Transitional loans do just this - they are originated to address operational, capital and/or leasing needs.



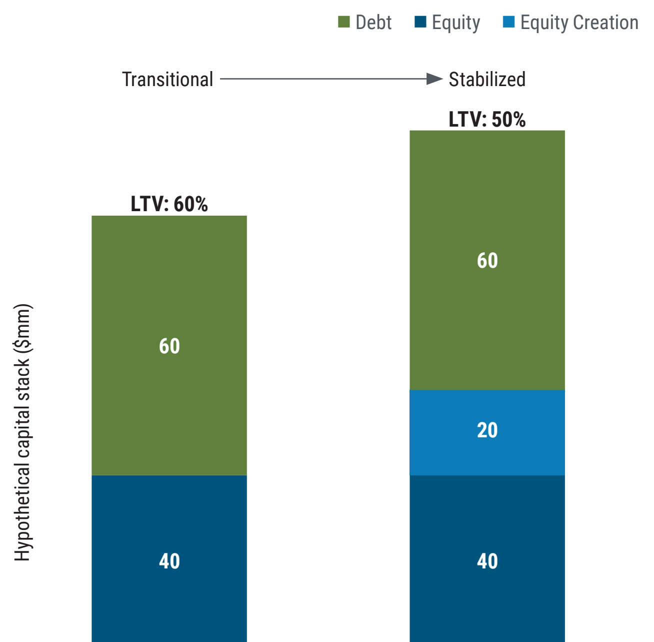
Helping assets achieve optimal use, backed by high-quality collateral and strong sponsors

Transitional CRE financing enables assets with superior quality and cash flow fundamentals to pursue higher performance. If successful, these projects will:

- **Create additional value** through an underwritten plan to drive leasing and improve operations
- **Provide a greater equity buffer** between the senior loan and the underlying asset value
  - » This buffer, supported by robust credit metrics, facilitates permanent refinancing or sale
- **Increase alignment between the borrower and lender** through the borrower's equity investment, which may enhance value creation compared to stabilized assets

PIMCO Focus: transitional loans backed by higher-quality collateral in markets characterized as "last to go, first to recover" and benefit from stronger sponsors with proven track records in executing business plans, with access to better capitalization, and the ability to make larger equity investment contributions.

Hypothetical capital stack of a transitional CRE project



Source: PIMCO. **For illustrative purposes only.**

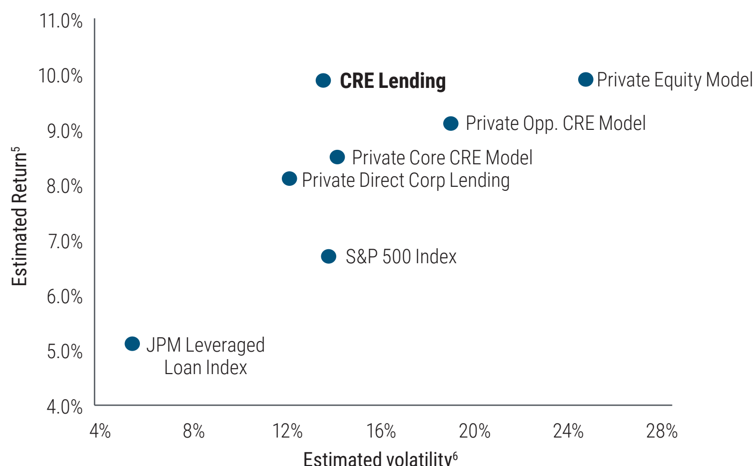
The Potential Benefits of CRE Debt

SEEKS SUPERIOR RISK-ADJUSTED RETURNS AND DIVERSIFICATION

Compared to many private market asset classes, such as private equity, private real estate lending exhibits significantly lower volatility on average. This trend also holds true when compared to public asset classes like equities, Treasuries, and high-yield bonds. The lower volatility is largely attributed to the downside mitigation often associated with CRE lending, as it is secured by hard collateral.

