Stormfield Capital

STORMFIELD INSIGHTS

Opportunities Abundant in Commercial Real Estate Bridge Lending

APRIL **2023**

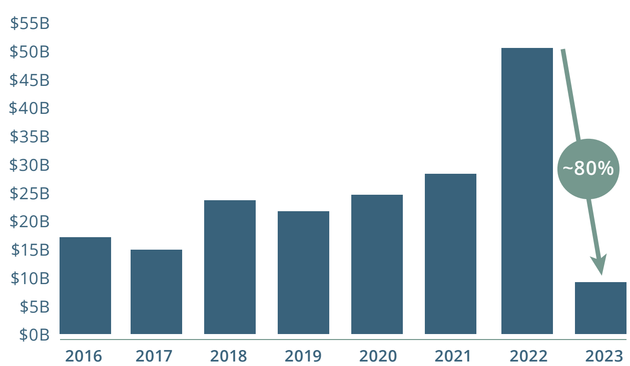
The past twelve months have seen a regime change in inflation expectations, interest rates and the cost of capital. Should the Federal Reserve follow through with current guidance at their next FOMC meeting, the Fed Funds rate will rise above 5.00% for the first time in fifteen years. This change has had, and will continue to have, significant implications for the value of all asset classes, whether they be fast growing technology companies or commercial real estate properties.

The implications are also significant for future capital markets activity as well as the structure and source of financing for commercial real estate transactions. As we will demonstrate below, these dynamics have created a particularly compelling environment for private capital to fill the void left by the dramatic decline in real estate debt securitization and likely future decline in bank CRE lending. Indeed, we believe we are in the very early stages of what will likely be a multi-year cycle of superior returns for Stormfield's core strategy of commercial real estate bridge lending. We deconstruct the environment before us into three distinct phases. Each phase is marked by its own unique set of catalysts and opportunities as well as commonly shared attributes which should benefit results for years to come.

Phase I:
March 2022 through Present

Phase one began in March 2022 and was marked by the Federal Reserve's belated recognition that inflation would not be "transitory," resulting in what would be the first of many rate hikes in March of 2022. The size and speed of rate hikes undertaken by the Federal Reserve quickly unsettled fixed income markets and resulted in a 75%+ drop in commercial real estate debt securitization thus far in 2023 versus the same period in 2022. The seizure of the securitization market eliminated a significant source of competition for bridge loans, particularly those backed by "fix and flip" or value-add transactions. As an unleveraged, balance-sheet lender, Stormfield has been able to capitalize on this dynamic by raising interest rates charged to borrowers, switching to floating rate notes which benefit from rising interest rates (and are hedged against declining rates by the inclusion of interest rate floors), lowering our loan-to-value ratios, increasing our borrower and property selectivity and skewing covenants (such as pre-payment penalties, interest reserves, extension fees and ratcheting floors upon extension) further in our favor.

SECURITIZATION ACTIVITY



Source: Bloomberg
Includes Private Label Conduit, SASB, CRE CLO, and Small Balance Transactions

Phase II:
March 2023 to Present

Phase two began almost exactly one year after phase one, with the collapse of Silicon Valley Bank (SVB) on March 10, 2023. Retail depositors quickly lost confidence in many regional banks and transferred in excess of $100 billion of deposits from smaller banks to a handful of banks deemed "too big to fail." While banks do not technically require retail deposits to fund loans, retail deposits generally represent the cheapest source of funding for a financial institution[1]. Forced to turn to the more expensive wholesale deposit market (or capital markets) for additional funding, many regional banks have responded by curtailing lending to mitigate risk. Significantly, regional banks account for roughly 70% of commercial real estate lending in the U.S. Publicly traded mortgage REITS (which, as leveraged vehicles are very sensitive in their own right to the cost of funds) have also been forced to significantly curtail lending, with volumes down over 40% in 2022. Also of significance, mortgage REITS have accounted for roughly 10% of commercial real estate lending in the U.S. in recent years. The combination of these two groups (regional banks and mortgage REITS) pullback from lending caused aggregate U.S. commercial real estate lending to decline in March 2023 for the first time since 2009-2012 (the period immediately following the Great Financial Crisis).

Much as with the environment during Phase I, the current landscape has provided strong negotiating power to Stormfield while also dramatically increasing our pipeline of time-of-the-essence ("TOE") closings and bridge-to-permanent transactions stemming from borrowers whose bank loan applications have been cancelled or delayed.

Phase III:
Mid 2023 through 2025

While we have already witnessed several high-profile defaults (for example, in early April, Applesway Investment Group defaulted on $230 million of debt secured by 3,200 apartment units located in Houston, Texas), we believe the vast majority of defaults remain in front of us. As with any distressed cycle, we believe the upcoming cycle will present abundant opportunities for conservative, unleveraged funds such as those managed by Stormfield to profit, in this case by offering bridge loans to restructure pre-existing debts or by purchasing non-performing loans at a discount to par.

Conclusion:

We believe we are in the very early stages of the most compelling investment environment since we launched Stormfield in 2015. We are now routinely originating loans with coupons in excess of 12%, which when combined with origination and exit fees, leads us to expected IRRs of 14% to 18%+ on new loan origination. Furthermore, as described above, we see significant catalysts for upside to these returns through the retrenchment of regional bank lending and a likely protracted distressed cycle.

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1. Banks utilize double entry bookkeeping whereby a new loan creates two corresponding entries on its balance sheet. The first is the creation of the loan as an asset on the balance sheet, the second is a corresponding newly created deposit, which is entered as an offsetting liability on the balance sheet. Hence, the creation of a loan actually creates deposits.
2. Source: Trepp