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Real Estate Capital USA

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Insight

2

Cover story

18

Analysis

28

"The focus for us is to create a platform that can be resilient [and] invest through cycles"

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PEI

Insight

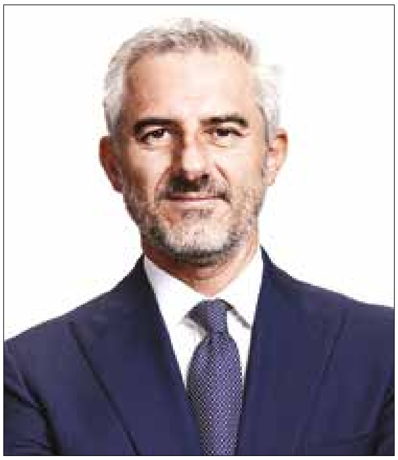
Market outlook **Finding opportunity in adversity**

For seasoned commercial real estate professionals, there is a sense of inevitability about what comes next. At best, commercial real estate is looking at an economic downturn spurred by higher inflation and rising rates. And at worst, there is the potential for a more severe recession that delays a broader economic and commercial real estate recovery, ***writes the Real Estate Capital USA team***.

Lenders and borrowers who spoke with *Real Estate Capital USA* over the past few weeks have highlighted their concerns over rising interest rates, fueled in part by the Federal Reserve's move to increase the federal funds rate by 75 basis points in June and opening the door to a similar rate hike in July.

But there is also a strong sense that the market's current challenges can lead to opportunity and, more importantly, innovation.

"When I started my company in 2009 [during the global financial crisis], it was a good time because in adversity there is opportunity," says Tammy Jones, co-founder and chief executive of New York-based manager Basis Investment Group (see related story, p. 12). "It's different now, and a little bit more difficult, but I believe we are back at that place, and that there are opportunities."



> "Increasing financing costs and inflation are the main and immediate drivers of uncertainty among investors and lenders"

Riccardo Serrini
Prelios Group

Regional parallels

The concerns being seen in the US are not in a vacuum, with domestic and international managers raising the same issues. These managers are also citing clear differences between the current market dislocation and what happened during the global financial crisis.

"Increasing financing costs and inflation are the main and immediate drivers of uncertainty among investors and lenders," says Riccardo Serrini, CEO of Milan-based Prelios Group. "One clear difference between today and what has happened in the past is the liquidity, the quicker reaction of central banks, and the government [programs] that especially during the pandemic helped the mindset. Quick reaction is key to be able to face downturns."

Prelios, like many of its peers in the US and Europe, is anticipating a steep rise in non-performing loans but is also preparing for an increase in a newer kind of distressed debt – unlikely-to-pay loans.

"The role of UTPs today warrants particular attention," Serrini says. "UTPs are indeed a completely different play than traditional NPLs management, and only operators with adequate expertise and advanced technological know-how stand to benefit from the deep ongoing transformation of the Italian distressed market."

The ability to handle an influx of these loans is based on developing integrated and scalable platforms. And there are broader applications of this process to the US market. "Technology, digitalization, data management, coupled with early intervention in company crisis are key elements for facing the next NPE wave. We are expecting €90 billion of new NPE inflows in the banking system in the next three years, mainly coming from SMEs belonging to the sectors most affected by the crisis," Serrini notes.

Data sets

Understanding how an asset fits into a broader portfolio and how it is performing in real time is also important to being able to underwrite loans effectively. This is especially important in fast-moving sectors like multifamily.

"The asset class has proven to be pretty recession-proof," says Jacqueline Meagher, a director of capital markets at JLL in Boston. "One thing that is interesting about the sector is that you're constantly changing the tenant base – you get to re-set rents and the asset on an annual basis. They'll be more aggressive going in, even if it means negative leverage, because they can get to those leases quickly."

Felix Gutinov, head of originations at Thorofare Capital, believes there is a light at the end of the tunnel.

"Although there are unavoidable inflationary pressures on many development projects across the country, a significant amount of construction debt and equity financings are still closing in desirable markets that demonstrate resiliency," he says. ■

Ups & downs

"Frankly, the events of the last few months around the world have made it more difficult for us to achieve what we want, which is 2 percent inflation and a strong labor market"

*Federal Reserve chair **Jerome Powell,** discussing the central bank's efforts to reduce inflation*

"Borrowers really want the prepay flexibility that floating rate loans provide. They do not want to lock in a fixed rate and then pay a big penalty when they reposition the property"

***Kara McShane,** head of commercial real estate at Wells Fargo, on why the bank's pipeline is heavily weighted toward floating-rate originations*

The big numbers

Rates on the rise, transaction volumes on the decline, and out of control inflation made the real estate debt headlines over the past two months

75bps

Amount the Federal Reserve increased interest rates to fight inflation in June, with a similar hike expected in July and a 50-basis point hike expected for September

$1.3trn

Capital invested into commercial real estate in cities around the world in 2021, a 59% increase over 2020, according to the Savills Resilient Cities Index, published in July

3.4%

Yield on the benchmark US Treasury on June 14, an 11-year high that has since declined to the range of 2.8%, per the Federal Reserve

$45bn

Amount of commercial real estate transaction activity completed through the end of May, per MSCI data, a 3% increase from the same period in 2021

$2.9bn

Total capital raised for Bridge Investment Group's fourth commercial real estate debt fund, Bridge Debt Strategies Fund IV, which closed in June and was the Salt Lake City manager's largest debt vehicle to date

$25bn

Size of a new affordable housing investment program launched in New York, aimed at building more housing in the city's outer boroughs at a time when more lenders are looking at the sector

Indices **New performance benchmark draws closer to launch**

The next evolution of the debt fund space may find its root in a still-developing index being jointly created by the National Council of Real Estate Investment Fiduciaries and the Commercial Real Estate Finance Council, ***Randy Plavajka writes***.

The duo of industry-representing associations are entering their third year of co-development on the commercial real estate landscape's first debt fund index and drawing closer to a full launch as the proposed benchmarking tool goes through further testing – and tries to attract a handful more of new debt fund participants. The move toward a formalized index comes as more institutional investors are turning toward debt strategies, with just under $30 billion raised in 2021.

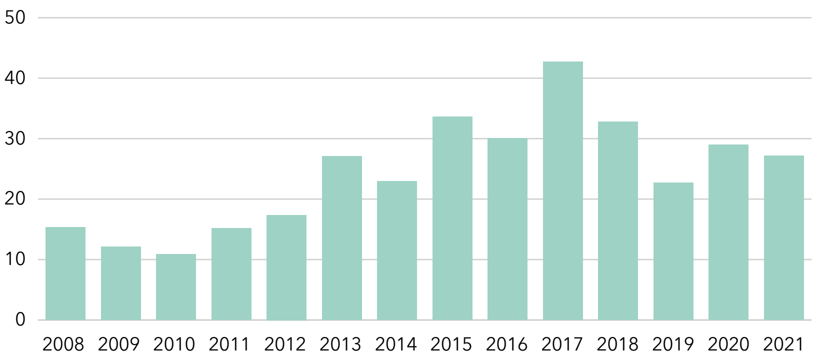
Lisa Pendergast, executive director of CREFC, says there is still significant growth to be realized in debt assets under management given the returns registered by such funds in recent years. "However, there is currently no fund-level debt fund index that can be used by investors to benchmark performance," Pendergast says in an interview with Drew Fung, managing director and debt fund portfolio manager at Clarion Partners, who is part of the effort to develop the index. "This is perhaps surprising given the abundance of indices available to investors to benchmark performance of various other asset classes."

The index would provide extra transparency for investors conducting due diligence around return generation and potential risks and rewards, a key to unleashing expected growth for the sector.

"As in many things, the devil is in the details," says Pendergast. "It's vital that the index allows for a like-to-like comparison and well identifies the varied investment strategies in the market today – think core, core-plus, value-add, etc – which are well-worn terms in equity real estate circles but not widely used in the debt fund sector."

> "It's vital that the index… identifies the varied investment strategies in the market today"
>
> Lisa Pendergast
> Commercial Real Estate Finance Council

Capital raised by RE debt funds ($bn)



Source: Real Estate Capital USA

Respectable returns

According to CREFC, early data shows CRE-focused debt funds logged performance results only slightly below that of equity funds from 2014 to 2020 and did so with far less return volatility and less risk.

Pendergast says such performance should prove attractive to those who currently do not have a permanent capital allocation to CRE debt and provide a measuring stick to support future allocations to the asset class.

"The benefit of a new index for debt is the ability to develop a more bespoke performance measure for open-end funds that deploy capital across a variety of CRE-focused debt vehicles, such as first and second mortgages, bridge and mezzanine loans, and preferred equity," Pendergast says. "There simply is no index today that captures the strategies and debt instruments that comprise today's debt fund activity."

Pendergast and Fung say CREFC is now working on gathering additional investor support and manager participation as well as the development of industry reporting standards to bolster and hasten the index's development.

While timing of the launch is tough to pinpoint at present, the two note that almost a year was spent in developing a framework for the index, determining what to track, how to track it and what to report.

Pendergast and Fung say the latest effort to develop a debt fund index is not done yet – the organizations will be focused on the project for some time. "That said, both traditional balance sheet lenders and the structured finance capital markets continue to provide institutional investors with highly liquid options for investing in commercial and multifamily real estate," they noted.

Lending **ING Real Estate goes for the green**

ING Real Estate is sourcing and incentivizing more green lending deals, with institutional and sponsor demand for the opportunities gaining traction stateside, ***Randy Plavajka writes***.

The Dutch bank, which is also an active US commercial real estate lender, has updated its priorities to look at more green lending opportunities in sectors such as multifamily, student housing, logistics, retail and life sciences after being heavily focused toward green office deals before the onset of covid.

Jeffrey Schwartz, a relationship manager and deal principal on the bank's real estate finance team, says there has been a preference among tenants and investors for better, more efficient assets carrying green certifications – such as LEED or NGBS – and the preference is reflected in the bank's lending targets across all asset classes.

ING Real Estate aims for LEED Gold assets or better to consider a deal as a green loan, and the firm's ongoing strategy is to bolster its portfolio with more such activity, even bringing in incentives as needed to enshrine the green status of a given asset.

Life sciences is one sector more abundant in opportunities now. Schwartz says the assets perform and fundamentals remain strong in key markets such as San Diego, the greater Boston area and Philadelphia, where ING has interest in carving out more new business.

As part of its strategy, ING looks for buildings with potential to become greener either through certification or upgrades, in the case of 'brown' buildings lacking in proper ESG components. Schwartz says ING's incentive takes different forms, whether offering more favorable interest spreads as green commitment goals are achieved or potential earn-outs when those milestones are met.

“We saw an opportunity to be innovative and try to bring [incentives] into our discussions with our clients”

Jeffrey Schwartz, ING Real Estate

Innovation incentive

"We saw an opportunity to become innovative and try to bring [incentives] into our discussions with our clients, who are also focused on it," Schwartz says.

