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Subordinate debt and the new era of real estate investing

Strong fundamentals, constrained bank lending, and reset property values have created opportunities for private credit investors

Andy Rubin, CFA®
Institutional Portfolio Manager

Key takeaways

- Commercial real estate (CRE) fundamentals appear positive in early 2026, supported by healthy property-level income, high occupancy, and limited new supply.
- Banks are lending on CRE at reduced proceeds (lower leverage), creating openings for private credit providers to supply capital at favorable yields and terms.
- Lending on reset property values at modest leverage enhances lender protections and the potential for higher risk-adjusted returns.
- Subordinate lending may be particularly compelling, as it offers structural advantages compared with other approaches, including flexible partnerships with senior lenders and the avoidance of financial leverage risk.
- Strong industry fundamentals, constrained capital, and historically modest leverage all appear to remain in place for CRE debt in early 2026.

Analyzing the fundamentals

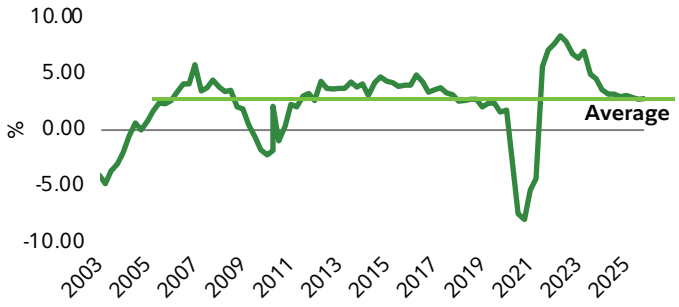
CRE fundamentals today are strong, with high occupancy rates and positive cash flow growth in most property sectors.

Most importantly, new supply of CRE has been declining for several years, and expectations are for a continued decline given elevated construction and financing costs.

Exhibit 1 (left) reflects that property net income growth has declined from the post-pandemic peak but remained positive and near historical norms.

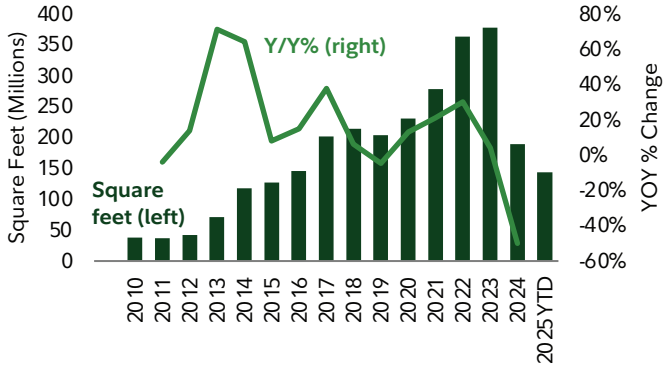
Exhibit 1: Fundamentals point to higher property income, constrained property supply

Property net operating income



Property net income growth calculated as four-quarter percentage change in same-store net operating income for equity REITs across sectors. Average growth since 1/1/02 is 2.3% (horizontal line). Source: NAREIT, as of 9/30/25.

Commercial real estate completions



YOY = year over year. U.S. retail office and warehouse completions since 1/1/10. Source: Bloomberg Finance L.P., as of 9/30/25.

Meanwhile, the annual change in the supply of new commercial real estate has fallen precipitously from its 2022 peak (Exhibit 1, right).

Combined, we believe these fundamentals support the potential for rising rents and, as an extension, provide support for property prices.

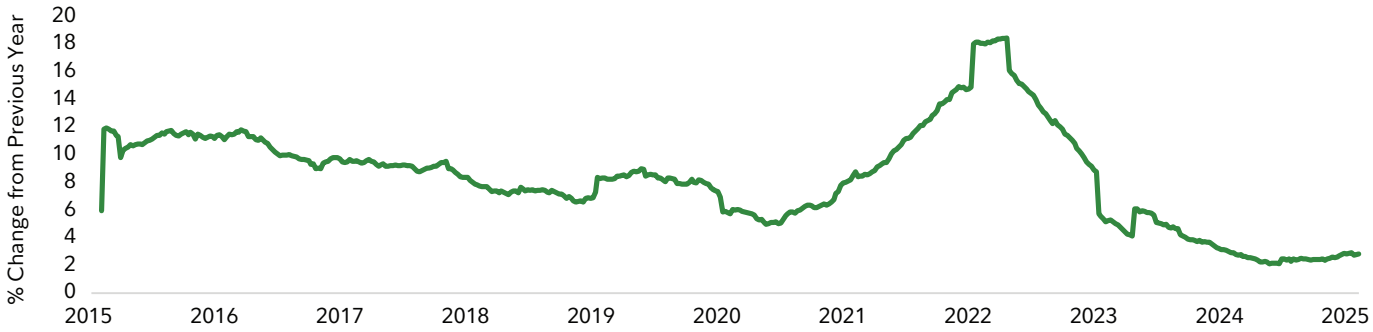
Studying the longer-term lending dynamics

