Urban Land Institute
Chicago

Capital Markets Update: How to Get Money for Your Deal

This is a summary of the ULI Chicago June 22, 2017 breakfast meeting at the Union League Club Chicago. The panel of experts addressed how lenders view the current state of the market.

Among other topics, the panel discussed what happens as the real estate market gets busier and transaction volume increases: lenders look to be more creative with capital structures, including more flexible terms, exploring a wider variety of property types, and taking additional property-level risk.

The moderator for the session was John McLinden, *Managing Partner,* Hubbard Street Partners. Panelists were Alison Coen, *Director,* Barclays; Christy Lockridge, *Principal,* PGIM Real Estate Finance; and Nat Sager, *Senior Managing Director,* Mesirow Financial.

Prompted at the outset by John McLinden's baseball-metaphor query, "What inning is the market cycle in?" — panelists made this much clear: it's not clear at all.

Alison Coen and Christy Lockridge gamely hazarded estimates that we're in about the fifth inning—roughly midway through the cycle. Their remarks, though, were understandably interspersed with a host of qualifying comments that hedged their pronouncements. Next, Nat Sager submitted this confession: "I don't have the first clue of what inning we're in."

"We thought we knew the credit markets were a precursor of what would go on in the broader macroeconomic markets," Sager elaborated. "That has had absolutely no practical application over the last 36 months. Every time we see the credit markets start to soften, they sling-shot back into place because of some geopolitical event that we just cannot foresee."

As a result, "calling the inning" is a market-by-market, even block-by-block exercise, he added.

While sectors like industrial and hotel are "hot" currently, there is an overall "wave of caution in the air," Sager added. "So just by judging by that, I would guess (we're in) the 8^{th} inning, but it's just a guess."

Among the dialogue's early topics was Commercial Mortgage-Backed Securities (CMBS). Several years ago, fears were widespread about a "wall of maturity" coming due around now. However, a variety of re-financing and other financial moves helped avert any crisis on that front, said Coen.

"It shows our business is not dependent on that…there are a lot of other sources for our business," she added.

Meanwhile, the retail market "has dried up," said Sager, and "the private markets, on the debt side, are desperate for yield. Because of that, there have been a lot of creative structures that have been born out of the credit-tenant lease structure over the last, say, five years."

Through a variety of creative approaches that he detailed, Sager said, "We look at things from a credit perspective, which is how our swath of the debt markets look at it, so any real estate asset we look at, we have to convince them that it's investment grade."

Such an approach played a role in how Mesirow consummated the deal for Chicago's Hotel Lincoln.

Panelists were unanimous in their assessment of the great challenge in predicting where interest rates will go.

“If the debt markets can’t gauge where the treasuries are going based on what’s going on in the macro-economic environment, it makes it all but impossible for a real estate operator to gauge where cap rates are going to be six to 12 months out,” said Sager.

Three years ago, an underwriter alerted him to this historic first: the Dow Jones Industrial Average went up over a six-month period in which Triple A corporate spreads also compressed.

“So there was simultaneously a huge investment in risk and a huge investment in credit,” Sager noted. “We said, `This can’t last. The rates have to go up.’ That was three years ago, and the rates are back to where they were and the spreads continue to compress.”

“When you talk about interest rates,” he added, “the fact that everybody has gotten it wrong for so long…should give everyone pause.”

Rating agencies—led by Moody’s Investors Service and Standard & Poor’s—have also become more rigorous in their assessments, a significant departure from a more lax approach that was among the factors leading to the Great Recession a decade ago.

“It’s good news that rating agencies are earning their money. Remember, it was the rating agencies who were getting million-dollar fees in the original crisis of the Great Recession,” said McLinden. “If anything, it sounds like they’ve gone to the extreme and are now too tough, but that’s probably better than where they were 10 years ago.”

Panelists also discussed mezzanine financing—a blend of equity and debt—with Sager noting that it’s evolved as a direct result of the changes among rating agencies.

“Mezzanine used to be 76 percent to 90 percent—that’s what mezz debt used to be,” said Sager. “Today, that’s 61-75 percent...it’s finding sources of capital that can play from 61 to 90 (percent), and then finding the right balance with conduits and understanding where the rating agencies are going to ding you.”

He also said that a “hunt for deals” among life companies, hedge funds, and asset managers has driven fixed-income investors into real estate.

“There’s hundreds of billions of dollars of small, alternative asset managers out there that are searching for good places to put their money,” Sager continued, including mezzanine deals with terms that are upwards of 15 to 20—and even 30—years.

“There’s a lot more money to be made in duration if you’re a hedge fund,” he said.

Lockridge laid out the five “buckets of money” at play, including mortgage loans, transitional loans, lower-leveraged mezzanine loans for stabilized assets, “debtquity,” or transitional mezzanine deals, and mezzanine or preferred equity deals. For each category, she offered ranges of various rates of leverage and anticipated returns.

The resurgence of CMBS, coined “CMBS 2.0,” marks a contrast to the former reliance on CMBS, when “there were a lot of cowboys out there,” said Coen.

“We see the stuff we were doing, and what were we thinking?” she said. Currently, the industry has taken steps to ensure there is no recurrence of “CMBS 1.0,” she said, with rating agencies more diligent in policing activity and buyers becoming more conservative.

“I think going forward that bodes well for the industry,” she said. “The market is $75-to-$100 billion, which is still a pretty big market and still sustainable.”

During a question-and-answer period, panelists tackled several topics, starting with construction lending.

Mesirow is getting a lot of calls from hotel developers looking for money, said Sager. Another trend is single tenants with build-to-suit projects. “If your deal makes sense,” he said, “construction money is out there.”

Over the past two years, said McLinden, construction lending is “much tighter” for rental and multi-family categories. “Most lenders are out of the market. They may come back in... but there are not many lenders doing deals in apartments,” he added.

On the impact of e-commerce on lending, Sager said “a big part of our business is in alternative debt structure products” and “it’s about finding a story to tell in the bond market,” particularly in the wake of retail’s struggles.

“It’s a lot easier to build a distribution center, and to sell it to an investor,” said Sager, when you can point to a low number of employees and a high level of automation at that facility.

Citing Amazon’s intended purchase of upscale supermarket chain Whole Foods Market, Lockridge said significant changes are afoot in the grocery sector. She also pointed to a rise in the retail sector on offerings that are “Internet-proof.”

“You’re going to have a restaurant, you’re going to have a Pilates studio—it’s where people have experiences that they can’t get on the Internet,” said Lockridge.

Retailers and malls do need to reinvent themselves, said Coen, but not all customers behave the same—ranging from New York City dwellers more inclined to shop online to those in “Middle America” more apt to drive to their local stores.

“Retail 10 years from now will look much different than today,” said Coen, “but I don’t think it’s going to be all e-commerce.”

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