ING tends to shy away from older assets and instead aims for best-in-class assets, which Schwartz says may already carry a green building certificate. "From a credit perspective, we just see [best-in-class assets] in higher demand from the ultimate occupiers that are demanding [green certification]. Even in a rental, they want to make sure that the building is [performing] from an energy efficiency standpoint; it's really dictating the designs going forward."

Fannie Mae and Freddie Mac are also tempting more business into the US green lending space by giving incentives to borrowers that measure up to select KPIs around efficiency and energy usage.

ING is also looking at affordable housing as a potential opportunity to bring in new green loan business through a socially focused angle.

Affordable housing requires more delicacy when structuring terms from the social lens. Schwartz says investors are often responsible for maximizing returns and if a lender is placing restrictions on maximum rents able to be charged, it ultimately affects returns. "It's trying to find a balance that still is doing good and creating a potential home for an underserved market, while still making the project work from an economic perspective."

Diversity and inclusion are also factoring into ING's thought process around issuing more ESG loans from the social lens. Schwartz says the bank is trying to figure out how such elements parlay into management team composition and managing diversity and inclusion at the borrower level.

Schwartz says the challenge for completing more green loans overall is getting clients to focus on such activity in the US market. At present, ING's green deal momentum is fueled in part by repeat business. Last year, the bank signed three sustainability-linked deals with one client, and has totaled six other green deals with another. ■

Advisers Marcus & Millichap sees opportunities in market slowdown

Marcus & Millichap Capital Corporation is finding its advisory and capital sourcing services are in higher demand as capital providers are dialing back lending efforts due to increased market volatility, ***Randy Plavajka writes***.

Evan Denner, executive vice president and head of business for the Calabasas, California-based capital solutions provider, says some lenders are hitting the pause button or dipping in and out of the market as interest rate hikes, inflation and hesitancy from a potential recessionary environment take their toll. The shift, however, hasn't changed the firm's core approach.

"For us, it is really business as usual," Denner says. "We have just dug our feet in deeper to make sure our clients are getting the best possible outcome, and whether that is proceeds, whether it is structure, whether it is carve-outs, we are just having to dig in more."

The firm is seeing differing amounts of liquidity from different types of lenders. Denner notes that lenders who tap warehouse facilities, finance themselves through the CLO market and use other securitization markets are having a more difficult time navigating the market compared with their banking and credit union colleagues.

"The other thing that we are finding is a lot of borrowers that had and have direct relationships with capital sources are now calling us much more because either their lender said 'We are out, we are sitting on the sidelines,'" Denner says, noting in some cases loan provisions are also shifting to more defensive approaches. "This is just market volatility and lenders are doing what they have to and really what they should be doing. I understand why and it just means we are working harder on the weekends."

"We have just dug our feet in deeper to make sure our clients are getting the best possible outcome"

Evan Denner
Marcus & Millichap Capital Corporation

Stable fundamentals

Compared with six months ago, M&MCC is seeing more credit departments slowing down or hanging out on the sidelines to wait out the volatility. Denner says the gyration in and out of lending can unintentionally cause angst among originators, prospective clients and borrowers.

Denner says the fundamentals of the commercial real estate debt landscape have to be separated from the financial markets themselves, noting generally fundamentals from 90 or 120 days ago to today have not changed much.

"[For] the asset classes that were in favor four months ago, very little has changed, and [for] the asset classes that were out of favor, four months ago, little has changed," Denner says. "What has changed is that when those assets are trading at very tight cap rates and rates have moved the way they have moved, now the deals start to make less sense or no sense, but it is not the fundamentals that changed, it is the pricing."

M&MCC has ratcheted up its client engagement in order to help mitigate any uneasiness stemming from the changing environment. Denner says his team is working more weekends and connecting with clients when they have downtime to chat about the markets as opposed to specific transaction activity.

"We have a lot of prospective clients now reaching out and asking for advice and [for us] to represent them because they are in the middle of an acquisition, they have got money hard, they have to close and they need us to make and clear the market for them immediately," Denner says.

Outside standard business, Denner explains that M&MCC is active in hiring mid-level and experienced originators across the country to stack its talent pool. The firm is also interested in acquiring capital markets and advisory companies to fuel additional growth. "Our strategy, in terms of how we work with and represent clients, has not changed and our growth strategy also has not changed; you have to just work through the volatility."

Lending Ariel tracks rising momentum on Big Apple retail loan activity

Multifamily borrowers in New York are looking at the city's mixed-use market in a new way, feeling out lenders about the prospect of financing opportunities within the sector where there is the potential for a ground-floor retail component, ***William Johnson writes***.

This emerging trend has gained steam in recent weeks, says Matthew Dzbanek, capital services professional at Ariel Property Advisors, a New York City-based full-service brokerage firm.

"A lot of borrowers are seeing more value in mixed-use assets that they are not seeing in the multifamily space. You get better returns because there is perceived to be more risk and a lot of clients are now comfortable taking that ground floor retail risk," Dzbanek says.

Ariel Property Partners, founded in 2011 by veteran broker Shimon Shkury, is seeing especially strong demand from potential buyers for small residential buildings with a retail component in areas with strong foot traffic. The firm tracked $1.7 billion of transaction activity for small mixed-use properties in 2021, with a little over $1 billion closed through the middle of this year.

"After everything started reopening, retail in residential areas really started to boom, more so than it ever has in the past. Sponsors who own these buildings in some more of the residential neighborhoods have really seen their retail tenants doing exceptionally well and making more than they were making pre-lockdown," Dzbanek says.

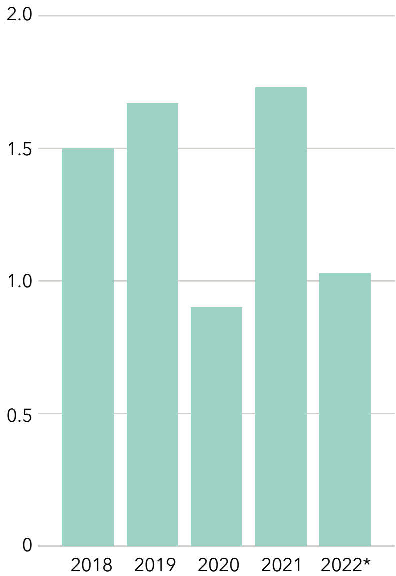
Sponsors are also looking at adding a retail component to an existing property. "In much of New York you're going to get more money on the ground floor for a retail building than you will for an equivalent residential unit," Dzbanek says.

The return of retail

Critical to the emergence of mixed-use properties has been an overall rebound in the retail market. Despite fears of an inevitable decline in brick-and-mortar shopping due to the growth of e-commerce and the pandemic, physical store openings rebounded nicely in 2021, and 2022 is shaping up to be a banner year as well, according to a report by Cushman & Wakefield.

"In the first five months of 2022, retailers have opened more than 4,200 stores, exceeding this year's store closings by 240 percent and putting 2022 on track to be the first year of net-positive store openings since 2016," the report states.

New York small mixed-use transaction activity ($bn)



*End June 2022
Source: Ariel Property Partners

And retail tenants can still offer landlords comparative advantages over their office or residential co-tenants, according to Dzbanek.

"A lot of times these retail tenants will walk in for longer terms, often signing five- to 10-year leases, as opposed to residential tenants who could turn every year and you have to deal with the re-leasing cost associated with that," he adds.

A mixed-use property's retail component can pay dividends for years to come, which is why lenders are listening, says Dzbanek.

> "A lot of borrowers are seeing more value in mixed-use assets that they are not seeing in the multifamily space"

Matthew Dzbanek,
Ariel Property Advisors

"If you are a savvy investor who is very confident in your abilities, you can usually get a deal where the ground-floor unit is getting a higher rent than the equivalent residential, and a tenant which is going to lock in for longer terms," he says.

Location, location, location

Much of a mixed-use property's success comes down to where it is.

"We're seeing retail doing really well in areas of Upper Manhattan, Brooklyn, Queens and the Bronx with heavier residential density," Dzbanek says. "We're financing a fully vacant mixed-use building right now in Greenpoint. [The sponsor is] going to be able to put in a high-quality tenant who is going to do very well from day one."

Sectors **Underwriting multifamily in a time of inflation**

The red-hot US multifamily sector has so far weathered the current economic dislocation with aplomb, but lenders are urging caution as inflation and interest rates rise and rents brush with the upper end of their registers, ***writes Randy Plavajka***.

For multifamily lenders, this has so far meant tweaks including more cautious underwriting from banks and considerable spikes in interest reserve accounts.

Chris Moore, managing director of capital markets and hedging at Kennett Square, Pennsylvania-based advisory Chatham Financial, says the current environment is unprecedented regarding how dramatically pricing across the commercial real estate debt landscape has gone up in the last six months across all asset classes. "There's this question about how much longer pricing can go up in the multifamily space," he says.

Tingting Zhang, founder and CEO of the El Segundo, California-based commercial real estate credit manager TerraCotta Group, says that, in a standard environment, multifamily rental prices are supposed to be able to catch up and match inflation more efficiently compared to the office sector.

"The curve will come down if inflation continues, because at a certain point the affordability factor kicks in," Zhang says. "There's only so much that the tenant can pay." She notes the current multifamily market has become more interesting because rental affordability has taken on a great deal of variation across different geographies wherein only some still have room for growth.

> "The curve will come down if inflation continues, because at a certain point the affordability factor kicks in"

Tingting Zhang
TerraCotta Group

"When rents are not increasing, the cap rate is going to expand," Zhang says. "We actually see that in some of the Sunbelt markets. Although there's still greater demand for multifamily space, significant growth in rents in recent years has undermined the affordability factor in the inflationary environment. This may not be a good thing."

Stalled deals?

While the conventional wisdom is that dealflow is not likely to be stalled in the short term on account of current supply or decreased tolerance from tenants to keep up with rising rents, the constant hunt among lenders for premier assets – especially in Sunbelt markets – does make for a more complex environment where even the most senior specialists only want to bet on properties with every tailwind in support of a potential deal.

William Colgan, partner at New Jersey-based real estate manager CHA Partners overseeing the firm's capital stack, says more caution is expected when looking at the increase in construction costs and subsequently the deliverance of new products.

Colgan believes there will be a slight slowdown in the multifamily landscape. "Covid-19 caused a supply side shock as material production was halted and a lot of folks were left competing over the limited supply of goods, which led to high inflation. However, we believe the imbalance is being corrected as production has ramped up and there is a demand-side slowdown as underwriting projects have become more difficult with price uncertainty and interest rate hikes," he says.

The interest rate hikes being rolled out by the US Federal Reserve to try and taper inflation have not added direct wind to the multifamily sails. After a 75-basis-point hike in June and the prospect of another in July, Colgan says the rosy sky assumptions must be adjusted to account for unknowns still at play.

