Real Estate Debt: A Primer

A persistent imbalance between US housing supply and demand may be bolstering home prices even as mortgage rates hover near levels not seen in more than two decades. At the same time, regulatory changes have prompted traditional banks to pull back from certain types of real estate lending, creating opportunities for private lenders to provide liquidity to the real estate market—and potentially generate attractive, long-term returns for investors.

KEY TAKEAWAYS

- The chronic undersupply of US housing in the face of consistent demand has buoyed home prices even as affordability has grown increasingly strained.
- Regulatory changes following the global financial crisis have reduced bank lending in real estate, creating opportunities for investment managers to provide necessary liquidity at attractive terms.
- Investors with the flexibility to opportunistically rotate between public and private real estate debt exposures may be particularly well positioned.

The supply of housing in the US has grown increasingly strained in the years following the global financial crisis, as a credit crunch amid the turmoil of that period prompted a massive decline in housing starts from which the construction industry has yet to fully recover.[1] The impact of new-home underbuilding has been exacerbated in recent years by the limited supply of existing homes for sale, due primarily to the "lock-in effect" of higher mortgage rates. At nearly 7%, the current 30-year fixed-rate mortgage far exceeds the 4.2% average on existing mortgages and is a significant disincentive for homeowners to sell.[2]

The demand side of the equation, meanwhile, has been well supported by unabated household formation, with the number of US households doubling since 1970[3]. More recently, consumer fundamentals have been a tailwind for demand; household net worth stands at a record high, debt levels remain manageable, and indicators of consumer confidence have been biased higher.[4] These trends are validated by Fannie Mae's Home Purchase Sentiment Index, which has reclaimed levels consistent with those preceding the early-2022 start of Federal Reserve rate hikes as consumers appear to have acclimated to the environment of higher home prices and higher mortgage rates.[5]

We believe these dynamics support compelling opportunities in both private and public US real estate debt investments. Yields on private-market exposures like residential transitional loans and homebuilder finance offer attractive complexity and illiquidity premia over traditional credit assets like leveraged loans and high yield bonds, alongside short durations and robust cash flows. Certain real estate-backed securities in the public market—including agency credit-risk transfer securities as well as instruments linked to mortgage insurance and non-qualifying mortgages—may serve as attractive complements to private-market exposures in our view. Investors with the flexibility to opportunistically rotate between private and public real estate exposures may be particularly well positioned to capture the benefits of each while also exploiting the relative-value discrepancies that periodically emerge between them.

Specialty-lending channels tend to have high barriers to entry, however. In our view, experienced sourcing, underwriting and structuring capabilities are essential for those looking to leverage the ample opportunities we believe exist in residential real estate debt.

1. Source: Federal Reserve; data as of December 31, 2023.
2. Source: Freddie Mac, Federal Housing Finance Agency, National Mortgage Database; data as of January 31, 2025.
3. Source: U.S. Census Bureau via FRED; data as of November 12, 2024.
4. Source: Federal Reserve Bank of St. Louis; data as of December 31, 2023.
5. Source: Fannie Mae; data as of January 7, 2025.

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- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
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- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
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- Below-investment-grade loans, which may default and adversely affect returns.

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