PCCP MARKET COMMENTARY

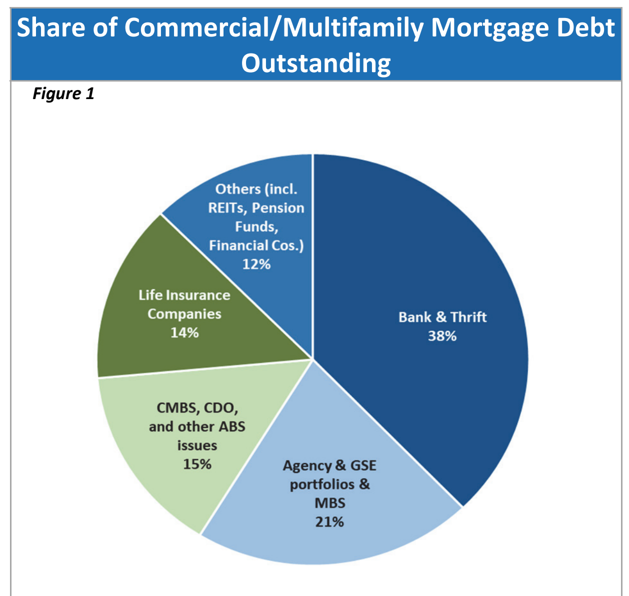
First Quarter 2023

The More Things Change…

For nearly 25 years, PCCP has participated in the evolution, maturation, and institutionalization of the commercial real estate private debt market. We believe we are one of the longest-tenured private real estate debt managers in the U.S. and have managed nearly $27 billion in loans throughout our history. Thus, we have had a front row seat for observing – and driving – changes within the market which have taken shape since our inception. Over this period, we have witnessed the noticeably waning presence of banks, which once dominated this space, resulting from both competitive pressures and the reverberating effects of the Global Financial Crisis ("GFC"). Meanwhile, private lenders like PCCP have increasingly provided the nimble capital needed to react to rapidly changing market conditions. As a result, a once nascent real estate debt market, with only a handful of private debt lenders, has matured into a saturated industry. Today, a multitude of private debt managers foster a robust marketplace for borrowers to procure floating rate leverage for transitional real estate. Current market conditions may signal more changes ahead, as interest rate uncertainty reduces activity and sidelines newcomers to the private debt market. Far from a newcomer, PCCP enjoys a nearly quarter-century long history as a relationship-focused, middle-market lender with the ability to pivot in changing market conditions which we believe leaves us well positioned to take advantage when strong market conditions return.

The institutionalization of real estate debt began over a decade prior to PCCP's entry into the market. It was in the aftermath of the early-1980s recession that the foundation was laid for real estate debt's transition to an asset class. During that time, we saw the creation of commercial mortgage-backed securities (CMBS) and the entry of banks into the value-add debt space. When PCCP entered this market at the conclusion of the Russian Ruble Crisis in 1998, there was less than $50 million of dry powder available in the private debt space compared to the more than $42 billion of available capital as of November 2022 (Source: Preqin). At that time, banks were not only our competitors within this space – making transitional non-recourse loans at higher leverage points than seen today – but were also partners in executing this business strategy. Banks and insurance companies dominated every aspect of the real estate debt market, with banks in particular operating freely throughout the capital stack. However, over the following decades, banks began to withdraw from some debt market activities due to competition from niche players and fallout from the Global Financial Crisis. This paradigm shift ultimately transformed the industry into what it is today.

The declining role of banks within the real estate lending space has similarities to the deterioration of mass department stores in the U.S. over the past three decades. Since the 1980s, department stores that once dominated the retail market have notoriously declined in popularity. In their place, we have seen the flourishing of niche-specific retailers, independent brand location, and e-commerce. Similarly, thirty years ago in the real estate debt market, there were primarily banks and insurance companies. Capital was concentrated within these major players. Over time, both markets – retail and commercial real estate debt – became more disseminated, with new market participants beginning to displace the dominant players. Department stores were confronted with the rise of Sports Authority, Game Stop, and other category specialists eating into their market share. While in real estate, banks experienced their own displacement in the debt market as it became more saturated with private debt funds and other non-bank lenders over time.