Colgan says moving on more deals in the current environment will require greater scrutiny around development yields and increasing project costs. "You're going to need a lot more NOI on a given project for it to make sense to move forward," he says, adding that his firm has started to see cap rates creep up as firms update underwriting and factor in the interest rate hikes on a go-forward basis, even if they are a relatively low-leverage borrower.

Strategy **How PGIM is calibrating against choppiness**

PGIM Real Estate is dialing up its focus for the second half of 2022 on multifamily and alternative lending opportunities in order to weather choppy market conditions brought on by inflation, continual interest rate hikes and looming recessionary conditions, ***Randy Plavajka writes***.

Lee Menifee, head of Americas investment research at the Madison, New Jersey-based manager, says the current lending environment is more interesting and challenging than in prior quarters as macro headwinds taper lender activity.

"We know that the investment environment has changed from both a debt and equity perspective, and it has changed very quickly – just in the last six months – and we know that there's a reset in real estate markets," Menifee says. "What we're really emphasizing here is we don't know what the next six months or 12 months are going to bring."

The firm has concerns about asset values across the spectrum, with PGIM digging into the topic in its most recent global outlook to better identify structural trends.

"I think of this year's global outlook as being very little about what to do because of what's going to happen in the next six months and much more about what's going to happen in the next six to 10 years," Menifee says. "So, we know it is a tricky environment to deploy capital."

Lay of the land

Like other lenders, PGIM is maintaining conviction around the residential market.

"With interest rates and borrowing costs now above yields in a lot of the housing markets and multifamily markets, that obviously changes the equation for a lot of investors," Menifee says. "And what we've seen is the exit of, or at least a pause [among], a lot of the highly leveraged buyers who are manufacturing higher-than-core returns via the use of leverage, and leverage is no longer accretive."

Looking at PGIM's transactions and the broader landscape, Menifee says the firm has seen the debtor pool thin because of the reduced amount and frequency of highly levered buyers participating in transactions. Deals now take a little longer to get done, which he says indicates a healthier market than iterations prior. "It's marginally better to be a buyer than a seller as compared to then."

Menifee says that, while the rise in rates has garnered the most press, what is not getting much coverage comparatively is the reduction in proceeds attainable now. "That's changing the landscape as well, because buyers are looking for highly leveraged loans," he says. "We have seen lenders be much more cautious about their loan-to-value ratios and that has been true across really all sources of lending."

The reticence from lenders has a twofold effect for PGIM. Menifee says the lending environment is better now for senior lenders amid higher rates. Meanwhile, to the extent that loan issuers don't need to offer exceedingly high loan-to-value terms, risk-adjusted returns are better despite tightened spreads.

"The other part is, that opens up even more of the gap in financing between where the equity and the senior debt is," he says, noting such gaps have widened substantially. "And while there are providers of that capital, not all those providers have that capital or are themselves as well capitalized as they should be, some of them also rely on borrowers."

Menifee says to the extent there is an opportunity in the gap financing realm, conditions now are better than a year ago, and it is more interesting for PGIM to participate in preferred equity or mezzanine deals because the risk-adjusted returns line up with the firm's standards.

Appointments Hires and promotions that mattered in the US commercial real estate debt markets

Pembrook

John Malysa, a veteran commercial real estate credit player, has joined Stuart Boesky's Pembrook Capital Management as a managing director to focus on underwriting, oversee asset management, and serve as a member of the New York-based bridge lender's investment committee. Malysa joins from Macquarie Infrastructure and Real Assets' private credit real estate debt platform, which he built from the ground up. He also filled a senior role at CIBC World Markets, where he was a managing director and head of CMBS securitization and distribution.

Greystone

Hafize Gaye Erkan has come on board at Greystone as chief executive, succeeding Steve Rosenberg. This move takes place as the New York-based investment manager and adviser looks to expand its core commercial, multifamily real estate lending and capital markets business. Erkan, who joins from First Republic Bank, where she was co-CEO and president, will report to Rosenberg.

Rosenberg, who is retaining his responsibilities as executive chair of Greystone's board, said Erkan will drive the next generation of Greystone's investment and innovation opportunities, including the pursuit of organic and inorganic growth opportunities, while working together on talent investments for the core commercial and multifamily real estate lending and capital markets business lines.

US Bank

US Bank has appointed Tony Janssen to lead a newly formed commercial real estate team that will provide bespoke loans to mid-market borrowers. The St Louis-based new team will complement an existing lending platform geared toward larger transactions and target an underserved area, said Hassan Salem, head of commercial banking. Janssen is a 17-year veteran of US Bank.

CBRE

Rachel Vinson has been named president of debt and structured finance at CBRE, with a mandate to lead its US debt and structured finance business, which last year closed $80 billion in loans. Brian Stoffers, CBRE's global president of debt and structured finance, said Vinson will be a key part of the firm's plan to grow this aspect of the US business. Vinson steps over from leading CBRE's global Capital Markets business, and before that, CBRE's Americas Advisory Finance organization. Prior to joining CBRE in 2019, she spent six years with Barings Multifamily Capital.

Oak Real Estate Partners

Brook Scardina has joined Oak Real Estate Partners as a managing partner and director of capital markets and investments, a role that helps the firm better market its commercial real estate debt products to institutional investors. The move comes as the small-balance-sheet credit manager launched its first institutional investor-focused fund, the $500 million Oak Institutional Credit Solutions. Scardina joins from Crescent Wealth Advisory, where he worked with the Georgia Tech Foundation, UNC Management Company and the UPS Retirement and Pension plans.

MetLife

David Politano has taken the top real estate debt post at MetLife Investment Management, following the retirement of Gary Otten from the role. He has spent 27 years at MIM and MetLife and most recently led the New York-based manager's international platform, north-east region and real estate capital markets group with MIM's real estate division. Politano began the new role in May and reports to Robert Merck, global head of real estate and agricultural finance at MIM.

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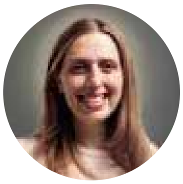
Editor's letter

Financing the future



Samantha Rowan
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The global commercial real estate market is facing generational volatility as the Federal Reserve and other central banks raise interest rates, inflation rises, and asset classes once considered mainstays are now facing severe challenges. There is also a sense of foreboding that the amount of distress will start to rise substantially in the coming months.

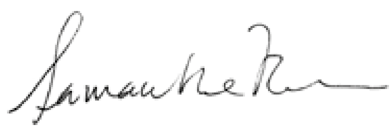
But there are some bright lights. Jonathan Pollack, a senior managing director and head of the structured finance group at Blackstone, this month speaks with *Real Estate Capital USA* about how the firm's conservative, data-driven approach combines with an understanding that the commercial real estate market of tomorrow will be substantially different from today.

"There is also a sense that in every downturn, there is opportunity"

There is also a sense that in every downturn, there is opportunity, and Tammy Jones, founder and CEO of New York-based Basis Investment Group, believes that creativity and flexibility in structuring loans and financing will be one of the ways the commercial real estate market will be able to start to move past its current struggles.

Still, the market has so far been somewhat hampered by a slowdown in transaction activity that stems from uncertainty over where pricing is on new loans, the impact of future rate hikes from the Federal Reserve and inflation that is still climbing steeply.

Watch this space as *Real Estate Capital USA* follows how this all unfolds and what it means for the investment strategy of lenders and investors over the next 12 months.



Samantha Rowan

Single vision

Basis Investment Group founder and chief executive Tammy Jones tells Samantha Rowan how she is scaling the firm and preparing for the future

Tammy Jones, the founder and chief executive of Basis Investment Group, has a single vision for the New York-based investment management company: to create the largest African American and female-owned diversified commercial real estate platform in the United States.

The goal was always part of her plan for Basis Investment Group, formed in early 2009 with an investment thesis of providing debt and structured equity to institutional-quality mid-market commercial real estate borrowers across the US. Thirteen years later, after a series of joint ventures and separate accounts, the firm has just closed its second commingled investment fund as part of its long-term plan to scale its platform.

"When I founded Basis, I wanted to create a company that would be different than other commercial real estate companies – one that valued diversity, equity and inclusion and employed the most talented, diverse people – and I'm happy that 13 years later, we have achieved that," Jones tells *Real Estate Capital USA*.

Basis invests and lends across the capital stack in commercial real

estate, with a focus on the mid-market, on behalf of some of the largest public pension plans and family offices in the country, as well as sovereign wealth funds. The firm is the only diverse investment company of its kind with a successful track record that is African American and female-owned, Jones adds.

"We are the only agency lender that has a license that is African American and female-owned, as well," Jones says. "Putting those pieces together has not been easy, but we are really on a good trajectory. The focus for us is to create a platform that can be resilient, invest through cycles, and provide investors with different strategies that can be nimble when you go through volatility."

Fundraising milestones

Basis Investment Group closed its second commingled fund in June, raising $832 million against its target of $550 million and a hard-cap of $750 million. With all the investors from its first fund making new commitments to the firm's second vehicle and new investors signing on, Basis Investment Group had to go back to its clients to increase the total size of the vehicle.

"When you look at a successful fundraise, you want your old investors to come in, you want new capital to come in, and you certainly want to achieve your target," says Jones. "The purpose of this fund is solidly a follow-on to fund one. It has the same strategies, with probably an allocation to potential distressed debt or situationally distressed opportunities."

The firm's inaugural offering, the $410 million BIG Real Estate I, closed in May 2019 and was also oversubscribed. Jones notes, however, that it was a long road to the firm launching the fund – the offering was the firm's ninth venture.

"It's important to note that you don't just go out and raise your first fund; you have to build a track record," Jones says. "We have been investing and managing capital on behalf of institutions all throughout our history."

Launching a new fund during the covid-19 pandemic was a bit daunting, but Jones was sanguine about the prospect due to the firm's track record and relationship with its investors.

"I had the faith that because we were delivering on returns and communicating with investors, it would be successful, but I didn't know that we would have to go back an increase our hard-cap," Jones says. "Many of our investors doubled or even tripled their allocation. Every investor from fund one came into fund two. That doesn't happen because of anything other than your track record."

Much of the fundraising for the firm's second fund was completed via Zoom, which demonstrated some benefits for Basis and its clients. While historically, much of this activity would have been in person, working through Zoom in some ways made the process more efficient.

"I can honestly say that I could not have called this outcome – that raising capital via Zoom would be as successful as it was," Jones says. "We are in an evolving and changing market, even with respect to capital raising. There is nothing that replaces us [meeting and] talking to each other. But if you have a process that moves as quickly as a fundraising process, this technology has made it more

"I wanted to create a company that would be different than other commercial real estate companies – one that valued diversity, equity and inclusion and employed the most talented, diverse people"

efficient because you can be in different places at the same time. It tested us all to say, 'Does this have to be in person?' And I think it shook us up. But I believe fundraising won't go back to just in-person meetings; it will be hybrid."

Jones sees a hybrid future for fundraising, noting that the same due diligence is being done and managers need to have the same meetings with risk, operational and investment teams.

