

What real estate debt can do for your portfolio

The good, the bad and some areas of opportunity

<u>David Israelson, Canadian Family Offices</u> Published March 4, 2025

With the economy looking somewhat unpredictable in 2025, it may be a good time for high-net-worth investors to look at investing in real estate debt.

Allocating a portion of a family office or high-net-worth portfolio to real estate debt can make sense in the current market, but you have to be careful, says Ken McKinnon, Senior Managing Director and Equity Partner at Institutional Mortgage Capital (IMC) in Toronto.

"The market is still uncertain," he explains. "While office properties are poised for a tentative recovery, there's an excess of condominiums in major markets such as the Greater Toronto Area and some development projects are taking longer to get going than investors may have expected. In our own debt business, we are being very selective when lending to land or office buildings, and our book is quite strong."

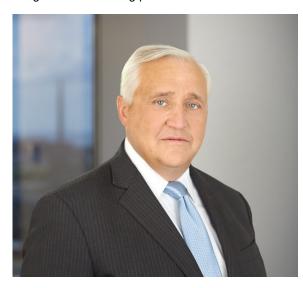
Investing in debt differs from investing directly in real estate. In a straightforward real estate transaction, the investor buys an asset such as an office building, shopping plaza, residential development or any other type of property. Usually this requires borrowing funds.

Investors who acquire real estate debt are on the other side of the property deal. The debt investor lends funds to the purchasers, either directly or through a fund that gathers multiple lending deals, with the borrowers committing to repaying over time, typically with interest. The property serves as collateral, providing the debt investor with security if the borrower fails to pay.

One of the benefits of a real estate debt deal for highnet-worth investors is that debt repayment can provide a secured, long-term, steady income stream. Allocating a portion of a portfolio to real estate debt can also help mitigate risk, says Natasha Khullar Relph, writing for Arrived, a U.S. based real estate investment firm.

"There are other benefits as well," says Robert Fitzpatrick, Senior Managing Director, IMC. "Real

estate debt is a good way to diversify a fixed income portfolio. Because of the shorter time horizon of the loan, there is fairly low-interest rate risk. Plus, similar to other hard assets, real estate can act as an inflation hedge while enhancing portfolio diversification."



Robert Fitzpatrick, Senior Managing Director, IMC

The potential downsides of the asset class? Default risk is one, and real estate projects may underperform expectations and take longer to repay. There is also interest rate risk, which may seem particularly challenging when the direction of rates is uncertain.

Both the Bank of Canada and the U.S. Federal Reserve have signaled that they expect to continue lowering rates as long as inflation is tamed, but shifting economic policies in both countries mean it's not at all certain that rates will keep going down. Real estate fund managers will typically try to mitigate this risk by financing transactions on a floating-rate basis.

There's also the risk that a lender will simply provide funds to underperforming segments. The office market, while poised for recovery, was shaky last year, as companies struggled to convince workers to return to their desks and the market had yet to absorb the cuts in interest rates that could spur new development activity.

"Some lenders have lent to land developments in the expectation that the development would take place within three to five years," McKinnon says. "That would make the land worth a lot more in the meantime, but it's taking five to seven years instead, which increases costs, lowers returns and increases risk of defaulting."

One way to avoid getting stuck in underperforming segments is to focus on shorter-term opportunities, notes Fitzpatrick. "When you do can do that, loans are repaid faster and the managers can redeploy into a sub-asset class that is performing better."

The overall market for lending is good right now, says McKinnon. "We have seen good debt investing opportunities in grocery-anchored retail shopping centres, residential rentals, certain hotels and student housing, for example."

One approach to consider when seeking debt investment is to look at the manager or lender's performance over the past few years when the lending environment was more challenging. Real estate lending that focused both on cash flow and low loan to values have done well despite higher interest rates.

"If you go through the different property asset classes we're not seeing a lot of stress," McKinnon says. "It's not like the early 1990s, when the entire real estate industry was turned upside down. The best managers have navigated through many economic cycles and are able to manage within various environments.

"There's not a lot of office property debt available. We have very little exposure to the space, but it may be a sector to watch as it starts to rebound," McKinnon suggests. Others agree. CBRE Research's 2025 Canada Real Estate Market Outlook says that "Canada remains a growth play," with this year poised to be one of increased investment in the commercial market.

"The past five years have dealt real estate a lot of shocks: inflation, lockdown, remote work, rate cuts (followed by rate hikes, followed again by aggressive cuts) and a housing affordability crisis," writes Adam Jacobs, senior national director, Colliers Canada.

"However, these shocks haven't been evenly distributed. Increasingly, downtowns are feeling the brunt of the new status quo. This is a reversal of decades of preference for downtown among occupiers, developers [and] investors."

McKinnon says Canada can be a particularly good place for investing in real estate debt. Canada's banking system is more tightly regulated and less competitive than U.S. banking—a fact that might annoy some banking customers but can be a boon for prospective lenders.

"Canada is a good market for lenders, with well-capitalized, strong banks," McKinnon adds. "And if borrowers run into problems in Canada, they're more likely to work with their lenders and ultimately repay their loan."

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