Financing the housing crisis

Lenders seek to differentiate themselves in a crowded – yet crucial – housing market. By Claire Coe Smith

While some investors are ready to call the bottom of the office market and return to deploying capital there, a growing segment of private real estate debt is focused on residential property moving into 2025.

Addressing the huge imbalance between supply and demand that exists across both the European and US housing markets – along with the need to upgrade residential stock to meet escalating ESG requirements – is creating opportunities for private debt funds able to navigate the challenges of a highly competitive space.

Ellis Sher, chief executive of Maslow Capital, Arrow Global's real estate financing business, covers the living sector in five European countries, with plans to increase to seven. "At a macro level, the opportunity set is driven by growing demand for housing. People are living longer, the housing stock is ageing, energy regulations are becoming stricter, and household formation is increasing, largely because people are getting married later or not at all," says Sher.

With net migration also rising in some European countries, the challenge is compounded by a lack of supply, as countries cannot build quickly enough to deliver the homes that are needed.

Sher adds: "If you look across real estate and superimpose residential and student performance on top of retail and commercial, the two sectors are almost inversely correlated in terms of occupancy, performance and rental growth.

"From a lender's perspective, we don't believe the additional margins gained from taking on commercial and retail risks currently offer a sufficient premium compared to what is available in the residential and student sectors."

That imbalance between demand and supply looks unlikely to change any time soon, which bodes well for collateral values. The difficulty for private credit, though, is finding an angle in a crowded market.

A competitive sector

Phil Moore, partner and head of European real estate debt at Ares Management, says: "Residential is probably the most competitive part of the lending market at the moment, in terms of supply of credit, alongside logistics. If you layer on lenders providing ESG-orientated financing, there is very strong participation in lending to standing assets, multifamily and student housing across Europe."

Moore says Ares seeks to participate as much as possible in this space, but for private lenders to compete on cost of capital with banks or insurance companies, there has to be some specific need to address, whether that is higher leverage or more transitional situations.

"We will strategically consider ground-up development if we can find opportunities at the right size," says Moore. "But newly delivered assets that need to go through lease-up also offer attractive opportunities for us, as do people bringing first generation assets up to higher standards to improve energy efficiency ratings."

Meanwhile, Bryan Donohoe, partner and co-head of Ares US Real Estate, says private credit's role is to have the vision of what these buildings can be, not just what they are currently.

"The opportunity for us has grown out of a shortage of housing

post-financial crisis as we collectively failed to build enough homes and apartment units," says Donohoe. "There is now a pretty sizeable deficit of places to live that is going to cause rents to grow and home prices to stay elevated, alongside a bank market that is less constructive around solving this issue from a financing perspective."

The US housing financing ecosystem is going through a meaningful transition. According to Leo Wong, partner and head of loan strategy at Waterfall Asset Management, some 80 percent of the entire market was refinanced in the two years immediately post-covid due to low interest rates. He says some $8 trillion of mortgages originated in that period and, since then, a strong and resilient housing market, driven by undersupply, has fuelled the investment opportunity.

"It remains the case that, in our view, interest rates are shaping housing demand and shaping private credit opportunities," says Wong. "The story now is less about supply and demand and more about affordability because 80 percent of people that own houses with mortgage debt in the US now have interest rates that are more than 100 basis points below the prevailing rate, so they are stuck.

"The rates they have are not going to be competitive in a refinancing scenario any time soon. As a result, the non-bank universe has not been able to create new loans because there is limited demand for 7 percent interest rates when most consumers out there have something lower."

Product development efforts have redoubled across the market to help consumers extract equity and access liquidity, with innovations like second liens, home equity lines of credit and reverse mortgages, for example. Wong says his team also sees opportunities in build-to-rent and in the fix-and-flip residential transitional loan market.

Michael Henriques, senior portfolio manager and partner at Magnetar Capital, says: "There were many home renovation loan products that existed pre-financial crisis and fundamentally disappeared as a result of bank regulation and the reduction of consumer credit on bank balance sheets. Private credit has filled that space, helping take older housing stock and bring it back online."

Changing tack

If rates stabilise or come down, firmer land prices will likely lead to more development, but there will be a time lag before that new stock becomes available. In the meantime, Magnetar sees opportunities to provide growth capital to companies that support a range of real estate investment opportunities, from affordable housing to mortgage origination.

"That includes investments with builders to renovate older housing stock," adds Steven Shapiro, a portfolio manager at the firm. "By stepping in to provide additional capital beyond what bulge-bracket banks typically offer, we enable these companies to scale their impact while our position is protected through our security in the assets on their balance sheet."

Debt funds need to home in on the sectors that are suited to private credit's ability to provide flexible capital. Henriques says these sectors often don't align well with banks because of regulatory constraints, nor with hedge funds, where redeemability and tight selling timelines can create challenges. Similarly, he says they don't fit the private equity model, which emphasises multiples over debt-yielding financing solutions.

"Private credit, on the other hand, thrives in these markets because of its long-term capital base," he says. "This allows us to work through potential challenges without being constrained by immediate liquidity demands or fixed redemption dates. With a reasonable distribution of yields and outcomes, private credit is better positioned to address the nuances of real estate opportunities."

LPs are keen on the combination of undersupply and government support that shapes the lending opportunity on both sides of the Atlantic. While concerned about construction costs and development risks, there is appetite for what looks set to be a good growth trajectory over the next five years.

"For private credit, this is a train that has been running for some time – we have been doing this for 15 years," says Maslow Capital's Sher. "The challenge for managers is that scaling private credit requires significant time and working capital. By its nature, private credit is a fishing expedition. To find opportunities, you need a large team originating deals from multiple sources, and you must delve deeply into the underwriting process."

Managers also need flexibility in their capital base, as real estate is very liquid in good times and illiquid in bad. However, those set up to ride the waves see plenty of opportunities on the horizon. ■