The rise of the all-weather manager

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As another real estate cycle begins, it is the managers investing in debt as well as equity that believe they are best set.
Managers with the ability to invest across the capital stack are preparing for what they believe will be a once-in-a-generation investment opportunity. As the market cycle resets to an environment with substantially higher interest rates than for most of the last cycle and commensurately lower valuations, these organizations are expecting to see substantial investment opportunities.

The impact of this higher rate environment means the near to medium term is expected to be characterized largely by refinancings, recapitalizations and active asset management, market participants tell Real Estate Capital USA. And against that backdrop, the ability to invest across capital stacks will be a key differentiator for managers, says Chris Lee, co-president of KKR Real Estate's global real estate business.

This mindset was part of the equation when KKR started its real estate business in 2011, says Lee. "The entire reason we built the business in this way was for a market like this. All of our risk is priced by one leadership team, and we have people across both businesses on our investment committees, with about 150 professionals across our equity and credit investment strategies who've been working closely together since day one."
Two houses

KKR Real Estate was among a score of private equity real estate managers born in the aftermath of the global financial crisis.

"It was clear to us that in the wake of the global financial crisis, single-strategy fund managers would find it challenging to run a business when their strategy wasn't the best market opportunity. Whether one realizes it or not, there is a tendency to become a forced investor at times like that if you only have one strategy, to rationalize investment decisions notwithstanding market conditions," says Craig Solomon, chief investment officer and vice chairman of manager Affinius Capital.

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As a result, Affinius, formerly Square Mile Capital Management, determined it would establish investment products across the capital stack. "Post GFC, we went about

structuring our business in a manner that affords us the ability to raise capital at every part of the capital structure from the most senior debt to development equity so that we could become an all-weather firm with the ability to dial up or down risk based on the market," Solomon adds.

Lowell Baron, president and chief investment officer of Toronto-headquartered manager Brookfield, says his firm also grew its debt and equity business in tandem. Likewise, he observed significant two-way benefits from the approach. "The relationship is very intertwined. You're a better lender and equity investor if you're doing both," Baron says. "Real estate credit is now the flavor of the month, but it has been an important part of our strategy for the past 20 years."

Baron's comments highlight a relative difference between organizations that started life with both real estate equity and debt aspirations and those that bolted on debt strategies later.

Jeff Fine, global co-head of alternatives capital formation within Goldman Sachs Asset Management, notes there is a difference between firms that built their businesses to invest across the capital stack over cycles and equity investors that have crossed over on an opportunistic basis.

"Certain managers think about the business differently, either viewing it as a trade or a production business, rather than one that is steeped in valuation," Fine says. "Our approach, and the reason why we run equity and credit in a single team in our direct investment business, is because the analysis starts and stops with valuation."

Whether buying an asset or lending against it, Goldman Sachs focuses on relative risk-return, he adds. "We underwrite the asset, look at the capital structure and find the best relative risk-reward and where the inefficiencies are in the market. There are times when credit is easy and that is a benefit to equity, and then there are times, like today, when that equation is flipped."

Putting it together

It is one thing for a firm to have debt and equity platforms, but another thing to operate them in a synergistic manner, says Nitin Chexal, chief executive of Austin-based Palladius Capital Management. He believes it is important to be cautious around the execution of this strategy because there is more to consider than the simple opportunity.

"It is critical to have the right accounting, asset management, and legal infrastructure in place if you're going to invest throughout the capital stack," he says. "Having flexible capital allows us to be thoughtful on our entry point into an asset, but our team's ability to operate assets, negotiate thoughtful intercreditor agreements, and work with servicers to navigate foreclosure processes if needed are critical to success."

Solomon agrees there will be a divide between the managers that early on established a full-scale lending and investing business and those moving opportunistically. "To

build a full-scale lending business takes resources, time and people to have effective servicing and special servicing relationships."

Barings Real Estate – a subsidiary of Massachusetts-based insurance giant MassMutual – has been in the debt and equity business for more than 25 years. The groups have always collaborated closely and now operate as one integrated platform, says John Ockerbloom, head of US real estate. "When I joined Barings in 2019, it was possible early on to see the advantages of running the businesses together."

This structure is practical in the sense that it allows the different arms of Barings' business to collaborate on lending and investment opportunities, he says. But over the longer term, it will be a critical differentiator, as will the firm's ability to offer its clients what Ockerbloom believes is a complete set of lending and investment products.

