Mining Opportunities in Commercial Real Estate

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Finding value in real estate is like sifting through rocks to find gold. Industry veterans hope to unearth nuggets of opportunity within the vast landscape of commercial properties. Also, what was once deemed valuable in the past may end up being fool's gold in the end. For example, no one was touting opportunities in the retail sector. It's a constant churn. In day two of CREFC's annual conference in New York, panelists revealed where they see opportunities across commercial real estate, both from the macro and the micro perspective.

Foreign Investment in the United States

Wesley Barnes, head of real estate finance in Europe and Asia for Citigroup Global Markets, said at the international panel that the United States presents the best investment opportunity if someone is agnostic as to where to invest. The yields are better for U.S. commercial real estate, the assets are more liquid, and there is more information available. He classified the European market as being "opaque," though the United Kingdom is somewhat better. Still, tenant sales information for retail properties and historical financials can be lacking. In addition, Barnes mentioned that the U.S. has the benefit of size. Europe is densely populated, with multiple legal systems and currencies. The U.S. has much more land available that all falls under the same federal government and legal system.

By year-end 2018, U.S. commercial mortgages totaled $3.3 trillion, according to Catherine Liang, head of U.S. real estate at China Construction Bank Corporation. About 7% of that is from international banks, up from 6% the year before. While this may seem small, Liang explained that a percentage point increase equals somewhere around $30 billion.

The presentation slides at the beginning of the panel show that the top five countries that invest in U.S. commercial real estate are Canada, Spain, Germany, France, and Japan. Those countries are each represented in the top five banks that hold U.S. commercial real estate, which are TD Bank (Canada), BNP Paribas (France), Deutsche Bank (Germany), MUFG (Japan), and Banco Santander (Spain).

CRE CLOs

One panel was dedicated to another opportunity: commercial real estate collateralized loan obligations. Polsinelli's Kraig Kohring, real estate and financial services department chair, explained to the audience that a CRE CLO is "a securitization vehicle designed to provide bridge loan financing." They are typically on transitional assets and come in two varieties—managed and static (or more accurately "lightly managed"). Erin O'Callaghan, counsel at Argentic, said that CRE CLOs are "an efficient alternative to repo and warehouse financing."

When asked if more banks will enter the CRE CLO space this year, the panelists unanimously agreed that more will. However, the answers were a bit mixed when asked about issuer involvement. Most said that more issuers will try out CRE CLOs, but a few people indicated that it might not be a large increase. Issuers may try, but not all will succeed.

While CRE CLOs are an opportunity, many issuers differ in their approach. Patrick Mattson, managing director at KKR, said that some focus on one specific property type, while others try to diversify their assets. Historically, CRE CLOs have been for middle-market lending (under $50 million loans), but larger players have entered the space, downsizing their originations to fit with the norm.

Manish Rajguru was the only one on the panel who spoke from the perspective of a portfolio manager. Lord, Abbett and Co.'s Rajguru believes "there is definitely capacity in the market to grow this product." He finds CRE CLOs to be a compliment to the conduit universe because the latter typically doesn't have short terms. "Right now there is a thirst for short-duration paper." Their normal lifespan is two years, after which originators can "call" the loan and demand repayment.

However, not all are equipped to handle this loan type. Gene Kilgore, executive vice president at Arbor Realty Trust, finds that the industry is bifurcated. "Either you have the resources to devote to it and you do it well or you shouldn't be doing it." Any company, regardless of size, will need the personnel that really understands the structure, reporting requirements, and compliance requirements for CRE CLOs, especially when creating a managed transaction, which is more hands on.

Company-Specific Preferences

Representatives from different companies shared their strategies at another panel. Starwood Property Trust is a public company that is not a low-cost provider. Its chief originations officer, Dennis Schuh, said that Starwood differentiates itself by going after large, complex loans, averaging over $100 million. Speaking to its affinity for complexity, Schuh revealed that Starwood has done some deals with assorted tax credits. While it hasn't closed any deals with property assessed clean energy loans, he said that Starwood is looking at them. Schuh said that his company is willing to get involved because it believes it will get outsize returns for being in a more complicated stack. It has $50 billion in assets under management as part of its opportunity funds. Property types in those funds include apartments (more so affordable housing than luxury apartments), office property across the globe, and hotels.

Brookfield has $5 billion in assets under management between its funds, per its managing director of real estate, Nailah Flake-Brown. Brookfield originates whole loans with the intent to syndicate first mortgages and retain the mezzanine loan for investment. Flake-Brown said that Brookfield does not use repo or warehouse lines following the lessons learned since the crisis. It mainly focuses on large deals in gateway cities to "really good sponsors in really good markets." In terms of leverage, Brookfield's opportunity funds will allow for up to an 80% loan-to-value ratio.

Finally, U.S. Bank oversees $42 billion in assets under management. Executive vice president Rex Rudy says that his company still sees opportunity in construction lending. However, he admits that the number of active construction lenders keeps dropping.

The array of responses among the panelists underscored a shared belief that the commercial real estate landscape presents an array of investment opportunities for those who have ideas about where to look, are equipped with informed strategies, and have a willingness and the resources to put in the work.

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