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Market Insights

Private Residential Credit - Portfolio Allocation

PALISADES

The market for private *residential* credit is estimated to be approximately 2.2 times the size of the non-bank corporate lending market, which is the prevailing definition of 'private credit.'

Private *residential* credit provides a myriad of product types, along with a variety of risk, return, and duration profiles from which to construct thoughtful and resilient portfolios. **Based on the respective size of the markets today, one could expect private *residential* credit to contribute 60% to 70% to any diversified private credit portfolio allocation.**

'PRIVATE CREDIT'

Private credit, or non-bank corporate lending, has garnered the lion's share of attention in 2023. Numerous alternative asset management firms that historically focused on private equity, leveraged loans, opportunistic/traditional fixed income, and/or distressed debt have raised sizable funds aimed at filling the gap left by the tightening of credit in the U.S. regional and money center bank market.

While most of the recent funds are focused on direct lending, or senior debt, traditional definitions of private credit include mezzanine debt, venture debt, opportunistic, and distressed strategies. According to Preqin, the size of today's private credit market sits at $1.6 trillion, and BlackRock's Amanda Lynam, Head of Macro Credit Research, estimates that it will grow to $3.5 trillion by 2028.

'Private credit' is typically characterized by direct lending provided by non-banks to small and mid-sized companies that are unable to, or choose not to, access public markets for debt financing. Senior debt involves making loans to support a company's growth, acquisitions, or refinancing needs. These loans are typically senior in the capital structure, secured by collateral, and **attractive in today's rising rate environment because they offer floating-rate interest structures**. While increasing interest income is attractive to investors, the same represents an interest expense for borrowers that can put pressure on their ability to pay back the loan and/or refinance the debt.

The benefits of a private credit allocation include:

- **Floating-rate structures that are attractive in rising interest rate environments, with spreads over SOFR typically ranging between 5% to 6% and reset every 30 to 60 days.**
- **Higher returns relative to traditional public fixed income products due to an illiquidity premium.**
- **Target yields currently in the 12% to 15% range.**
- **Less volatility and mark-to-market risk relative to public securities.**
- **Ability to secure better covenants and credit protections through bespoke loan structures.**

Unlike public debt, private credit loans tend not to need credit ratings and rather rely on the due diligence conducted by the lender. According to research reports, senior loans often have more conservative credit metrics, such as lower loan-to-value ratios, higher debt service coverage requirements, and stronger covenants. **It will be interesting to observe the evolution of underwriting discipline in the private credit sector as competition for deals heats up alongside the increase in dry powder.**

With the recent turmoil in the U.S. bank market, ongoing and anticipated regulatory changes, volatility in the U.S. equity markets, and the significant amount of capital raised, **many private credit funds have started to target large companies that would have historically sought capital structure solutions in the public debt or equity markets**. As a result, we are hearing about the ever-increasing size of private credit transactions.

"Private credit firms seeking to capture market share from traditional bank lenders are giving up investor protections as they snag larger financings, according to Moody's Investors Service.

Direct lenders have been siphoning business from the broadly syndicated leveraged loan market in recent years, in part by staking a claim to increasingly larger deals. But an analysis by the credit-rating firm shows that legal safeguards that protect investors tend to weaken as the size of the transactions increase.

Moody's has already written that the competition between banks and direct lenders in the leveraged buyout arena will likely result in more defaults as riskier debt deals get done, part of a "race to the bottom" between the two groups as they compete for a limited number of financings. Weaker protections suggest private credit firms could be in store for more pain than previously expected should their loans sour."

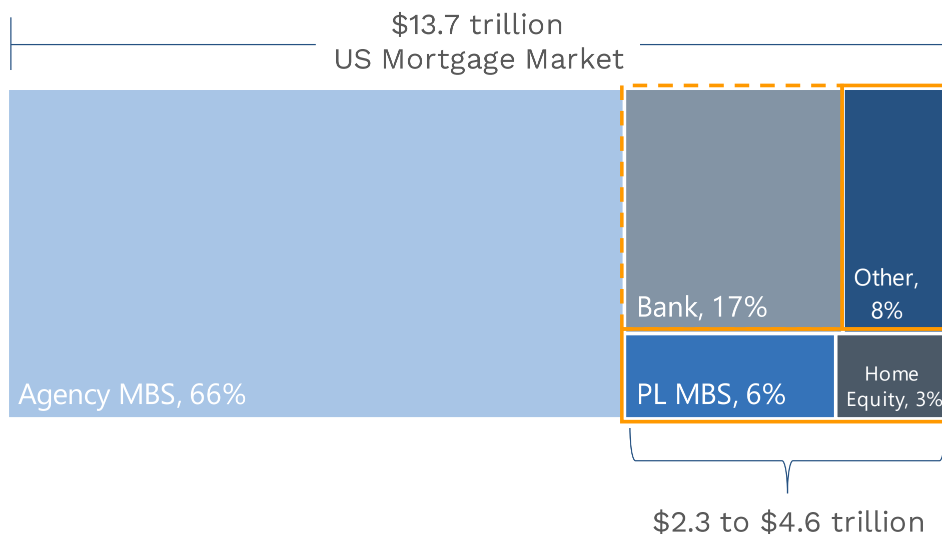
Bloomberg, Private Credit Weekly
October 26, 2023