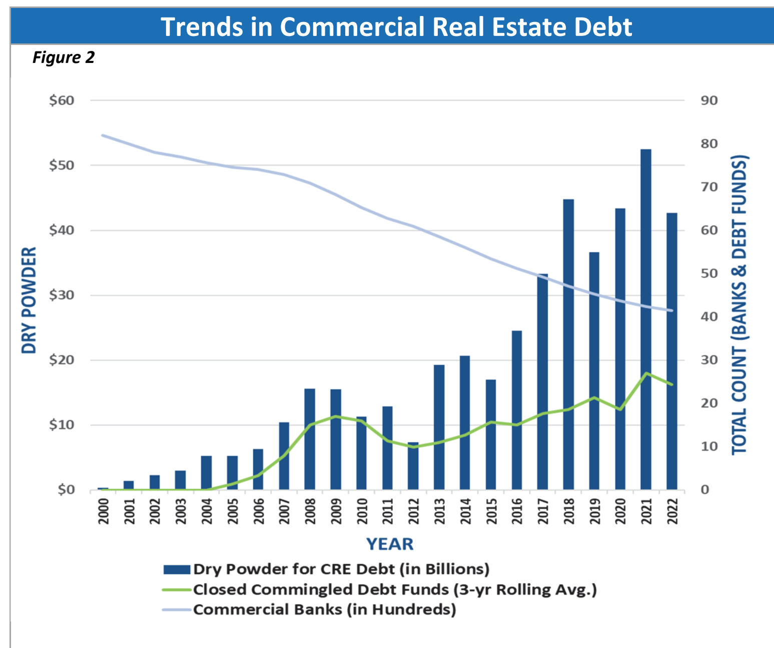


Source: Mortgage Bankers Association *As of 22Q2*

The displacement of banks in the private debt market was accelerated by the Global Financial Crisis, which became a watershed moment for the role of banks in the real estate lending business. In response to the crisis, banks were forced to abide by more restrictive financial regulations. In particular, a regulation known as Basel III (an international bank capital framework published in 2010) set leverage and capital ratio requirements for banks. Its intent was to help mitigate the liquidity risk that had imbalanced the financial system in 2008. To adhere to the Basel standards, banks moved down to much lower leverage points, initiating a movement that

saw the rise of securitized leverage, warehouse/repo lines, and the sale of senior financing positions. As a result, the banks that once competed with PCCP in the real estate debt space now typically provide the leverage to operate our business instead- and at a lower risk point. In the wake of the GFC, banks were forced to de-leverage, paving the path for private debt lenders to move into the gap they left in the capital stack.

As this new status quo developed, so too did more complex structured finance, as A-notes, warehouse repos, and note-on-notes became more commonplace and ingrained in the business. Leverage became an integral part of real estate debt, and this ability to start levering debt brought in more institutional capital. Investors began increasingly seeing the opportunity to achieve returns desirable for their platforms. With the institutionalization of equity in the private debt sector, and a robust clearing market for leverage, private debt has now evolved into a nimble market participant to supplement the role of banks, life insurance companies, and commercial mortgage-backed securities. We believe that we are experiencing the continuing increase in market efficiency in the real estate lending space, which has taken shape throughout PCCP's history. We were there at the beginning of this process, and we remain here throughout its development.



Sources: FDIC, Green Street, Preqin — As of 22Q3

Today, as we approach our 25th anniversary in the commercial real estate lending business, we find ourselves operating in a world vastly different than the one we entered, or could have anticipated, when we first joined the market. Investment capital for real estate debt product has increased more than a hundredfold, and this influx of dry powder has coincided with a paradigm shift in the make-up of the industry. The number of banks in this country has been cut in half from 2000 (Source: FDIC), while a flood of non-bank players establishing themselves in this space has driven the institutionalization of the asset class. The first commingled funds specifically focusing on commercial real estate debt closed in 2005. As of the third quarter of 2022, there are over 200 such vehicles actively investing in the market (Source: Green Street Advisors). The market has become incredibly saturated, not only in the number of players but also in the type of products and in the complexity of deals.

The unique state of the capital markets today may provide the opportunity for another inflection point in the evolution of the commercial real estate debt industry. The unprecedented pace of interest rate hikes has thrown the capital markets into disarray, putting banks and institutional investors on hold with new activity through at least the new year. Liquidity has dried up accordingly, and many lenders are completely out of the market, with those remaining generally deploying their capital to a few of their strongest existing relationships. A substantial portion of the market, including many of the private real estate debt lenders who entered the market during the last cycle, have seen little to no activity over the past several months. We believe challenging market conditions favor those that are time-tested and that have developed strong relationships in the industry. We anticipate that once liquidity floods back in and values and uses are determined, the infrastructure that has been built over the last quarter century in the real estate lending business will make the industry stronger. We believe the industry is poised for those who participated in this development, without relying upon its excesses, to re-enter and be positioned stronger than before.

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