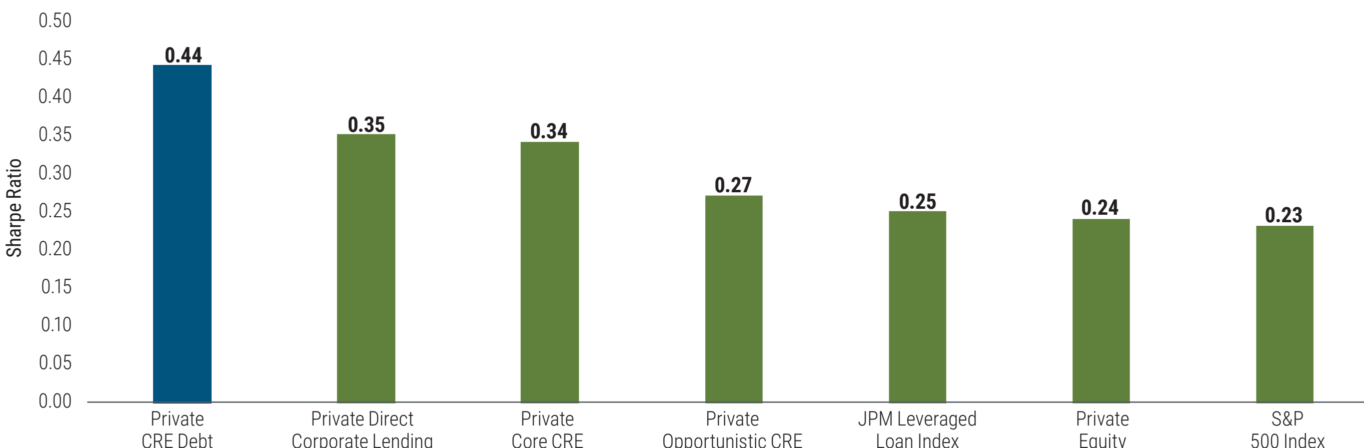
One effective way to visualize these characteristics is through the Sharpe ratio. Private CRE lending presents a compelling Sharpe ratio when compared to other asset classes. This metric measures the return relative to the standard deviation of the excess returns over a risk-free rate. The following Sharpe ratios compare private CRE debt with other asset classes, highlighting the trend of downside protection.

Risk-return characteristics of various asset classes
(As of Sep 2024)



Source: PIMCO. **For illustrative purposes only. Figure is not indicative of the past or future results of any PIMCO product or strategy. There is no assurance that the stated results will be achieved.**

Transitional lending provided investors downside mitigation compared to other asset classes[7]
(As of Sep 2024)



Source: PIMCO. **Past performance is not a guarantee or a reliable indicator of future results.**

COMPARATIVE ADVANTAGES OVER DIRECT LENDING

Incorporating private real estate lending can naturally complement other areas of private credit, particularly private direct lending. PIMCO believes that by adding an allocation of transitional private CRE debt to a hypothetical portfolio of private direct lending, investors can potentially achieve higher returns and lower volatility.

Moreover, private RE lending adds a number of diversification benefits to investors' existing allocation to private direct lending, including:

- Hard asset collateral and easier foreclosure process
- Highly structured and negotiated terms, potentially resulting in stronger rights and remedies for lenders

5 Unless otherwise specified, return estimates are an average annual return over a 5-year horizon. Please refer to appendix for additional information on estimated returns and asset class definitions. Estimated cash return = 3.51%. Model risk factor exposures are based on analysis of historical index data, third party academic research and/or qualitative inputs from senior PIMCO investment professionals.

6 Refer to appendix for additional information on asset class definitions. Conditional-Value-at-Risk (CVaR) is an estimate of the average expected loss beyond a desired level of significance. A positive value indicates a loss. Model risk factor exposures are based on analysis of historical index data, third party academic research and/or qualitative inputs from senior PIMCO investment professionals.