The firm also found a hybrid strategy worked for its annual investor meeting, with some clients attending in person and some participating online. "I do think that would have never happened pre-covid. At that point, we only had a live conference," Jones says. "A hybrid format means all of the investors can participate – some will be in the room and others will be virtual. It's a change that shows the evolution of the industry."

Grateful debt

Debt as an investment has been increasing in popularity with institutional investors since the end of the global financial crisis, with a greater understanding of how these strategies work and fit into an institutional investment portfolio, Jones says.

"Investors are really understanding the nuances of debt – that there is senior debt, mortgage debt, mezzanine debt and preferred equity. There are all of these different strategies within the asset class," Jones says. "I think they're appreciating in this market that debt and credit provide a defensive strategy and consistent cash-on-cash returns.

"It can also provide equity-like yields, with a lot of protection against downside and volatility through the structuring that can happen in debt instruments that doesn't necessarily

Ninety/90

Basis Investment Group recently closed a loan in southeast Queens, New York, with a repeat client, BRP Companies.

The sponsor, a New York-based company co-founded by Geoff Flournoy and Meredith Marshall, is breaking ground with Ninety/90 – a $367 million multifamily mixed-use development that happens to be close to the neighborhood in which Jones grew up.

Basis provided $141 million of structured equity for the transaction with BRP – a major African American-led developer – and the sponsor obtained a construction loan from AIG.

"In this transaction, two African American-owned firms came together for the development of a 614-unit multifamily project, 30 percent of which will be affordable," Jones says. "What is also really special to me is being a person who grew up in South Jamaica and walking by that site many times as a young girl and being able to return to my community with a beautiful multifamily product and to be able to partner with another successful African American-led firm."

While this project is an important one, there is still a long way to go for African American and other minority-owned developers in commercial real estate. These firms are typically capital constrained, which makes it difficult for them to scale their businesses.

"Post George Floyd, which highlighted some of the systemic and structural racism that we know has existed, there has been somewhat of a shift, but there is still a ways to go. If you look at the asset management business, minorities and women are 1.2 percent of that capital. It speaks to a larger, broader problem," Jones says. "This financing in Queens is an example of bringing together two firms that have two different areas of expertise. Basis is an allocator of capital, and BRP is a developer that has been very successful, first starting with smaller projects and now doing projects like these."

As a lender, Basis wants to only work with smaller developers. "We need folks to scale – that is what Basis is trying do and what this developer is also trying to do," she adds.

happen when you're playing for the upside and investing in equity."

The firm is finding that many investors are seeing the core benefit of a debt strategy, which is the ability to tap into equity-like returns with downside protection. "Many investors are saying, 'This makes a lot of sense; I can get similar returns, have less risk and be at a basis that is more protected,'" Jones says.

Being able to structure bespoke investments that take all of this into account will be critical as the commercial real estate market moves through today's economic and geopolitical headwinds. "We rode the wave of recovery up for the past decade-plus," Jones says. "When I started my company, it was a good time because in adversity there is opportunity. It's different now, and a little bit more difficult, but I believe we are back at that place and that there are opportunities."

Investors today are looking at their portfolios in different ways. "It's about capital preservation and ensuring you have defensive positioning today because not everyone is so sure about the equity yields and growth," Jones says. "You come back to capital preservation, and asking, 'Where can I get consistent returns and where can I mitigate risk?'"

The birth of dequity

A key principle of Basis Investment Group's investment philosophy is the idea of dequity, or commercial real estate debt, which has equity-like features. Jones says it is an example of the creativity that is possible in structuring debt investments. But it is also about diversification.

"Our investors love dequity because it speaks to a way of diversifying the strategy – dequity means a blend of credit- and equity-like yields," Jones says. "You can have senior debt, preferred equity and even more structured equity that complement each other and create a blended portfolio with the right profile of risk."

Basis points

Tracking the firm's milestones through the years

2009 Basis Investment Group founded

2011 Basis ranked in top 10 US commercial mortgage-backed securities issuers

2016 ESG policy adopted, Emerging Developer Loan Fund launched in conjunction with the New York City Economic Development Corporation

2017 Establishes Impact Foundation

2020 Receives New York City Comptroller's Office Diverse Practitioners of the Year Award

2021 Becomes Principles for Responsible Investment (PRI) Signatory

2022 Closes second commingled real estate fund

The firm is originating debt that fits this profile in all of the main commercial real estate asset classes throughout the US, with Jones noting that classifying Basis Investment Group's investment process simply as a "credit" strategy doesn't capture what the firm is doing.

"We have geographic diversity and, as a mid-market player, we're focusing on the smaller check sizes," Jones says. "We're also looking at the real estate lifecycle and having deals that are not all stabilized, which means value-added or development deals as well. Having a diversified strategy also includes bridge debt, mezzanine debt, preferred equity and even some CMBS B-pieces and distressed debt. We are putting together this portfolio that equity-like returns and debt features."

In addition, dequity creates the ability to provide customized solutions for borrowers that also work for the underlying real estate.

"It's about trying to come up to a credit solution that is appropriate and customizable for that property. If a property doesn't have cashflow, you can build in a reserve," Jones says. "There are things you can do that make the debt structure appropriate for that property, but you have to understand the real estate. Other credit providers are very debt-focused – but we are both real estate- and credit-focused. We look at the underlying real estate, and that matters first. We also understand the technology of debt structures. We can marry those two worlds and that makes us better debt investors."

Rising rates

Rising interest rates are the most common concern for the firm's borrowers. "We have known this was going to happen, but we have also had some unprecedented movements from the Federal Reserve, and folks are trying to understand how that truly impacts returns, especially at a time when inflation is at

40-year highs," Jones says. "Folks are worried about the volatility."

This is particularly true for deals that have a floating-rate component. "Cap costs are high and, for borrowers with a value-added strategy, they're worried about supply chain issues. If we're doing a development deal, they're worried about construction costs and budgets," Jones says. "There is also a general sense of caution, and borrowers are worried about their ability to fix their debt, because who knows it if it's going to get higher? Yes, we have the forward curve and people are looking at that, but people are thinking rates are expected to go higher. If they miss the opportunity, then they may have made a decision that impacts them for many years."

However, Jones notes, there is a big difference between what is going on today and the global financial crisis, when the financing markets were frozen.

"Certain aspects of the market are more challenging than others. The CMBS market has had huge volatility and it's been difficult, but I think the debt platforms have been stepping up to fill the gap," Jones says. "Borrowers have to be creative about building out the capital stack. Today, it's not just getting that one loan at 3 percent and getting all of the capital you need. Now you have to say, 'What can I get with my senior mortgage? Do I need some preferred equity? Can I be creative about my equity because returns are harder to achieve?' We're trying to show folks that dequity can actually be accretive to the equity as you look for creative ways to build a capital stack."

"We're trying to show folks that dequity can actually be accretive to the equity as you look for creative ways to build a capital stack"

The DNA of ESG

When Jones formed Basis, the principles behind ESG and diversity, equity and inclusion were a part of the firm's philosophy. Part of this was based on her personal experience as an African American woman working in commercial real estate.

"I grew up in the commercial real estate business, but I never saw anyone who looked like me in the C-suite. I never saw any African American women and very rarely saw African American men," Jones says. "And although I'll say that I always had an entrepreneurial spirit and that was the main reason why I started Basis, I also knew that I needed to create my own role as a CEO if I wanted to become a CEO. If you look at the numbers and do the research, you'll know what I'm saying is true."

With this understanding, Jones set out to create what she hoped would be a commercial real estate company like no other. "My company was going to be diverse and inclusive," Jones says. "And to that end, 75 percent of our team is comprised of women and minorities, and now we have invested more than $1.2 billion of capital with qualified diverse and female-owned commercial real estate companies."

The firm has incorporated many ESG principles in its investment process since its inception, formalizing that commitment in 2016 with the adoption of a firm-wide ESG policy.

"Many years ago, we looked at the ESG risks and opportunities through the lens of the stakeholders, had internal and external ESG goals and committees. It was literally incorporated into our process," Jones says. "We produce an ESG report that talks about measurable targets we have hit. As an allocator, we're not running the properties, but we can certainly influence our borrowers, track our outreach with diversity, and understand the environmental risks within our properties, which are ever-changing because of climate change."

And while ESG risks are real, they also present opportunity – and a chance to be a part of the great change of use and efficiency that is happening in the commercial real estate industry. Investing in an office building to make it more efficient can be accretive to the bottom line, just like having an agency lending license helps provide liquidity for affordable and workforce housing, Jones notes.

"We look at those opportunities, we look at who we're doing business wit, and try to understand how they're approaching ESG, and we're focusing on affordable housing and workforce housing," Jones says.

"We're making sure diversity is included in who we're doing business with, and asking the right questions, and we're happy to see that other lenders are beginning to do the same. We did this from the start, and we're now getting good information that we hope will help make a change in the industry."

Positive impact
Jonathan Pollack on taking the pragmatic path

Cover story

Blackstone's Structured Finance Group head is using macro trends and robust data to navigate generational volatility and help drive progress in the commercial real estate market, writes Samantha Rowan

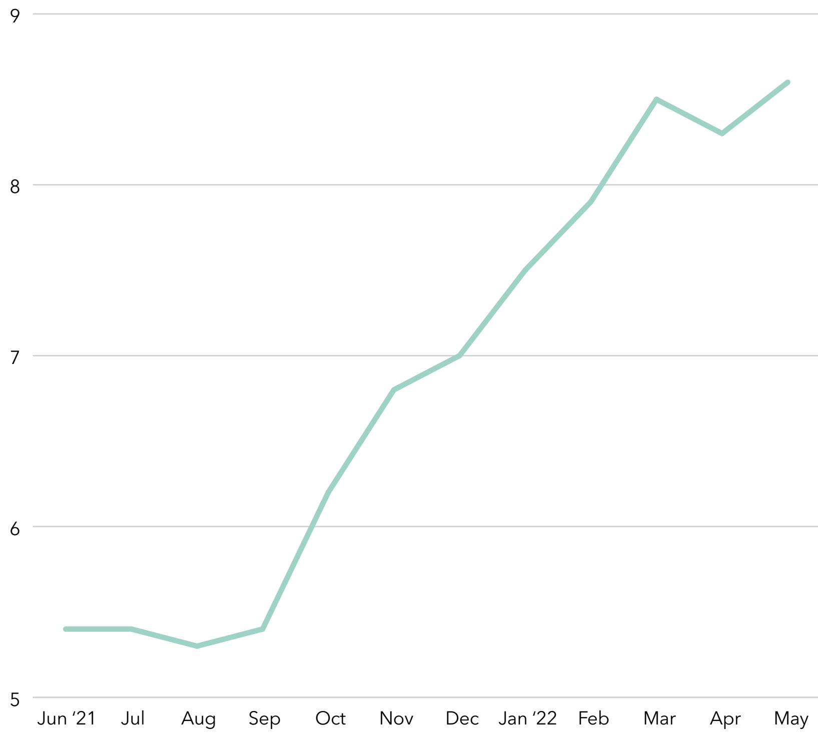
PHOTOGRAPHER: KEITH BARRACLOUGH

It is an unusual, perhaps unprecedented, time for the global commercial real estate market. As it navigates through the end of a once-in-a-lifetime crisis, the covid-19 pandemic, the industry is now bracing for what could be a period of generational volatility stemming from steep inflation, quickly rising interest rates, and the impact of the war in Ukraine.

