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The intersection of distress and stability

Timothy Sloan, head of commercial real estate debt at Fortress Investment Group, says the firm sees the strongest long-term outlook for senior loans. But in today's market, its history as a distressed investor will still be critical. By Samantha Rowan

Fortress Investment Group has both a near-term and a long-term investment thesis, and the two are intersecting in today's market. This includes the impact of a higher-for-longer rate environment, increased regulation for commercial banks and a $2.9 trillion wall of maturities through the end of 2028.

"Over the next two to five years, we will see a significant number of distressed opportunities because of that maturity wall," Tim Sloan, vice-chairman and head of commercial real estate debt, tells *PERE Credit* in an interview at the firm's global headquarters in New York in late August. "In addition to that, today we are seeing opportunities to provide senior debt for commercial real estate borrowers. We think that will be the fastest-growing part of our business."

Fortress, which got its start in 1998 as a diversified investment management company, will be using every facet of its platform as it seeks to help commercial real estate sponsors and institutional investors solve problems.

For sponsors, the firm can step into a variety of stressed and performing situations while seeking to align the loans it originates with the income needs of its investor base.

"We have always had a very broad and diversified real estate strategy at Fortress, both debt and equity," Sloan adds. "We have different products we can provide to our customers, borrowers and partners."

None of this is new for the firm, with Sloan noting Fortress has always been a lender and investor in commercial real estate, working via diversified domestic and global debt and equity strategies to allocate capital across geographies, asset classes and capital structures.

"We don't have a dedicated commercial real estate debt strategy in the US. Historically, when we have provided credit, preferred equity or mezzanine, we have done that through both open-ended and closed-ended credit-oriented lending strategies," Sloan says.

"The firm can be creative in terms of how we structure those products, providing lower-cost senior debt if a borrower wants to bring in a larger amount of equity and reducing their leverage levels," Sloan adds. "We can also provide a higher level of debt or originate preferred equity, mezzanine or common equity. We can solve a variety of needs."

Basel's new lending order

Fortress has long been a provider of senior debt and anticipates increasing its origination levels as the expected July 2025 implementation of Basel III comes into focus.

"I think what has exacerbated the longer-term issue of Basel III is that in the short-term, there is a $1 trillion wall of commercial real estate loans that are maturing," Sloan says. "It also provides opportunity because it creates a finite event – the maturity date – for us to step in and refinance a loan from a bank."

Originating senior debt today will mean working with borrowers to make loans of $25 million or more with loan-to-value ratios of 50-70 percent at what Sloan believes will be very competitive pricing.

"Most of the loans we will originate will be floating-rate loans of generally three years with two one-year extensions that are performance-based.

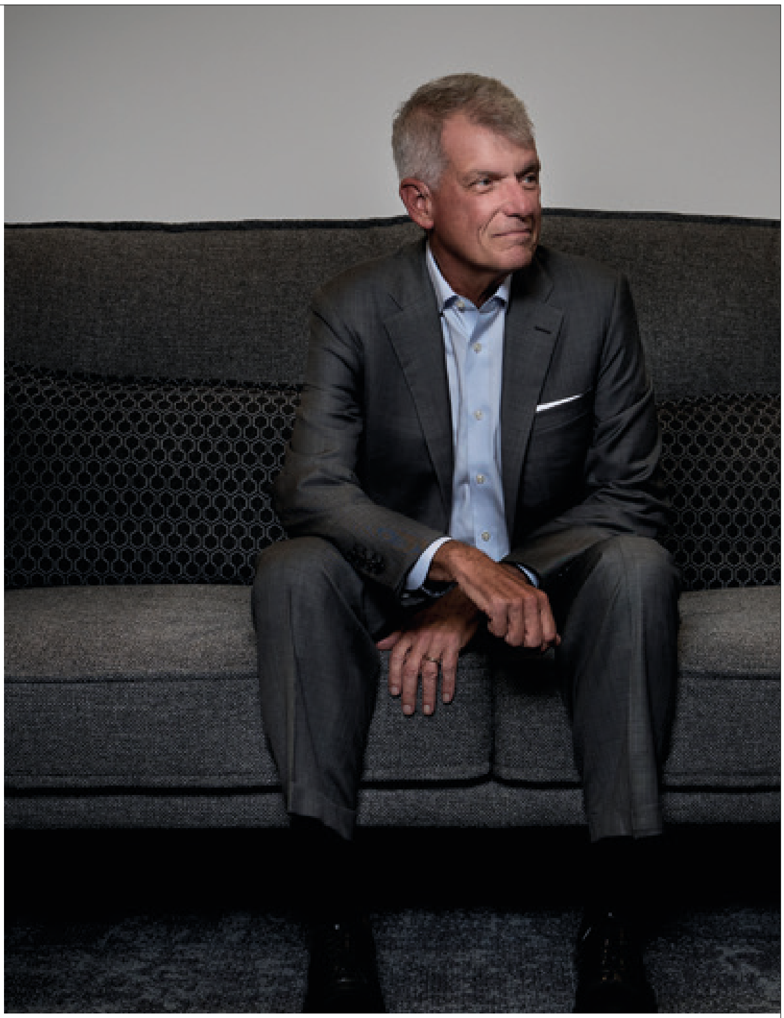
Analysis

Preferred equity and mezzanine will be structured a little differently; sometimes there is a term or some kind of redemption," Sloan adds.