Capital constraints for new commercial real estate projects and loan refinancing continue to benefit CRE debt investors by supporting yields and lending terms.

Exhibit 2 reflects a long-term year-over-year decline for commercial real estate loans issued by small U.S. commercial banks. These banks historically supplied the majority of CRE credit. Yet in recent years, many have tightened CRE lending standards and sought to shrink CRE loan exposure. Private lenders and debt funds have stepped in to fill the void.

Exhibit 2: Commercial banks leaving CRE has led to opportunities for nonbank lenders

Commercial real estate loans from small, domestically chartered global banks



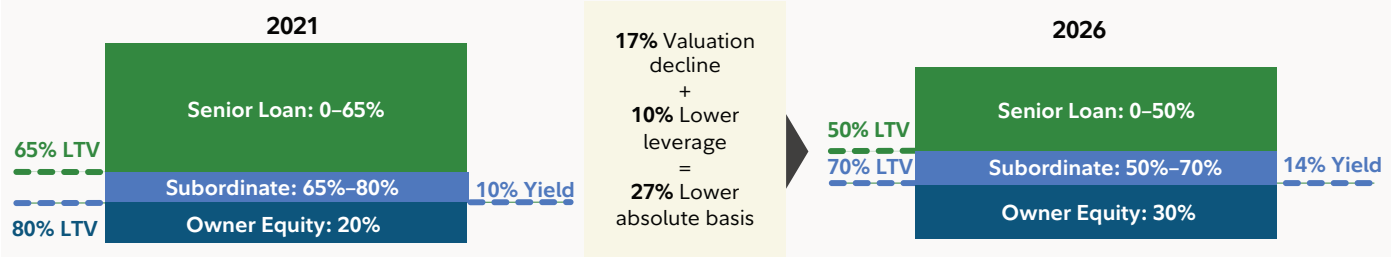
Source: Federal Reserve Bank of St. Louis, Fidelity Investments, as of 12/31/25.

The nonbank lenders have often done so at higher yields, lower leverage ratios, and more restrictive covenants (rules and conditions in the loan agreements). This has resulted in many attractive investment opportunities for private real estate debt funds. This pattern may continue to be the case if the nonbank lending trend continues.

Seeking higher returns at a lower absolute basis

A double-digit decline in property values since 2022 has provided an opportunity for lenders to originate loans at a lower basis with less leverage. Exhibit 3 reflects how the real estate debt market has changed over the past four years. A valuation decline of 17%, on average, has allowed buyers to set a new, lower cost basis (the total amount invested from an accounting perspective). Furthermore, lenders today benefit from lower leverage (measured by loan-to-value ratios) and higher yields compared with 2021.