For Jonathan Pollack, senior managing director and head of the Structured Finance Group at New York-based mega-manager Blackstone, there is a rational way to adapt to the current situation. In an interview with *Real Estate Capital USA* in early June, Pollack laid out a strategy fueled by data-driven pragmatism, conservative leverage, and an understanding that the commercial real estate market of tomorrow will be substantially different than what it is today.

On June 11, the US government reported an 8.6 percent year-on-year

US inflation rate, June 2021-May 2022 (%)



Source: US Bureau of Labor Statistics

increase in consumer prices in May – a 40-year high. And on June 15, the Federal Open Markets Committee raised interest rates by 75 basis points – the largest increase to the Federal Funds Rate since 1994 – and raised the prospect of a similar increase at its next meeting. But there are more factors to consider than just looking at the numbers, Pollack says.

"In normal times, 8 percent inflation would be the dominant headline for an entire year. But at this moment, there's much more than that going on in the world, including the war in Ukraine, which is not only a humanitarian crisis, but also has broader impacts around the world," Pollack says. "Now, you also have the fight against inflation, the pullback of excess liquidity following the pandemic, and central banks from around the world – including the Federal Reserve – are raising rates and shrinking their balance sheets. All of these have real-world impacts on individuals and businesses, and contribute to a great deal of volatility and uncertainty in the marketplace."

Investment approach

Blackstone's investment strategy, particularly in its real estate debt business, is informed by a few key principles, a broadly conservative approach and analysis of data from its $550 billion real estate equity portfolio. As an institutional manager, Blackstone's primary focus is on the preservation of capital, Pollack says.

"That is job number one, and in order for us to achieve that, we have to believe that the value of the real estate will grow, and this has to do with the modernization of purpose," Pollack says. "Being a transitional lender was very valuable coming out of the financial crisis, but it was also where our capital sources wanted us to be focused – that is still a very important part of our DNA."

The firm's lending process is driven in part by data and analysis gleaned from its $550 billion equity portfolio.

"We can talk about real estate fundamentals because we have the benefit of being a part of the largest owner of commercial real estate in the world," Pollack says. "We have access to tremendous data, and incredible asset management and portfolio management teams that provide data to our investment team in real time so that we can make decisions about new investments, as well as [for] our existing portfolio. We are driven by where we see growth, where we see supply challenges, and we build our portfolio with those factors in mind."

Having that kind of information to hand gives Blackstone an edge, particularly given the firm's approach of taking very conservative views of the attachment point of loans, argues Pollack.

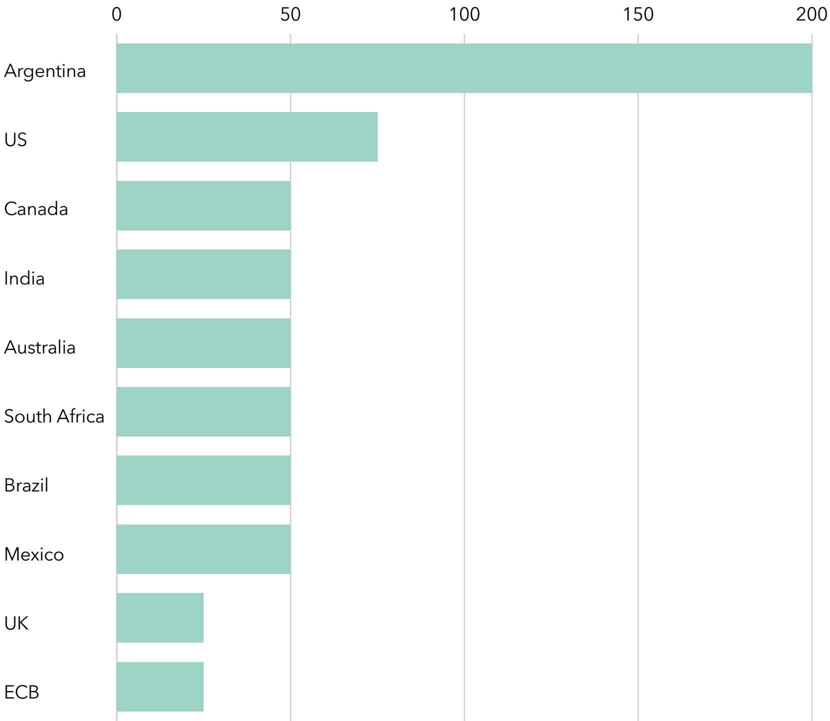
"That helps us run that conservative attachment point playbook in lending or in securities, where we have a very big presence in commercial, as well as residential, mortgage-backed securities," Pollack says. "We're consistently looking at the instrument and underlying real estate and asking, 'Are we at a comfortable attachment point?'"

Historically, in both Blackstone Mortgage Trust (BXMT), the firm's senior loan-focused mortgage real estate investment trust, and the real estate debt platform, average loan-to-value ratios have been in the mid-60 percent range.

"There's a lot of equity cushion," Pollack says. "I'd say that this is also a product of the world since the financial crisis, because, at the time, one of the biggest challenges our sector faced was excess leverage. Since then, both lenders and the equity investors have done a better job staying away from that."

The firm is a floating-rate investor in almost all the investments it makes across its strategies. "We do not have

Global central bank rate increases as of June 16 (Basis points)



Source: New York Times

exposure to the interest-rate volatility that the market has experienced in recent months. Looking ahead, we feel we are positioned to benefit on the return side as central banks have raised base rates, trying to slow growth and inflation," he says.

Driving growth

As an investment company, Blackstone has been focused on what it believes are fundamental drivers of growth, and the firm's real estate equity and debt businesses are no exception.

"We own a lot of industrial, multifamily, life sciences, office and hospitality [properties]. That is because fundamentals in those areas are strong and you can experience growth that is supportive of the long-term value of the asset, notwithstanding the inflationary environment. Being in markets where people are moving, populations are expanding, businesses are hiring – that all drives fundamental strength underlying those types of real estate assets," Pollack says.

"The transition and the improvement of real estate is one of the most fun parts of what we do. Being a part of that process in different markets and seeing the creativity that goes into it is exciting. There is always some reason for real estate to be in transformation mode – today it feels specifically substantial."

Building a career

Pollack credits three key points as vital to his experience that are key to how he runs Blackstone's structured finance business: taking a role on Deutsche Bank's CMBS trading desk in 1999, helping the bank launch and build its European business a few years later, and the international experience gained by working in London.

"About two years after I started my career, I got the opportunity to move to the CMBS trading desk [at Deutsche Bank] where we were trading bonds, pricing loans for securitization and doing syndications," Pollack says. "I worked with sales teams and our trading counterparties, and I traded bonds on my own. Being thrown into that at such a young age – with especially good guidance and mentorship – really forces you to think independently and commercially."

The context of Pollack's earlier experiences gave rise in part to how the team at Blackstone is bringing along the rising generation of lenders. "Hopefully, the experience of working at Blackstone includes that type of education, because for me, that experience throughout the earlier part of my career was foundational. It can be easy in a big organization to let the organization make decisions and just go along for the ride – and my experience was not that. We strive to not let that happen here at Blackstone, either," Pollack adds.

Pollack got the opportunity to further hone his ability to think independently 18 months after he joined Deutsche Bank, when he moved to London to help the bank launch and grow its CMBS lending business. Pollack was the associate-level person in New York dedicated to that effort, moving abroad to work with new senior leadership that had been tapped to build the business.

"We went from two or three people on day one to about a hundred people by year five. I was able to see that growth unfold from the front lines and help build that business and manage others," Pollack says. "Getting that chance at a relatively young age, seeing it happen from the beginning, was an incredible opportunity to learn. It opened my eyes to how you go about building a business and how to think about all the various factors that come into play during that type of growth, from risk management, personnel, and infrastructure of the

team – all things that need to be done well to build a lasting business."

The experience of working in London was invaluable to Pollack, who is now based in New York. "There is no substitute for putting your feet on the ground somewhere else for an extended period of time and learning how to adapt to different cultures, learning how to transact in a new market. It broadens your thinking and gives you the tools needed to operate in all different environments," Pollack says. "London is connected to so many different places and it was a wonderful place to be. While living and working there, I developed great relationships that I still rely on today and it also gave me valuable perspective as we have built out our European team."

Pollack brought out this toolkit when he joined Blackstone in 2015 as its global head of real estate debt and used it to expand the firm's business in Europe. "It was important for us to bring those things to bear every single day, thinking commercially and with an international perspective. Fortunately, we built a very big business in Europe," Pollack says.

Pollack cites Michael Nash, the co-founder and chairman of Blackstone Real Estate Debt Strategies, and Jon Gray, president and chief operating officer of Blackstone, as key mentors when he joined the business. The senior management team now includes Tim Johnson, who stepped into Pollack's shoes as the global head of real estate debt (when Pollack became global head of the Structured Finance Group); Katie Keenan, the chief executive of Blackstone Mortgage Trust; Mike Wiebolt, who manages the real estate group's liquid securities activities; and Steve Plavin, a senior managing director who heads the firm's European real estate debt business. This team, Pollack says, has been key to the ability to grow assets significantly over the past eight years.

"Together, we were able to expand

"We're consistently looking at the instrument and underlying real estate and asking, 'Are we at a comfortable attachment point?'"

Timeline

Blackstone real estate debt milestones

2008 Blackstone launches Blackstone Real Estate Debt Strategies

2012 Acquires Capital Trust

2013 Launches a new IPO of Capital Trust as Blackstone Mortgage Trust

2015 Acquires GE Capital Real Estate's loan portfolio, substantially increasing its loan book

2021 Announces a transaction with AIG through which BREDS would manage a portion of the insurance company's capital

2022 Manages a global debt business, with offices in New York, Los Angeles, London and Sydney, and assets under management of $55 billion this business from $9 billion in AUM to north of $50 billion today," Pollack says. "We ask the questions, 'What are the organizational structures? What will the future look like, and how do we get there responsibly? How do we expand at scale?'"

Pollack and the rest of the senior managers at Blackstone are now working to mentor the next generation.

"The young people who join our organization learn how to be investors, learn how to think for themselves so that when they come to the conference table to present a deal, they're not just reporting on it and looking to the senior people around the table to make a decision about it. They're making the case, and that is very valuable."