While borrowers are certainly more aware of alternative lenders than they were prior to the global financial crisis, there is still a learning curve, Sloan explains. "There is definitely an education process for the private real estate credit industry as we continue to grow our real estate debt platforms to make sure borrowers, their advisers and loan brokers know we are open for business, and it takes a co-ordinated effort to get the word out," Sloan adds.

One thing that has helped is the firm's long-standing relationships with banks, which they are working with to refinance maturing debt or acquire notes on specific properties.

"These banks have borrowers with loans coming due and we can work with the bank and the borrower to make that occur," Sloan says. "We're also working with banks that want to reduce their commercial real estate exposure on a portfolio or one-off basis. We're also doing this with insurance companies, mortgage real estate investment trusts and any commercial real estate lender which, regardless of how they're



Transaction snapshot

Fortress has been actively deploying capital across a wide range of real estate strategies, including the acquisition of loan portfolios, the origination of construction loans and the funding of credit facilities

Debt acquisitions

Aug 2023
Capital One
Acquired a portfolio of 26 office loans with an aggregate balance of $895 million

Dec 2023
Carroll Portfolio
Acquired a portfolio of six performing NYC multifamily loans to one sponsor with an aggregate balance of $62 million

Feb 2024
Market Street
Acquired a $22.2 million performing loan secured by an office and retail asset in downtown San Francisco

"I think what has exacerbated the longer-term issue of Basel III is that in the short-term, there is a $1 trillion wall of commercial real estate loans that are maturing"

High-yield originations

Feb 2024
Parkview
Provided a $146 million senior credit facility to Parkview Financial. The facility is secured by a portfolio of seven construction loans with a total commitment of $224 million

Jul 2024
Colts Neck
Closed on a $95 million construction loan to the Kushner Companies for the development of Livana Colts Neck in New Jersey

Sep 2024
Monmouth Mall
Originated a $303 million construction loan for the residential development component of the de-malling of the Monmouth Mall in Eatontown, New Jersey

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regulated or capitalized, may have similar issues in terms of too much concentration or challenging loans."

Rising rates, falling values

While there have been some distressed transactions, Sloan believes the bulk of these deals are yet to come.

"Values haven't bottomed yet, regardless of product type, and we haven't gotten through the maturity wall yet. Regulated lenders have not gotten their portfolios down from a concentration standpoint," Sloan says. "That means there will be a distressed opportunity that could last as long as five years."

There is a common problem that is affecting many commercial real estate sponsors: the impact of the more than 500-basis point increase in interest rates from March 2022 to July 2023.

"Investors who purchased or refinanced properties in a lower-rate environment [are in a place where] the underlying real estate was valued at a lower cap rate. As rates then rose, you discounted those future cashflows and the value of a property, even if it is performing well, has gone down," Sloan says.

While the exact decline depends on the underlying asset, performing real estate projects have seen a 10 to 30 percent diminution on value simply because rates are been higher, Sloan adds.

"[In addition to value declines] the cost of the capital structure for real estate projects has increased significantly. When rates were lower, the cost of debt was lower," Sloan adds. "This cost has more or less doubled now."

The final issue borrowers are grappling with is inflation and its impact on operating costs.

"The cost of employees and all sorts of products and services, the inputs to commercial real estate property, have gone up at a very similar level to inflation," Sloan says. "The one cost that has gone up at a much higher rate than average inflation is insurance costs."

All these issues become part of the underwriting process for Fortress.

Analysis

"We underwrite the borrower in terms of their industry and operating experience, and then we develop a structure that we think makes sense to solve their needs," Sloan says. "We tend to be agnostic to what's hot and what is interesting. From our perspective, given our credit focus and the fact that we have been involved in distressed real estate for decades, we are looking across the broad [landscape]. There is no product type or geography that is off-limits to us."

Fortress, like many of its peers, is taking a cautious but open view to opportunities in the office sector. The firm in August acquired an approximately $1 billion portfolio of office loans from Capital One and is willing to look at other deals, Sloan says.