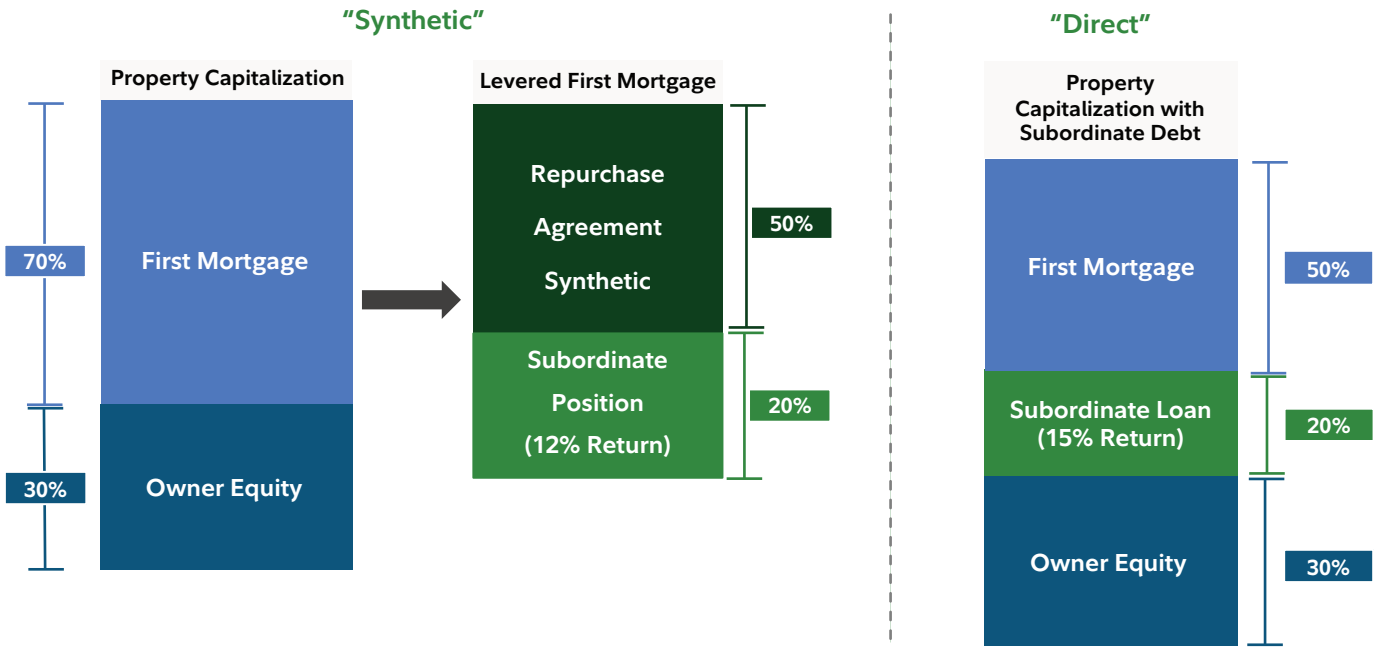
Exhibit 3: A theoretical look at how a valuation decline has made subordinate financing more attractive



The theoretical look in Exhibit 3 is for illustrative purposes only. Data is subject to change. The analysis is based on indicative pricing and the spread over Secured Overnight Financing Rate (SOFR). Potential downside protection is no guarantee against future losses. Based on Green Street CPPI as of 12/31/25. Source: Green Street CPPI, Bloomberg Finance L.P. and Fidelity Investments, as of 12/31/25.

There are two main ways to invest in high-yielding real estate loans: The direct approach and the synthetic approach (Exhibit 4).

Exhibit 4: Analyzing the synthetic vs. the direct approach



For illustrative purposes only. Potential downside protection is no guarantee against future losses. Source: Fidelity Investments, as of 12/31/25.

Direct approach

Offer an unlevered subordinate loan in partnership with banks, insurance companies, and other balance sheet lenders, who provide the first of two separate loans. The subordinate loan can be floating rate or fixed rate. This can be advantageous to lock in current high base rates.

Synthetic approach

Originate a whole loan and finance the loan with another lender, while retaining the "synthetic" subordinate risk tranche of the loan (also known as the levered whole loan model). The loan is typically floating rate, akin to a regional bank business model, where effective management of liabilities (i.e., deposits for banks/secured line of credit for debt funds) becomes more important, especially in market downturns.

For both structures, the underlying credit risk is the same, but we believe the direct model, a focus of Fidelity's real estate debt team for more than 18 years, may offer advantages.

Under the direct model, unlevered subordinate loans mean there's no margin call risks during times of market volatility (i.e., COVID-19) or large secular change (i.e., office demand decline).

Rather than selecting among a few lenders, we can partner with the most cost-effective among thousands of senior balance-sheet lenders in the market.

Lastly, the direct model allows us to be a partner to lenders, offering flexibility and cost efficiency, and advice when it comes to paying down existing debt with direct subordinate loans.

Conclusion:

The backdrop for CRE in 2026 appears compelling, supported by healthy property fundamentals, reduced new property supply, and favorable loan terms for lenders.

At the same time, lower property valuations have reset cost bases and improved structural protections for lenders, allowing loan providers to extend capital at lower leverage points with potentially higher yields.

In this environment, we believe a direct subordinate approach—unlevered, flexible, and built on strong partnerships with senior lenders—may be among the most attractive.

Author

Andy Rubin, CFA®
Institutional Portfolio Manager

Andy assists portfolio managers and their chief investment officers in ensuring portfolios are managed in accordance with client expectations. Also, he is a principal liaison for portfolio management to a broad range of current and prospective clients and internal partners.



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