US Treasury rate, July 2021-June 2022 (%)

Source: St Louis Federal Reserve Bank

Symbiotic data

One of the benefits of having a real estate equity portfolio of Blackstone's scale is the ability to dig into data on a real-time basis. For commercial real estate, historically a backward-looking industry in terms of data and analysis, being able to do this is a game-changer, argues Pollack.

"There is rarely a property we look at financing where we don't have a view on that property from the equity side, whether it's because we own something else in the market nearby, where we have real-time leasing data, or we maybe have even owned those assets in the past. I think that is a scale that is not rivaled and is a big benefit to us. If you're trying to be a lender and keep yourself out of trouble, there is nothing better than that," Pollack says. "We haven't had a realized loss in our lending portfolio."

Part of the reason why the firm has been able to build such a large business is there is a bigger ecosystem of work in which the firm has multiple touch points with clients on the debt and equity side.

"We've created an ecosystem for the counterparties in the marketplace and the people we lend money to," Pollack says. "They're buying real estate from us, we're selling real estate to them. There is a broader ecosystem that evolves where those relationships really matter on a lot of different fronts. And with our scale, we are able to find different ways we can be supportive to those borrowers, including, for example, at the basic level of procurement. We have been able to build a strong business because we are a performing loan provider and we're not in the business of trying to foreclose on a borrower."

Rising rates

As a floating-rate lender, Blackstone is able to participate on the upside as rates rise.

"Normally when rates are rising, fixed-income investors don't get to experience wider spreads as well. That is because when base rates are higher, total returns are therefore higher. Spreads tend to tighten and offset that impact and right now because of the volatility from all of those forces in the world, spreads are wider," Pollack says. "Especially in our securities business, we have been able to buy safe bonds, and we've migrated up the capital structure to be focused closer to the investment-grade part of it, where we are picking up not only the base rate increases, but the wider spreads."

Across the return spectrum, the firm is lending at a time when real estate debt has really become an institutional investment class. In the higher-yielding end of things, there was a breaking-in period for institutional investors to identify how real estate debt's return and risk profiles made the strategy a place they wanted to allocate their portfolio.

"We have experienced the flywheel effect from that. We have our high-yield platform that we have managed

Lending snapshot: 799 Broadway

BXMT originated a roughly $270 million loan to refinance debt on 799 Broadway, a newly constructed trophy office building in New York, on behalf of Columbia Property Trust.

The LEED Gold-certified property fit the mortgage REIT's lending profile given its high quality, abundant light and great air – all factors that are proving attractive to tenants in a post-covid world.

The building also has floor-to-ceiling glass windows and 15-foot ceiling heights, 17,000 square feet of outdoor space, including private terraces on almost every floor, and a courtyard garden off the main lobby, Pollack notes.

from day one, but it's not the only thing we do anymore. Managing BXMT, a publicly traded REIT that invests in senior mortgage loans that are almost exclusively floating-rate, opens us up to a different part of the lending market, with different spreads and different types of borrowers," Pollack adds.

And over the years, the firm has also become a large-scale manager of insurance company capital, another more historically classic investor in real estate debt. "The impact on our business has been positive from having the toolkit to address the market for each of these things – making 10-year, fixed-rate loans on stabilized properties, buying 10-year fixed-rate CMBS at the single-A level," Pollack says.

The insurance business gives the firm another way to engage with its borrower base. "We have more than 500 borrowers that we've done business with, and we are able to address their construction loan, transitional financing, bridge loan and stabilized needs. Each of those gives us another touchpoint with the market and also helps us see more opportunities, which gives us more flexibility. Conversely, it also gives us more of a scope into what's working in the market and what's not – and that allows us to steer away from certain things," he says.

Navigating a post-covid world

The firm was one of the early re-entrants in the market, working to get its teams back to the office in September 2020 after the initial easing of covid restrictions.

"A lot of the normal baseline activities around investing, including traveling to see properties, are so important to our business," Pollack says. "I think one of the things we found culturally was that it was great for our team to get back to a rhythm instead of just being stuck at home."

Trying to execute the firm's business plan was challenging in a virtual environment. "Trying to extrapolate our understanding of a property through Google Maps and photos is very difficult. Walking a building is very helpful – you experience the quality, the age, you see the vision and understand the building in the context of the market. There is no replacement for that," Pollack says.

While there will always be individuals who prefer the work from home environment, there are drawbacks. "People appreciate coming to the office with a positive culture and environment and the opportunity to learn in person," Pollack argues. "That is difficult to replicate. For us, it's looking over someone's shoulder to see how they model something in excel or how they talk about an investment in a room together – there is just no substitute for that."

In terms of bringing up talent, this interaction is critical. "We're trying

> *"In normal times, 8 percent inflation would be the dominant headline for an entire year. But at this moment, there's much more than that going on in the world"*

to teach our team members to think like an investor and be able to present a case for a deal, both in writing and in person. We want our people from a very young age to sit at a conference table with the most senior people and explain why they think something is a good idea, and be engaged in that debate and learn how to hold the table. It is a very important part of training, and you can't do that as well when it is virtual," Pollack says.

Zoom can be democratic in the sense that it levels the playing field for everyone on the screen, allows people to call in when they need to be out of the office, and although Pollack believes it provides value, it is not the same as in-person interaction.

"Video conferencing is very valuable to the business. But having a positive culture, where people feel like they can be their most positive, creative self, is critical. If you can't feel like you're having fun, or there isn't a good interpersonal dynamic, then you're not exercising your full brain or capacity. It's not just a strategic thing – it has a positive impact on the way the team functions and, as we grow, maintaining a positive culture is super important," Pollack says.

The next mountain

After interest rates, the next summit for the commercial real estate market, particularly in the US, will be implementing ESG principles in bricks and mortar portfolios. But the task seems less daunting than it might have been a few years ago.

"ESG has been an integral part of how we think about investing, and has been for a long time. The opportunity and some of the challenges associated with the environmental impact is that the tools for measuring impact are evolving and they're only just getting better," Pollack says. "We ask, 'What are the standards to which to hold an office building or an apartment building? What sorts of improvements can be made? What are the costs?' These things are becoming more transparent and integral to how people invest in real estate."

For Pollack and Blackstone, it's not just a question of doing the right thing because it is green. "It is fundamentally impacting the value of the real estate, the demand tenants have to be there, the demand lenders have to lend on it and investors have to capitalize on it. We're trying to do things to further impact what we can as a lender – we don't own the real estate, but it is an important part of how we underwrite how we do things," Pollack says.

The firm works with its borrowers to communicate the message about what it is trying to do with the asset class. This includes a major focus on the use of renewable energy, Pollack adds.

Diversity of the team's staff is also important. Firmwide, 49 percent of Blackstone's 2021 US analyst class is racially diverse. Additionally, Katie Keenan, the CEO of BXMT, leads a diverse board for the company.

"We are also very much focused on diversity, within our firm as well as with our business partners. Blackstone's targets on board diversity for our portfolio companies on the equity side, as well as our programs designed to create career opportunities with communities, are initiatives we share with our counterparties. We've made progress, but we know we have a lot of work still to do," Pollack says.

Bigger picture, there is great awareness at the firm of both the here and now, as well as the future.

"As a lender we're trying to introduce our borrowers to the different things we're doing and help them think about those opportunities for the real estate they own," Pollack says.

Miami momentum

The city's growth is paving the way for new lending opportunities, Randy Plavajka writes

The burgeoning popularity of the southern Florida region as a choice location for employers and their workers is creating new lending opportunities beyond the hospitality fixtures typical to Miami and its surrounding neighborhoods.

What was once a vacation hotspot deriving a significant portion of its economic value from tourism is now a top-tier metropolitan area that is nearing or at parity with other US gateway cities. For Miami especially, the increased pace in relocations has provided stability – and rapidly rising rents – in a locale that historically has seen more volatility as market cycles waxed and waned.

Miami's newfound steadiness has accelerated the region's growth story and subsequently attracted more banks, brokers, debt funds and alternative lenders to try to capture office, multifamily and industrial deals in the area.

Amy Julian, senior vice president in the debt and structured finance division of CBRE's capital markets group, says that, despite volatility and uncertainty across US lending markets today, fundamentals remain strong in southern Florida and Miami, with vacancy tight across asset classes, and rent growth occurring across the spectrum.

"Multifamily and industrial are strong in most major submarkets throughout the country, but I think office is difficult in a lot of markets," Julian says. "But there's somewhat of a safe haven in South Florida, and when you're going to lend or invest in office, why not choose a place where the fundamentals are tightening, people are working, people are in their offices."

A smoother cycle

Justin Oates, senior vice president responsible for overseeing Cain International's Miami portfolio, says the region has historically been a cyclical place and more speculative in nature.

"But what we saw differently in this cycle is the newfound density of options and infrastructure – mostly social infrastructure – which really make Miami a desirable place to live, with countless dining, fitness and entertainment options," says Oates. "This increased density and variety of options, enhancing the social infrastructure, have made Miami a desirable place for people to move their families, their businesses."

Cain is one of many commercial real estate debt managers that have established and subsequently expanded a lending presence in the greater Miami area in recent years. The New York-based investment firm entered the area in 2016 and currently holds five assets in Miami, including 830 Brickell, a 54-story tower comprising 600,000 square feet of Class A office space atop ground floor luxury retail.

Matthew Rosenfeld, senior vice president and head of US debt at Cain, says the firm saw a disconnect with the product being offered up during the 2016 foray into southern Florida where condominiums and multifamily were great but there was a vacuum among office assets. "The only amenity in an office building in Miami at the time was the ATM in the lobby," he says.

There are certain neighborhoods within the city that are also seeing interest from tenants rise. "Neighborhoods growth as seen in Brickell, Design District, Midtown and Wynwood are why we find Miami to be a compelling market long term," Oates says. "If you look back 10-15 years, Miami was a leisure destination. It was perceived as a place to visit, not necessarily to work and live, but since the early- to mid-2000s – before the global financial crisis – there's just been a ton of development and density in mainland Miami, away from the beach and typical tourism destinations."

Monte Greenberg, a senior member of Colliers' debt and equity services group, says Wynwood especially has experienced accelerated growth as a result of successful rezoning measures driven by property owners in the area.

Greenberg cites The Gateway, a 12-story high-rise in Wynwood, as the

first office to find success in the neighborhood and expects Wynwood25 – a creative-geared apartment asset – alongside other multifamily developments to follow suit as they come online.

The increase in high-grade office tenants and headquartered employers in Miami has also been a boon for the greater metro area. Spotify, PwC and New York-based hedge fund Schonfeld represent a fraction of the businesses that have increased their personal office leasing in southern Florida, as an example.

Larbi Benslimane, managing director of US real estate credit at Leste Group, says the Miami-based alternative investment manager has seen the new entrant inflow become more diverse, which in turn gives more stability to the residential market.

Recent lending activity in southern Florida features financiers such as Square Mile Capital, 3650 REIT and Churchill Real Estate, which all issued loans at or above $100 million between June and July 2022.