"For the foreseeable future, we will be in a very favorable lending environment. But there will come a time when the pendulum swings back," Ockerbloom says. "We believe having a cross-trained team will allow us to serve our clients better as the next cycle starts."

The strength of focus

Still, not all firms believe it is necessary to have debt and equity platforms. Calmwater Capital, based in Manhattan Beach, California, is a firm that has always been focused solely on lending, says Larry Grantham, managing principal. "While I see both sides of the debate, our focus has always been lending and we believe that gives us a competitive advantage. We have seen the mega-funds continue to grow even larger, and for public companies, this means growing their earnings in addition to assets under management. Firms that have chosen this trajectory will need to offer additional investment products, regardless of their core competencies.

"The argument is that there are synergies between different groups. I can appreciate that on a theoretical level. I think, in practice, it is harder to show that attribution in the returns. For us, we live, breathe and sleep lending, and we believe for a firm or our size, this specialization is a value-add for our investors."

Paul Rahimian, chief executive of Los Angeles-based commercial real estate lender Parkview Financial, has a dedicated approach to construction lending that includes an integrated in-house construction team comprised of architects, engineers and past contractors.

"Providing one product that is fixated on the development of real estate projects is a strategy that allows us to do what we do best, without the distractions of doing multiple things," Rahimian says. "We have built out our team over the years to provide construction financing to projects throughout the US. The team's experience and background provide the necessary help to our borrowers to get to the goal of a completed project."

Jim Simmons, chief executive of New York-based Asland Capital Partners, says the multifamily manager has worked more with private credit lenders over the past two

years. The firm, generally a balance sheet or government-sponsored enterprise borrower, has seen liquidity decline amid the rise in interest rates and the failure of regional lenders such as Silicon Valley Bank, First Republic and Sovereign.

“Specialist or non-traditional lenders have stepped into the breach,” says Simmons.

“Some of those institutions have multiple business lines including equity and debt origination.

“Being a one-stop shop is the ambition of many alternative asset managers, which makes relationship management easier for borrowers who also seek equity to complete their capital stacks. This can be situational, however, as the aggregation of large pools of capital continues, particularly at the top end of alternative managers.”

Asland is generally agnostic as to whether a lender also has equity offerings, Simmons says. “It does, however – based upon the depth of the relationship – make the transactional process easier if there is a pre-existing affiliation on the other side of the lending institution. All things being equal, Asland seeks to both broaden and deepen its relationship with its counterparties and therefore would look favorably upon an organization that had both and could be that much more accretive to our goals and aspirations.”

John Sweeney, a partner at New York-based capital markets and advisory Park Madison Partners, says the firm has found the most successful aggregators of discretionary capital since the GFC have been vertically-integrated operators specializing in specific property types or geographies, rather than all-weather managers.

“However, it’s not unusual to see real estate equity managers trying to start a debt platform, and there are several reasons they might try it. One of the more obvious reasons is growth. The real estate private equity industry has matured considerably since the GFC, so managers seeking platform growth often feel compelled to consider a wider range of options than simply raising bigger flagship funds,” Sweeney says.

Another reason for equity managers to expand into debt is the additional opportunity it provides at different points in the cycle. “Recent history is a good example. Equity investments have been difficult to execute recently due to higher interest rates, lower capital availability, and wide bid-ask spreads,” Sweeney says. “At the same time, less credit availability provides private lenders with better deal flow and more pricing power, particularly in less favorable property types, business plans, and locations. In this type of scenario, launching a debt platform might seem like a natural pivot, and by now managers have several success stories from which to draw inspiration.”

The data factor

There is a notable correlation between the sophistication of data in the commercial real estate market and the number of firms investing across the capital stack, says Bryan Donohoe, partner and co-head of New York-based manager Ares Real Estate. Twenty years ago, it was common for lenders and investors to consider traffic patterns

or physically count people walking past a particular shop to glean data points. “Now we can track activity more easily,” Donohoe says.

Ares, which can allocate capital from core to opportunistic strategies and across debt and equity channels, gleans data from its own portfolio and regards team collaborations as a key to determining investments.

“We want the team to be able to identify relative value and invest in a particular market or with a specific operator at every point of an asset’s life cycle,” says Donohoe.

“That just makes us a more relevant counterparty to the relationships we share across debt and equity. We can bring together the data, the relationships and our collaboration in the office in a way we believe will improve the overall return profile.”