7 Refer to appendix for additional information regarding asset class definitions and volatility estimates.

ROBUST MARKET POTENTIAL DRIVEN BY PERSISTENT OPPORTUNITY

We observe persistent demand for real estate credit in various economic conditions:

- **In periods of low interest rates**, the demand for real estate credit is driven by relatively high transaction volumes
- **In periods of high interest rates**, real estate valuations typically fall, presenting more opportunities for recapitalizations of existing assets as borrowers grapple with a basis reset as well as "rescue capital" opportunities for borrowers undergoing significant liquidity issues
- **In any rate environment**, there exists an impending maturity wall of existing loans, leading to a wave of refinancing opportunities or sales that would require new acquisition financing

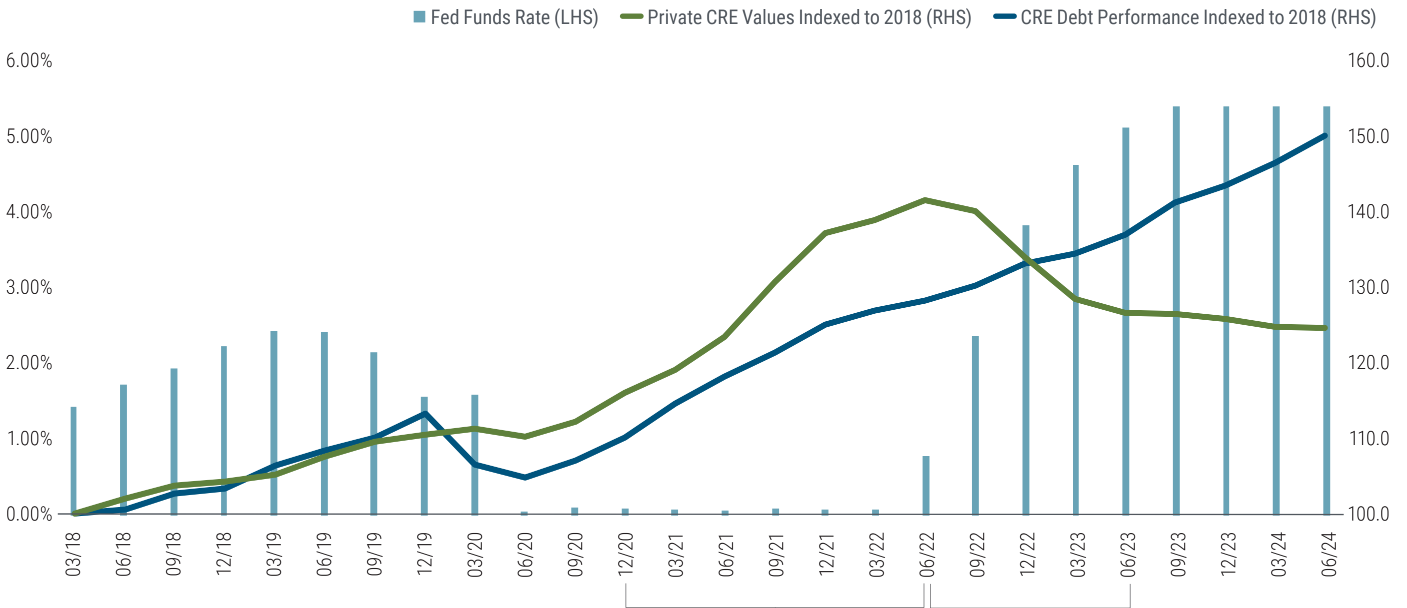
As mentioned previously, banks of various sizes have historically been the largest lenders in the CRE debt space, but have been reducing their exposure primarily due to regulatory requirements for tighter capital controls. Private lenders are poised to benefit from this growing retrenchment, driven to fill the market demand as well as a growing desire from institutional investors to allocate to the asset class.