US commercial real estate bank stalwarts such as JPMorgan and Wells Fargo remain active in the locale, too. In May this year, the duo of lenders issued a $1 billion two-year, interest-only floating rate loan with a 2.6 interest rate to the Taubman Group for the revitalization of Miami's Dolphin Mall, according to Traded, a real estate transactions data provider.

Toby Cobb, co-founder and managing partner of New York-based 3650 REIT, says his firm has tracked strong rent growth in the Florida market among other parts of the US South, such as Texas and the Tennessee Valley. He notes, however, it would be naive for market participants to expect this kind of growth to continue.

Supply challenges

Miami is not immune to constraints on the supply of office or multifamily asset availability akin to the rest of the US. The broader region is affected by interest rate hikes and inflation similarly to other Sunbelt metro areas.

"This rate environment gives us less visibility on exits, and cap rates are starting to move up a little bit, but not a lot on the multifamily side," Benslimane says. "We are less active on large multifamily projects, but we've been pretty active investing in value-add office projects."

Multifamily specifically is tough to navigate as a lender, and Benslimane notes there has not been enough supply of apartments despite the new construction taking place. "When you're looking at financing new acquisitions, it's hard today – especially in this rate environment – to make sense of a sponsor's business plans when they're eyeing an exit two or three years from now at a sub-4 percent cap rate," he says.

Benslimane says Leste is bullish on the southern Florida market as a whole, but is watchful of the new office, multifamily and condominium supply coming online. "It may be a little difficult getting that kind of visibility, and especially considering a lot of sponsors are underwriting rental rates or sales prices that are higher than today's market."

Shannon Rex, executive managing director of Colliers' debt and equity finance group in southern Florida, says that, while rates have increased and created some pause, they are still historically low and there is room for great deals still among the increased waves of competition. "It's not necessarily a straight line," he says. "We look at past performance and how well things are performing in the market in general, as well as the property specifically and base underwriting off that."

Rex says the southern Florida market has matured over the last decade and become more service-oriented. He notes hedge funds, private equity managers and traditional asset managers have all set up shop in the area in some form, whether it is Carl Icahn's relocation to Miami or Goldman Sachs' new local base in Palm Beach.

While high-grade tenets do not beget immunity to market volatility, having a more sustainable economic base does provide some additional stability when evaluating the lending viability of Miami and southern Florida generally. As of May, unemployment figures across Broward, Miami-Dade and Palm Beach counties all clocked in nearly a full percentage point below the national average of 3.4 percent, according to the US Bureau of Labor Statistics.

47%

Increase in leasing activity seen in Florida's office sector in the first quarter of 2022

64%

Class A office tenants' share of all leasing activity in the state in Q1

17%

Increase in rents for Class A office space in Florida over the past two years

Source: Cushman & Wakefield

Change of space

Randy Plavajka explores how conversions are spurring life sciences lending momentum

Sustained demand for life sciences assets in a limited supply market is driving lending opportunities toward converting properties in major research hubs, including San Diego, San Francisco and Boston.

New research and lab creation, which was increasing prior to the covid-19 pandemic, has accelerated due to user demand and interest from lenders and investors trying to fill what is seen as a substantial supply-demand gap. CBRE data shows a record 31 million square feet of life sciences assets were under development as of 2021's end, including ground-up projects and conversion initiatives.

Meanwhile, Cushman & Wakefield data shows funding in the life sciences sector has been steady alongside the development pace. The Chicago-based real estate manager's first quarter update noted National Institutes of Health funding clocked in at $33.5 billion in 2021 and outpaced pre-pandemic levels by 7.8 percent. According to Cushman's first quarter North American life sciences sector update, private equity funding exceeded $44 billion in 2021 and contributed more than half of the $86 billion invested into life sciences companies from March 2020 onward.

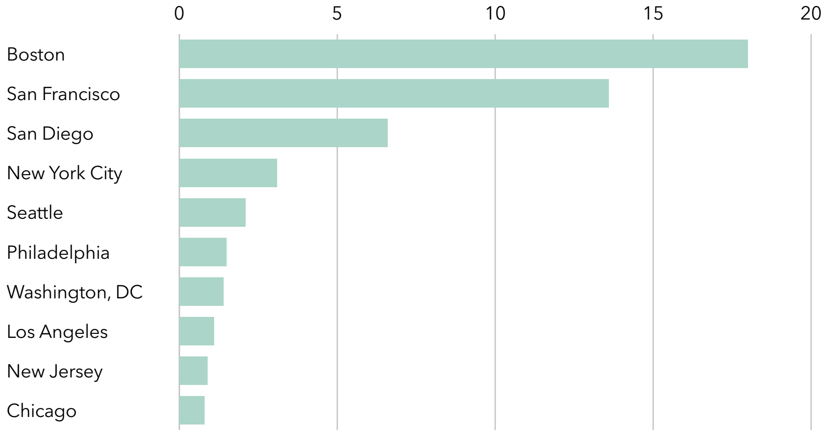
Akbar Tajani, managing director of real estate at Barings, says the Charlotte-based investment management arm of MassMutual is looking toward STEM markets in particular because of their anticipated growth from tenant, employer and employee composition in such locales.

"You do not want to be an outlier in the middle of nowhere in your own space," Tajani says. "You want to be around a lot of life sciences companies."

Widening portfolios

With pre-built stock limited in major STEM markets, Barings and its peers have focused more on dormant office assets to widen their portfolios in the sector. "I think the momentum of conversions that we have experienced so far continues," Tajani says. "But there is a finite amount of buildings you can convert, and at some point, the rents and the preferences are such that many big tenants will want to get newer, purpose-built buildings. I do see a greater push for new life sciences assets that are purpose-built, modern and have all the characteristics we are talking about, especially as many of these companies mature and go from Series A to B to C of funding."

Top 10 life sciences markets by VC investments, Q1 2022 ($bn)



Source: Cushman & Wakefield

In April this year, Barings landed a new lending deal in San Diego to acquire and convert Sorrento Ridge Research Park through a venture with Sterling Bay and Harrison Street Real Estate Capital.

"We look for the same leading indicators that we have looked for since we started investing in the space," says Tajani, referring to "public and private research funding, where the universities are that are actually investing in research and spinning out start-ups; and then related to that is the PhDs and where the educated, skilled labor force is; and then the depth of the private and public companies that are there alongside that particular market's growth rate."

Brad Tisdahl, a managing principal at New York consultancy Tenant Risk Assessment, says there is more to the conversion deals than what appears to be on the surface for lenders.

"The Fed is already increasing rates and selling off their bond portfolio, two factors that could both have an impact on the cap rates in many commercial real estate asset classes," says Tisdahl. "And as we know, there has been a lot of discussion around recession and there has been a lot of discussion around inflation. But I am less interested in that and more interested in what the fundamentals of the economy are right now and what is driving it, because that is going to have an impact on different components of commercial real estate."

Tisdahl says the rush to satiate demand in the life sciences sector cannot overlook the tenant composition across the industry. "You are not always going to see a Merck or a Pfizer in that space – you are sometimes going to find a start-up that has raised quite a bit of money but [which] has risks associated with, for example, raising additional capital to fund research and development or getting approval from the Food and Drug Administration for a treatment."

Converting office assets is not an insignificant feat to tackle in terms of building costs as well, whether the end-goal is to create a modern life sciences space or even market-rate multifamily apartments. Tisdahl says a build out could be as much as $250 per square foot in some cases, double the cost of a traditional office build out. "That can be more of an outsize risk for lenders that are financing the conversion of these properties," he says.

No dent in activity

Despite some of those initial hurdles, life sciences development has not lost momentum through the pandemic, according to a June report by CBRE. Projects under construction in the top 12 US life sciences markets ticked upward 44 percent in 2021, ground-up development increased by 42 percent and lab conversions jumped 49 percent.

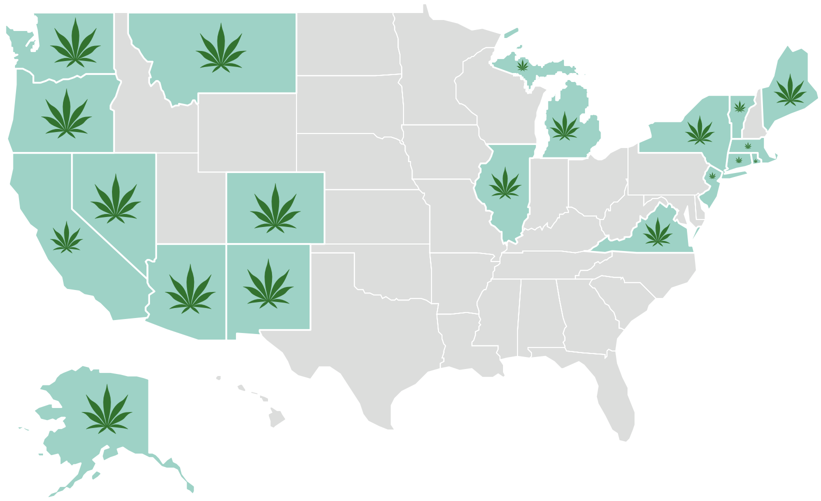
Nick Jann, senior analyst at Dallas-based CBRE, says the gap between supply and demand is prodding building owners to convert existing office space into lab space despite the upfront capital required. "Owners view these renovations as a down payment on a future of greater rents and higher occupancy over time," he says.

Those renovations can consist of system improvements to get air and power capabilities up to par, upgraded loading and unloading capabilities, and accommodating the movement of scientific equipment and materials.

Cushman & Wakefield data shows San Diego has been one of the most active cities for life sciences conversions recently, alongside Raleigh, Durham, Boston and Philadelphia as of the first quarter this year. More than six million square feet of lab space has been added in San Diego since 2015 and another 3.25 million square feet is currently under construction according to May data from CBRE. There is 6.5 million square feet of planned conversions and construction planned for the city in the next two to three years as well.

> *"There is a finite amount of buildings you can convert, and at some point, the rents and the preferences are such that many big tenants will want to get newer, purpose-built buildings"*
>
> **AKBAR TAJANI**
> **Mass Mutual**

US states that have legalized cannabis



Source: National Conference of State Legislators

Five things to know about underwriting cannabis-related real estate loans

This emerging niche presents unique risks and opportunities for intrepid lenders, William Johnson writes

A small group of commercial real estate lenders see room to increase their origination of commercial real estate loans secured by cannabis-related properties such as dispensaries, manufacturing plants or growing facilities. And the trend is expected to accelerate, as more US states write into law legislation allowing for the sale of cannabis from licensed retailers, market participants tell *Real Estate Capital USA*.

But there's one thing all potential entrants into this market need to understand: the risks are different than almost anything in traditional commercial real estate lending. Here are five things lenders need to consider when underwriting mortgages, credit facilities or other financing tools.