"The office sector is the one that is obviously the most distressed. It's just more challenging to look at providing debt or buying a note at a discount from a bank on an office," Sloan says. "We bought a large portfolio from Capital One – so while it's not as if we have no interest in office, we take a particularly careful approach."

Fortress is interested in different asset classes and capital structures for its various investment vehicles.

While there is substantial interaction between the firm's originators, underwriters and asset managers, there is

Low-yield originations

Sep 2022 — **Hilton Times Square**
Funded a $69 million, or $145,000 per key, loan to a joint venture between Apollo, Newbond Holdings and Witkoff Group to acquire the leasehold interest in the 478-key Hilton Times Square hotel

Jun 2023 — **Sony Culver City**
Acquired a $100 million Culver City office loan at an 88-cent price

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JVs/lines/co-GP high-yield

Dec 2023 — Entered a $500 million, 70/30 joint venture with Derby Copeland Capital to pursue small-balance, mid-market multifamily debt investment opportunities in New York City

Dec 2023 — Makes $142 million LP investment within Forum Investment Group's Structured Finance Fund an equally large number of views.

"It's not as if everyone in the real estate platform at Fortress has the same opinion and that is a good thing. You want that diversity of opinion.

"In our pipeline calls for our real estate debt business, in addition to our originators and underwriters, we also invite all our asset managers, and all our originators are part of our asset management review. We want that level of communication and transparency because that is how you make good decisions and prevent yourself from making really bad decisions."

In addition to debt and equity investments, the firm will also consider buying discounted tranches of commercial mortgage-backed securities single-asset/single-borrower deals. The firm has a small team that looks at all the SASB deals completed over the past seven to 10 years and, from there, looks at the properties it believes are the strongest in their markets.

"We develop a view in terms of the value of the property and the debt tranches, so when one becomes available for sale, you can react quickly with a lot of information. It is difficult to be responsive if you get a call about a tranche of a SASB on, for example, an office deal in San Francisco if you haven't already underwritten the property," Sloan adds.

The borrower view

The firm is always investing, however, with the understanding of its dual needs to work with its clients and its investors.

"We wouldn't have such a broad platform if we didn't have investors telling us they wanted that sort of risk with the returns we have provided to them. Likewise, if there wasn't demand on the borrower side, then there wouldn't be a lot to do," Sloan adds.

Commercial real estate borrowers today are in an understandably difficult position, he says. "They would love for interest rates to come down and very quickly. That is their biggest focus today and the biggest question they have is what the interest rate environment will be six months or a year from now."

To the extent a borrower has a view, the borrower is more than likely to want to engage in a short-term loan. "The borrower wants an opportunity to not get locked into a long-term capital structure at higher rate," Sloan says.

Borrowers are also concerned about the maturity structure of their underlying debt, he adds. "When loans are coming due, they're focused on how to deal with those situations given the value of the property might be lower than when the originally took the loan out," Sloan adds.

And Fortress, for its part, is a borrower from banks to fund its real estate private credit and other aspects of its business.

"When you look at the fastest-growing category of lending for commercial and investment banks, it has been loans to other financial institutions, like Fortress," Sloan says. "We have excellent relationships with banks in this country and in Europe who provide us credit. We get equity from our investors and get credit from banks."

Managing risk (and distress)

Fortress, as an investment management company which has always had a diversified portfolio, believes this to be a significant asset as the firm seeks to expand its reach. Part of this is the ability to apply some of the evolution already seen in the broader private credit space for commercial real estate, Sloan notes.

"There is a transformation in terms of who is providing real estate lending in this country. It's similar to what's happened in the non-real estate private credit world," he says.

While there are risks on the horizon, there are many that Fortress cannot control. "We are very good at underwriting commercial real estate, borrowers and markets. Are we perfect? No, no one is ever perfect, but I feel good about our ability to make good decisions," Sloan says. "What I worry about most are the risks outside of our control: where are rates going to go, are we going to have a soft landing, is there some kind of geopolitical event or other exogenous factor? We're also focused on how real estate will be used over the next five to 15 years."

But the firm is confident in the work it has already done to build its platform over the past 25 years and in its ability to invest across markets and cycles. "The quality of our team and our long history of experience positions us incredibly well. We want to continue to be known as one of the most sophisticated lenders and investors on the distressed side – and alongside that, continue to grow and diversify the business," Sloan says. ■

Low-yield JVs

Aug 2024 Given its established relationship with Derby Copeland Capital, enters a new $500 million, 85/15 joint venture to target lower-yielding, higher-quality assets with FCR's lower cost of capital with the company

Jul 2024 Enters a new $200 million, 90/10 joint venture with Keystone National Group to pursue mid-market multifamily and commercial lending opportunities