For KKR Real Estate, the firm’s internal collaborations and data analysis on more than $200 billion of securities, loans and properties is critical, Lee says. “[Our portfolio] informs us about what is happening on the ground from a fundamental perspective. It also makes us better in structuring and restructuring loans because we know where the pressure points are and have a real view, as a lender, on where value is.”

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The growing relevance of managers investing via both debt and equity is leading to a shift in the way they discuss their activity, essentially evolving their parlance to describing both simply as investing in real estate. Brookfield’s Baron attributes this shift to the ability to have real understanding and operating capabilities in every sector and to be able to own and manage an asset and create value.

“When we talk about being an investor in real estate, it is across the entire capital structure,” says Baron. “Whether we are an equity investor or a lender, what we are doing is backed by a real estate asset. If you want to acquire or lend in a responsible way, you must be able to operate those assets.”

Peter Miscovich, global consulting practice lead at Chicago-based advisory JLL, says data and the increasing use of AI will be a hallmark of the next evolution of commercial real estate lending and investing.

“I think you will see commercial real estate lending and investing transform as artificial intelligence tools become more powerful,” Miscovich says. “These tools can accelerate existing dealflow and transactions, which means the volume and velocity could be ramped up significantly. It will be interesting to see if the quality of real estate finance will be enhanced because of the evolution of AI capabilities. It is the beginning of a new era and will transform this sector in a significant way.”

Counterparty rewards

Many of the market participants who spoke with Real Estate Capital USA raised the importance of strong relationships with counterparties with which they could do business across multiple products, asset classes and markets.

"It all starts with establishing a relationship with a counterparty, finding out if that counterparty is appropriate and then where the opportunity fits," Solomon says, underscoring that Affinius would never invest in different parts of a capital structure with its pools of capital.

"We ask if it is a fit for a loan, an equity investment or somewhere in between, with a goal of establishing a relationship that is bigger than the transaction."

Workouts in progress

Firms are planning for a looming wall of maturities

The US commercial real estate market is facing what New York-based data provider MSCI pegs as a roughly $1.9 trillion maturity wall over the next three years. All managers with legacy portfolios are spending significant time on asset management around these situations.

Danielle D'Ambrosio, head of real estate debt asset management for Charlotte-based investment manager Barings, says the firm is expecting to see workouts rise this year as lenders and borrowers confront the looming wall of maturities. Last year the firm modified about $3 billion in loans, with borrowers putting in more than $100 million.

"We realized zero impairments and did not subordinate a dollar of debt," D'Ambrosio says. "At Barings, we look at markets and research to drive our debt and equity investment decisions and when it does come to a difficult situation with a borrower, we likely have assets in those markets and have a team on the ground doing deals every day."

Additionally, a growing number of institutional investors believe working with a firm that can invest across the capital stack is an enhancement to the relationship, says Ran Eliasaf, founder and managing partner of New York-based manager Northwind Group. The firm started off buying distressed debt in the wake of the global financial crisis but expanded into equity investing as the market shifted, Eliasaf says.

"We have found that the data and knowledge help us to invest in each vertical and that these verticals are complementary," Eliasaf says. "Due diligence by US institutions takes about two years to complete and we are finding what we offer is complementary for institutions, which often want to work with a smaller number of managers."

Bob Fordi, chief executive and chief investment officer at Annapolis-based manager Realterm, notes that the idea of servicing clients is what helped the real estate and real assets specialist expand into the lending market over the past few years. "From a capital perspective, sometimes equity is needed and sometimes debt is needed. We have primarily invested on the equity side and have made some loans.

"When we think about our counterparties, if they can find a solution provider who is the easy button for them, that is a valuable counterparty. It completes a product offering for us in that we're able to service our clients across the risk spectrum."

Colin Hill, a managing principal at Boston-based advisory Meketa Investment Group, cites several nuanced factors that go into the decision-making process of manager selection, including the priorities and constraints of the investors. Some of these groups may only meet two or four times a year to make investment decisions.

"To introduce a new manager to that process can take a long time," says Hill. "Whereas if it a manager that is already in your portfolio, either in real estate or perhaps on the private equity side, that familiarity helps."

The business of managing managers can be labor-intensive for investors. "Fewer relationships help to reduce the number of touchpoints," says Hill. "Doing more with fewer managers can also give investors a bigger seat at the table."

Having specialist managers, particularly in commercial real estate debt, means a mindset around principal protection. "It is a more defensive mindset," Hill says. "You'll hear debt managers say, 'We will always think about what could go wrong,' whereas equity folks tend to be more optimistic."

