**Genesis North Tower:** Barings financed the completion and lease-up of this 21-story life sciences building in the San Francisco Bay area

# A time for balance

Dean Dulchinos of Barings talks to *PERE*'s Kyle Campbell about how he expects the US real estate debt market to shape up in 2019

After 10 years of steady growth, many in the private real estate industry feel a correction is imminent, even if there are as yet no clear signs of distress. Uncertainty of this kind normally drives investors toward defensive strategies, but closed-end real estate debt fundraising actually fell in 2018 for the first time in four years, according to *PERE* data. However, Dean Dulchinos, head of Barings' Real Estate Debt Portfolio Management and Capital Markets Groups, tells *PERE* that traditional methods for tracking this part of the market do not tell the whole story. The 26-year veteran has seen investors flock to real estate debt but through different vehicles and sometimes with goals that go beyond financial returns.

***PERE**: What opportunities exist today for investors in the real estate debt asset class?*

**Dean Dulchinos:** There are two primary opportunities that investors seem to be most focused on today. The first is the opportunity to enhance their existing exposure by adding real estate debt investments. Some may be long-time equity real estate investors looking to reduce volatility, while others may be fixed income investors looking to increase yield or reduce correlation within their portfolios by adding illiquid secured debt.

The second opportunity is more structural in nature. Many investors seeking to invest in real estate debt are focused on open-end funds, which is a shift in the marketplace. Open-end equity funds have been around for years, but the concept of an open-end debt fund is fairly new. We have seen a number of these come into the market recently. Open-end structures can offer some advantages over closed-end structures, such as investor liquidity and capital efficiency – as these structures allow investors to maintain steady capital deployment through a single investment vehicle, rather than ramping up and down as they would with multiple closed-end funds.

***PERE**: What types of investors are active in real estate debt in the US and what are the attractive characteristics of debt as opposed to equity in the current market?*

**DD:** We are seeing a lot of activity from pensions and insurance companies, both in the US and internationally, as well as sovereign wealth funds. It is an active, well-diversified investor market right now. We are a long way into a market recovery, and while fundamentals still look good, many investors are planning for potential volatility in the marketplace. For these investors, adding an allocation to real estate debt in their portfolio may be seen as a way to reduce volatility while maintaining exposure to real estate. Because debt is not in a first-loss position relative to the real estate asset, it can provide some protection against volatility if the value of the underlying real estate collateral fluctuates.

Another component of real estate debt that is attractive to investors is its ability to offer significant current income. For example, if you are invested in core equity real estate, you are looking to a combination of current income and appreciation to achieve your total return, whereas the return on a debt investment can be structured as all current income. Some real estate investors see real estate debt as a complement to equity. They may have significant equity allocations in their portfolios, but their expectations for appreciation are limited. So they may view adding an allocation to real estate debt as an opportunity to de-risk while still maintaining an attractive current return.

***PERE**: Investors seem to be a little more conservative in terms of the risk-reward profile they are seeking. Is that something you are seeing at Barings too?*

**DD:** Yes, I think that is right. If you look at the broader investor marketplace right now, you will find that the majority of investors seeking new real estate debt investments are looking to go down the risk curve, and are willing to accept a lower return for that lower risk, and that is a valid strategy. In fact, that is a large portion of the demand in the borrowing marketplace right now. Although, at the same time, there are investors looking to provide capital where the market is less efficient, and that is a relative value play that can be really rewarding. Some examples of that might be construction lending or lending on transitional assets where there are temporarily disrupted cashflows.

The important thing is for investors to identify and understand the risk they are taking and then, if they are comfortable with that risk, to make sure they are getting appropriately paid for it. There are a lot of fund investment options in the market, each of which has a slightly different strategy for providing targeted returns. Underlying it all, there are a few basic risks that investors can take in real estate debt – for example, market risk, borrower risk, leverage risk, cashflow risk and business plan risk. The way a particular strategy accesses or avoids each of these risks is an important factor in the overall risk of the investment. Understanding how managers define 'core' or 'core-plus' strategies is a critical part of this risk management.

In the current market, our team at Barings is finding opportunities to take risk and get paid for it in construction lending, especially larger loans, and lending on properties that are experiencing temporary cashflow disruption. These are opportunities where we have found that some lenders may be less efficient. At the same time, you will not see us taking excessive risk on borrowers and markets, or on leverage.

**Dulchinos:** seeing a lot of activity from foreign and domestic pensions and insurance companies

***PERE**: The opportunity zones program has been a topic of conversation in the industry as of late. Although it is an equity initiative, are there opportunities for your business in and around these developments?*

**DD:** We have done some work around opportunity zones and understanding them as a firm, both from an equity and a debt perspective. As you said, it is really an equity play. The opportunity zone is based on a tax incentive related to capital gains. As a lender, one of the things we like about opportunity zones is the potential for the new rules to attract institutional capital to areas that need improvement and are not otherwise attracting capital efficiently. That fits well with our focus on ESG and our desire to partner with like-minded institutions to supply capital that benefits areas like this. For example, we have a robust affordable housing lending strategy. As a result, lending into zones where more and higher quality affordable housing is needed is important to us, and the Opportunity Zone legislation is hopefully creating incentives that will bring equity capital for housing and other infrastructure into zones that need redevelopment. The rules affect all property types, but since multifamily is a particular focus for our firm, we are hopeful that the new Opportunity Zone tax incentive will provide the impetus necessary to advance the pace of development for affordable and workforce housing in underserved communities making this investment economically feasible.

***PERE**: There is the feeling that we are nearing the end of an elongated cycle. If things shift in the coming months, how do managers stay competitive and attractive to investors?*

**DD:** As we move through the next stage of the credit cycle, maintaining a focus on risk is paramount. Once risk in an investment is identified and mitigated through structures such as reserves and covenants, it is important for lenders to monitor ongoing risk during the life of the loan, especially where the borrower is executing a business plan at the property to increase value. Beyond that, it is important to regularly monitor assets and ensure that they are adhering to their stated guidelines. To the extent that an investment hits a speed bump, debt managers should become active participants in discussions with borrowers and be prepared to provide flexibility while maintaining credit discipline in order to get the project back on the right track.

As a lender, you also need to be ready to own real estate assets. Although the bulk of Barings' lending strategies are not focused on ownership, we will always analyze our debt investment as an investment in the real estate itself at a price equal to our loan amount, or what we call our loan basis. If we would not be comfortable owning the real estate at that price, then we won't make the loan on it. □