While competition often leads to loosening credit standards and/or elevated pricing, the current iteration of the private credit sector still seems to be early in the deployment cycle, with a reasonable amount of quality demand as regional and money center banks pull back, and equity market exits for established venture-backed companies remains less than ideal.

However, to structure a private credit portfolio allocation with the optimal expected return for a given level of risk tolerance, **investors could be expected to include a meaningful mix of *diversified private residential credit products*, one of the largest credit sectors in the U.S.**

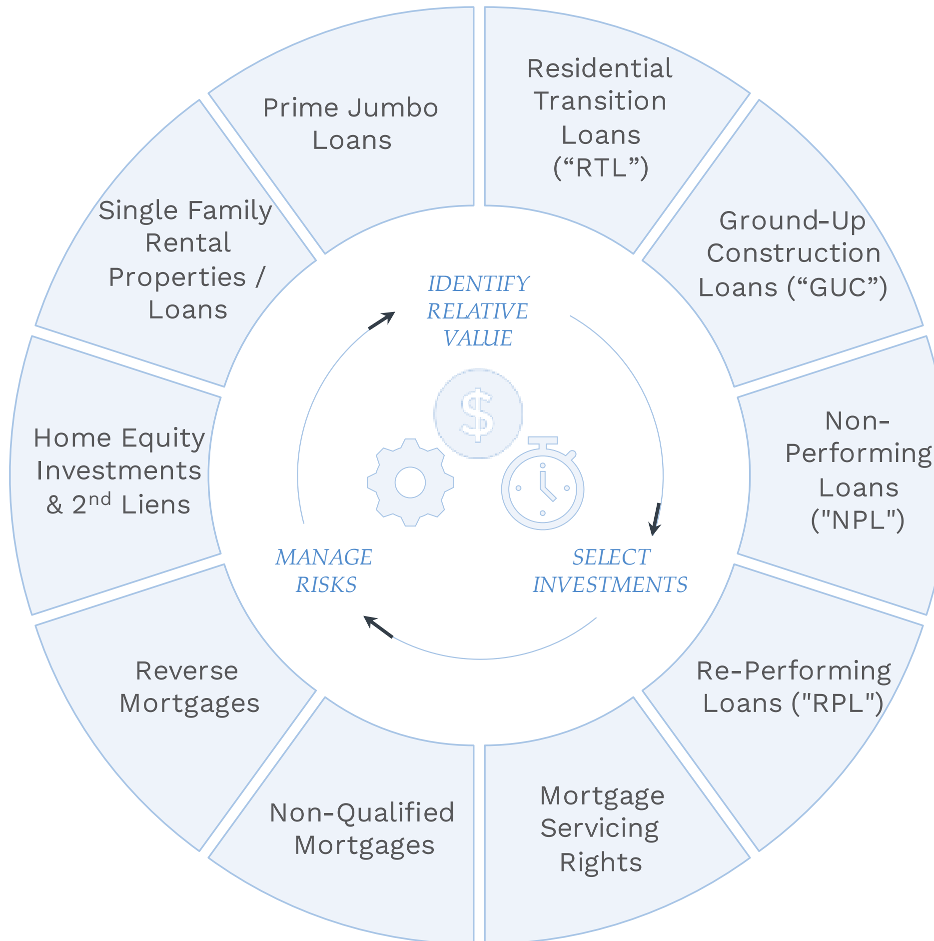
PRIVATE RESIDENTIAL CREDIT

Private residential credit is a huge tent comprised of a myriad of loan products that are collateralized by, or tied to, single family residential real estate. It is considered by many to be a niche or esoteric sector that often ends up in a purgatory between an allocator's credit, fixed income, and real estate allocations. We estimate the U.S. private residential credit market to be comprised of at least $3.5 trillion in total debt, which is a subset of the $13.7 trillion U.S. mortgage market.



The product set is constantly evolving and can include everything from distressed and non-performing loans to high credit quality long duration consumer loans, short duration construction loans to builders and developers, negative duration products backed by loan servicing fees, and home equity products.