Real estate investing for all

The shift toward real estate platforms through which managers can invest across the capital stack is about more than adapting businesses to be more resilient in the wake of the global financial crisis. It is also about a growing trend of democratization of investing in the asset class, says Toby Cobb, managing partner and co-founder of national real estate lender 3650 REIT.

The democratization of real estate investing

1960 – Congress passes legislation creating real estate investment trusts

1986 – The 1986 Tax Reform Act created Real Estate Mortgage Investment Conduits, allowing for the securitization of residential and commercial mortgages, and allowed for the creation of non-traded REITs

2010 – The Dodd-Frank Wall Street Reform Act gives rise to the expansion of the private real estate credit market

"At its core, commercial real estate is a wildly idiosyncratic asset class and there has been a strong effort to democratize it," Cobb says. "The [passage of] the REIT rules in the 1960s allowed individuals for the first time to own shares in large, institutional-quality buildings."

The next stage of democratization came in the late 1980s, when Congress passed the REMIC laws to allow for the securitization of residential mortgages and, ultimately, commercial mortgages, Cobb says.

“These laws and the introduction of non-traded REITs have allowed individuals to be invested in real estate, which is a healthy thing and one I believe will continue,” Cobb says. “But the challenge for managers is that democratization is not homogenization.”

Homogenization is about trying to create an algorithm around which to invest. Real estate, however, defies that, and that phenomenon is why it is better for managers to have broad experience, Cobb says.

“It is possible to have four assets on four adjacent corners in New York City and have four different outcomes even though all the properties are on the exact same block. This is why it is important for managers to complete due diligence, underwrite, and know the assets. If you see firms that are historically capable firms moving into credit, there are distinct things about being a lender that are not necessarily known to developers that they will learn.

“I do believe it is healthy for lenders to have broader real estate capabilities. But for a lender, picking the winners is not our business. It is missing the losers.”

Mukang Cho, founder of Boca Raton-based investment manager Morning Calm Management, believes the current environment presents a much different investment backdrop than the GFC.

“During the GFC, if you bought an asset cheap, the capital market tailwinds that existed for a decade thereafter gave most owners the ability to make money,” Cho says. “What we see now is more of a stock picker’s market. There will be many falling knives and this characterization won’t just apply to the office sector. Investors who paid up for assets during the last few years are facing capital market challenges, whether they’re looking to sell or refinance.”

John Murray, managing director, global private real estate at PIMCO, believes that, while the coming years will be bumpy, it will be an attractive time to be a solutions provider. “With many traditional lending sources on the sidelines, we find we can originate or acquire senior debt positions with healthy cushions to today’s adjusted values, with better covenants than we’ve seen in the last several years.”

The firm, which has been less active on the equity side as it pursues what it believes is better relative value in credit, believes equity opportunities will continue to be limited. Owners are unlikely to sell today unless they must, and will first look to restructure their capital stack, Murry says.

“The more types of solutions that you can provide, the more likely you are to find a deal that is executable,” he adds. “In many cases, we’ve found that counterparties don’t know exactly what they need in terms of capital, so being able to provide a menu of solutions across the capital structure reduces our competition and enables us to generate the best relative value via structuring.”

The next evolution

There is a broad consensus that turmoil in the US banking system last spring will lead to greater regulations around lending. That, in turn, will trickle down to the debt funds and other alternative lenders.

While banks will continue to be a significant component of the commercial real estate lending landscape, alternative lenders will have the opportunity to increase their market share.

That said, alternative lenders do not yet have the scale required to fully replace the quantum of debt maturing, Fine says. “Alternative lenders will have significant pricing power in the coming years as solutions providers in a period in which capital structures and values are resetting.”

A key component of what is coming is what happens next with the Federal Reserve and other major central banks, Cho adds. “I’m somewhat constructive about the capital markets, although we are far from being out of the woods. Debt and equity markets rallied in the past few weeks, with yields coming in substantially in the past few weeks alone, on the expectation that the Federal Reserve is not only done raising rates, but will soon be cutting rates.

“Even if yields continue to generally move lower, it will take some time for liquidity to return to the marketplace, as banks and insurance companies won’t open the spigot the next day.”

But debt will continue to play a critical role in the workouts and restructurings, says Baring’s D’Ambrosio. She recounted a situation in which Barings was meeting with brokers about the current market.

“One of the brokers said, ‘How do you spell equity today?’ and the answer was ‘D-E-B-T,’” D’Ambrosio says.

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