63% Of institutional investors indicated they are planning to invest more capital in real estate debt over the next year[8]

HISTORICAL STABILITY ACROSS CYCLES

Private CRE debt has demonstrated resilient performance even as property valuations and the broader interest rate environment have shown significantly greater volatility.

CRE Debt Performance Relative to Other Benchmarks
(As of Sep 2024)



Between the COVID shock and before the beginning of the most recent rate hiking cycle in 2022, real estate valuations increased 29% to reach historical highs. Private real estate debt was up 22% in the same period.[7]

In 2022, the Fed began aggressive rate hiking cycle and increased the Federal Funds rate by over 5%. This caused real estate valuations to decrease by 11%, while real estate debt performance maintained its upward climb and increased by 11%.

Source: MSCI, Real Capital Analytics, Preqin. "Private CRE Values Indexed to 2018" reflect the change in the MSCI RCA Commercial Property Price index from 2018 through Q2 2024. "CRE Debt Performance indexed to 2018" reflects the change in the Preqin Real Estate Debt Index from 2018 through Q2 2024.

Past performance is not a guarantee or a reliable indicator of future results.

8 Hodes Weill, 2024 Institutional Real Estate Allocations Monitor, November 2024.

Appendix

Additional information regarding definitions and volatility estimates:

Private Commercial Real Estate (CRE) Lending Model: Model risk factor exposures are estimated using holdings data in PIMCO systems which align with the commercial real estate lending sector. Leverage assumptions are based on existing PIMCO accounts. We then add adjustments for illiquidity premia and idiosyncratic risk based on the historical distribution of alpha (relative to the PME benchmark for private real estate) in the Preqin category. **Private Opportunistic Real Estate Model:** Model risk factor exposures are estimated through a regression on the NCREIF Opportunistic Real Estate Index. We unsmooth returns to remove the bias from accounting-based reporting. **Private Core CRE Model:** Model risk factor exposures are estimated through a regression on the NCREIF (ODCE) Core Real Estate Index. We unsmooth returns to remove the bias from accounting-based reporting. **Private Equity Model:** Model risk factor exposures are estimated based on a public equivalent benchmark and alpha estimates are derived from historical data on private funds in the Preqin Private Equity Universe (ex-VC). The public market equivalent is a custom index of publicly traded US firms matched to the size, EBITDA multiple, and revenue multiple observed from PE deals in the Preqin database. We also add additional filters for value (top half of Book-to-Market, top half of Earnings Yield), leverage and equity return volatility (filtered to approximately match HY CDX issuers), and eliminate outliers. We then add adjustments for illiquidity premia and idiosyncratic risk based on the historical distribution of alpha (relative to the PME benchmark) in the Preqin category. Median and top quartile models reflect alpha estimates from the median and 75th percentile of the historical alpha distribution, respectively. Unless otherwise specified, models reflect the median of the historical alpha distribution. Private Direct Lending (also known as **Private Corporate Lending) Model:** Model risk factor exposures are estimated using holdings data in PIMCO systems which align with the corporate lending sector. Leverage assumptions are based on existing PIMCO accounts. We then add adjustments for illiquidity premia and idiosyncratic risk based on the historical distribution of alpha (relative to the PME benchmark for private credit) in the Preqin category.

Past performance is not a guarantee or a reliable indicator of future results.

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Hypothetical illustrations have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve results similar to those shown. In fact there are frequently sharp differences between hypothetical results and actual results subsequently achieved by any particular trading program.

One of the limitations of hypothetical results is that they are generally prepared with the benefit of hindsight. In additional, hypothetical scenarios do not involve financial risk, and no hypothetical illustration can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or to adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation if any specific trading program which cannot be fully accounted for in the preparation of a hypothetical illustration and all of which can adversely affect actual results.

INDEX

It is not possible to invest directly in an unmanaged index.

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