SELECT PRODUCT TYPES
WITHIN THE RESIDENTIAL CREDIT SPECTRUM



A benefit and curse of private residential credit investments (i.e. residential loans) are the barriers to entry; most prominently, the ability to prudently manage large and granular portfolios – amounting to tens of thousands of loans, which is only exacerbated for investors that seek a diversified portfolio mix of product types. Additional complications arise when the manager utilizes multiple mortgage loan servicers who all have unique technology systems and data delivery mechanisms. Some of these challenges can be addressed by managers with captive loan servicing operations, however, captive loan servicing often comes at the expense of redundancy and continuity in key service providers, increased conflicts of interest, and reduced information flow relative to managers that have integrated with and oversee multiple third-party loan servicing platforms.

Another traditional way to obfuscate the ongoing credit management challenges is to simply outsource the asset-level risk management to the designated mortgage loan servicer(s). This approach eliminates the manager's need to build out robust data management processes and systems and hire staff with related expertise, with the cost being that the value-add components of the strategy are contracted out to a third party that may not be fully aligned with the investor in terms of optimizing the economic outcomes within the portfolio.

The practical execution and management of a private residential credit strategy involves:

- **Taking a top-down approach to product and asset allocation; not being anchored or conflicted with respect to any single product type.**
- **Thoughtful portfolio construction across a diverse set of residential credit products.**
- **Robust infrastructure necessary to take on and manage large datasets.**
- **Access to technology applications used to convert data into actionable and efficient asset-level decisions.**
- **Control-oriented approach to credit risk management with the ability to influence outcomes.**
- **Experienced specialists at every stage of the investment lifecycle (due diligence, trade management, collateral remediation, asset-level credit risk management)**

PRIVATE RESIDENTIAL CREDIT
VALUE-ADD CREDIT MANAGEMENT

Due Diligence Oversight
Transaction/Trade Management
Data Validation
Credit Risk Management
Payment Date Tracking
Natural Disaster Monitoring
Federal Aid Oversight
Loan Modification Optimization
Loss Mitigation Strategy
Loss Mitigation Monitoring
Real Estate Management

The 2008 financial crisis marked the nadir of the U.S. housing and mortgage markets since the Great Depression. **Today, there are stark differences in housing/mortgage market risks relative to 2008.**

Excess Demand Relative to Low Levels of Supply

- *51%* | Existing home inventory (*1.1 million*) below the historical average (*2.3 million*)
- *3.4 months* | Months' supply of existing homes below the *5.3-month historical average*
- *0.7%* | Owner-occupied vacancy rates at historical low levels
- *48 days* | Days on market; *16%* below historical average for the month of September (*57 days*)

Low Affordability for Prospective Buyers

- *8.04%* | Highest mortgage rates since March 2020
- *5.5%* | Year-to-date home price appreciation (S&P Case Shiller 20-City index)

Strong Mortgage Consumer Credit Conditions

- *$10.5 Tn* | Mortgage Loans originated from mid-2019 to mid-2020
- *3.7%* | Average interest rate on the stock of U.S. residential mortgage loans
- *$30.7 Tn* | Historically high level of home equity
- *3.9%* | Delinquent loans and foreclosures near historically low levels

Strength in the New Home Market

- *28%* | New home inventory as a percentage of total inventory (*13% historical average*)
- *~6.0%* | Interest rates for new homes after builder incentives go toward rate buy-downs
- *2.4 months* | Months to sale since completion of new homes (*5.5 months historical avg*)

While housing demand has no doubt been curtailed, the rising interest rate environment has disproportionately impacted inventory levels which explains the supply/demand imbalance and associated rise in year-to-date home values in 2023.

This backdrop of high credit quality mortgages, high housing demand relative to supply, large swaths of low interest fixed-rate loans, a new home market that is enjoying a competitive edge relative to the resale market, and a loan origination sector that is roiling with low volumes and profit margins, creates opportunities for mortgage credit investors.

TAKEAWAYS

- A diversified private credit portfolio should have an allocation to residential credit commensurate with the relative size of the respective markets.
- A properly constructed multi-product residential credit portfolio can offer investors an attractive return profile that is resilient across economic, housing, and interest rate scenarios.
- Today's housing and mortgage market backdrop is rife with opportunities to identify relative value in residential credit products.
- Non-commoditized and operationally complex product types can offer incremental risk-adjusted returns due to the lack of competition and reduced price risk.
- **Investors can choose between:**
  - **Managers with captive versus non-captive strategies:**
    - Captive in-house lending and servicing capabilities; or
    - Non-captive utilization of a multi-product network of lenders/originators and non-conflicted and redundant servicing resources.
  - **Managers with specific asset-level credit risk management capabilities (specialists) or those that contract out credit decision-making to a third-party loan servicer.**

While headlines often emphasize the first order observations related to reduced affordability and decreased housing transaction volume, the second order effects stemming from these dynamics can present valuable opportunities for investors.

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