1 Hazy regulatory environment

Over the past 10 years, 19 states and the District of Columbia have put into place laws that legalize the retail purchase of cannabis for individuals who are at least 21 years old. These laws vary wildly from state to state, causing confusion – and opportunity – for potential market entrants. A key area of uncertainty is whether a state is a so-called 'limited license' state, where there is a cap on the number of dispensaries, or if its guidelines are looser.

"We have lobbyists, we have feet on the ground in all the states in which we lend," says Len Tannenbaum, CEO of Advanced Flower Capital, a mortgage real estate investment trust (REIT) specializing in real estate loans secured by cannabis real estate. The firm is active in the 15 limited license states, where it believes it can be safer to be a lender because there is a cap on competition.

States with looser regulations, such as California, tend to have a glut of competition, which can lead to supply and demand imbalances. "You'll see some bankruptcies and liquidations in those markets because there is a big oversupply," Tannenbaum adds.

2 Structuring loans

There are several ways lenders can originate cannabis-related real estate loans, including origination loans collateralized by land or making loans directly to companies. So far, much of the capital being directed toward cannabis-related real estate has come from private investors, according to John Mazarakis, co-founder and chairman of Chicago Atlantic Real Estate Finance, a commercial mortgage REIT focused on lending primarily to state-licensed cannabis operators.

The Chicago-based lender was recently able to upsize its credit facility from \$45 million to \$65 million, with a cost of capital of about 5 percent. "We're lending to the cannabis space, with real estate as collateral, and our debt to real estate is under 60 percent loan-to-value. We are trying to stay within conservative, advanced rates, with respect to real estate values," Mazarakis says.

3 On the sidelines

As the legal cannabis industry expands, big banks and other large lenders have started to look more closely at the potential. Yet, there are still too many questions around state laws and licensing, and the lack of a federal framework, for banks to get comfortable.

"Banks want to lend in this market because it's real estate-secured," Tannenbaum says. He notes that these loans also offer richer yields than more mainstream assets. But there are risks associated with a failing business that are different to those in a traditional commercial real estate property.

Banks and other lenders may have asset managers that can operate a multifamily property, for example, but likely do not have the expertise in overseeing a dispensary or farming operation.

"If a property goes into foreclosure, the bank will own an asset that produces marijuana, with the equipment to do so, and yet the bank cannot [utilize that facility for production]," Tannenbaum says.

Anthony Zeoli, partner at law firm Freeborn & Peters, brings up a further concern: "All the laws we have that exist for contracts or loans are not easily tailored to situations involving cannabis."

Mortgage REITs, which have emerged as a primary source of capital for this market, are not constrained by the same regulations. "REITs are sitting in a very good position relative to banks and traditional lenders because they are not subject to the tough monitoring environments the banks are subjected to," explains Joseph Cioffi, partner at law firm Davis+Gilbert.

Additionally, dispensaries that are engaged in the cannabis industry are not allowed to deduct typical business expenses associated with their activities when filing taxes, according to the Internal Revenue Service 280E Tax Code. "Cannabis companies are prohibited from deducting operating expenses," Cioffi adds.

4 Inflation angle

Managing a cannabis company is very different than managing a traditional commercial real estate asset, in part because cultivation and storage is highly specialized, expensive and fraught with risks.

Additionally, the sector is feeling the impact of record inflation on everything from raw agricultural materials to high-end air filtration systems – these factors are making new properties more difficult to underwrite than existing assets. Finally, there is a disconnect between headline inflation risk and the inflation these operators are seeing.

"The headline inflation is eight percent. But, if you're in the construction world, it's up 25 to 30 percent, if not more," Tannenbaum says. "This means the value of your existing real estate is worth a lot more today than new construction, which is just going to be 30 percent to 50 percent more."

> *"For me, there is a unique problem-solving aspect to it"*
>
> **ANTHONY ZEOLI**
> **Freeborn & Peters**

This economic turbulence could narrow the cannabis real estate playing field sooner rather than later. "Now that we have higher interest rates and inflation driving up costs more, I think you are going to see some liquidations and consolidation at a much faster clip," Tannenbaum says.

5 No uniformity

While the trend toward cannabis legalization is growing quickly, industry experts do not expect federal legalization and regulation anytime soon. The Safe Banking Act, a law meant to protect cannabis lenders from federal prosecution, has languished in the US Senate for years, despite being passed in the House of Representatives multiple times – most recently in May.

"Other than the Safe Banking Act, I don't see anything on the horizon federally," Zeoli says.

What's next?

For many of the market participants active in this sector, the innovation and uncertainty – and return potential – is part of the appeal. "There is a unique problem-solving aspect to it and that's why I enjoy it," Zeoli says. According to Chicago Atlantic Real Estate Finance, a large portion of the US population has accepted cannabis and, says the firm, 67 percent want some form of reform. But finding the silver bullet that will make everyone happy does not come easily, Mazarakis explains.

"That is why we've been in this limbo state for a couple of years. Cannabis is still a schedule one substance, which technically ranks federally higher on the illegal scale than cocaine," Mazarakis notes. "There's a general acceptance for what we do as being somewhat uncorrelated or counter-cyclical, but the data is somewhat limited. We always expected to have a negative beta. So, we're very excited about that." ■

Benchmarking impact

Samantha Rowan explores how lenders and borrowers are accounting for ESG

Commercial real estate lenders and borrowers are looking at ways to benchmark their loans and investments as institutional investor interest in and regulatory guidelines around green and sustainable strategies move up the industry's agenda.

The Securities and Exchange Commission in March published proposed governance that would compel public companies to report climate-related risks stemming from their businesses, while a joint venture between the National Council of Real Estate Investment Fiduciaries and the Pension Real Estate Association this month published a list of the key ESG performance metrics for the private real estate industry, according to affiliate title *PERE*.

Meanwhile, CBRE's *2021 Global Investor Intentions Survey*, released earlier this year, found that 60 percent of respondents said they'd already implemented ESG criteria into their investment strategies. The report also projected greater regulatory pressure to enhance sustainability in the US, the UK, Europe and parts of the Asia-Pacific region, including tightening codes around green buildings, using more sustainable materials, and reducing carbon outputs.

Fannie Mae and Freddie Mac were pioneers in the US green lending space, offering borrowers incentives for meeting specific KPIs around factors that included energy usage.

"We saw an opportunity to become innovative and bring that into our discussion with our clients, who are already interested in it," says Jeffrey Schwartz, a director at New York-based ING Real Estate Finance. "Our private equity fund clients have investors pushing them to acquire a property that is green or to take it to the next level. We've structured loans with green incentives where the borrower is committing to go out and achieve a green building certification under LEED or the National Green Building Standard."

Opportunity knocks

Investments in opportunity zones have the potential to check a number of these boxes for borrowers and lenders, according to Reid Thomas, a managing director at San Jose, California-based JTC Americas. The specialty fund administrator believes its practice in the OZ sector is helping lenders and investors to benchmark their investments and track where the money is going.

"Opportunity zones were invented to help communities in need, and we believe they could be transformative, but this kind of transformation will take decades to achieve. We want to get everyone focused on the bigger picture related to these investments and if they are doing what they're supposed to be doing for investor motivations and other factors," Thomas says. "To try to tie opportunity zones closer to impact investing and ESG, which is a global phenomenon, is a really important thing; they are 100 percent aligned."

Interestingly, there is not always a great understanding of the connection between opportunity zones and impact investing. JTC completed a survey of 145 investors, developers, brokers, fund managers, bankers, advisers and other relevant participants from December 2021 to February 2022 and found that, while four out of five respondents viewed OZ investing in a favorable way, only about half said they understood the relationship between opportunity zones and impact investing, Thomas says.

Lenders should be aware of the opportunity zone initiative because the vast majority of these projects will have associated lending opportunities, Thomas says. "Within the OZ space, lenders will be able to identify opportunities that meet the target of virtually all focus areas in terms of asset class, term, risk profile, size, geography, borrower and credit level. Lenders are also able to receive [Community Reinvestment Act] credits for loans in these sectors," he adds.

The firm does the financial accounting for OZ investors, extending it to account for the impact of these projects, and Thomas believes it is possible to quantify and report these statistics.

"We know how much money is being spent and what it is being spent on, what the labor income in the community is going to be – there are things you can derive using normal economic tools to figure that out," Thomas says. "It doesn't have to be a massive burden to do this kind of reporting and tracking if you set it up right at the beginning.

"Our company started with the idea that there are well-intended investment opportunities that get set up and then fail. We approach the market with the standpoint of: can we develop technology to really track the investment monies to make sure there is no fraud, abuse or other issues?"

> *"Lenders who claim to be enabling positive ESG outcomes are likely to face increased reporting and compliance mandates going forward"*
>
> **REID THOMAS**
> **JTC Americas**

Looking ahead

At this point, there is not yet software available that does standardized reporting on ESG or impact reporting. But this could be coming. JTC America's approach includes using businessman and philanthropist Howard Buffett's impact rate of return to break down disparate projects and investments, and comes up with common, understandable scores. Thomas believes this ability to accurately report on ESG metrics will become more important in the coming years.

"Regulators are increasingly concerned about greenwashing. Lenders who claim to be enabling positive ESG outcomes are likely to face increased reporting and compliance mandates going forward," Thomas says. "The OZ Transparency, Extension and Improvement Act calls for the OZ fund managers to monitor and track the impact of the investments, which helps remove the burden solely from the lender. Fund managers need to tell their story and the investors want to ask questions or get information about what they really care about. You always have to have the ability to have this customized – it can't be automated."

Warehouse dislocation

Market volatility is causing disruption in the warehouse lending market, reports Anna-Marie Beal

Rising interest rates, mismatched pricing and market volatility are all causing dislocations to emerge across the real estate debt space – and commercial real estate lenders that use warehouse lines of credit are the latest capital source to feel the impact from these changes.

Dan Lisser, a senior managing director at New York-based advisory Marcus & Millichap, tells *Real Estate Capital USA* it is now more difficult for a lender that relies on a warehouse line to originate loans than it was three or four months ago.

"The whole securitized market – CMBS, conduit, single-asset single borrower, and the CLO market, which is primarily the market that we're talking about – has seen a slowdown," Lisser says.

Warehouse lines function as a credit line for debt funds and other alternative lenders and are typically provided by banks and insurance companies. In a less volatile environment, warehouse lines – a short-term destination for loans slated for securitization or sale in the secondaries market – would have an advance rate of around 75 percent.

But the current volatility means warehouse lenders are offering a lower advance rate – the amount of the value of the collateral the warehouse lender is willing to take on as a loan – and raising pricing.

"Certainly, in this era of volatility, as pricing and rates have increased across the board, [warehouse lenders'] costs to fund have increased," Lisser says. "So even if you keep your credit margin the same, your base rate has increased. And due to the volatility, the advance rate [of what used to be] 75 to 80 percent might look more like 65 to 70 percent."

"In this environment, their exit or their perceived ability of the borrower to execute on the business plan [is in some doubt], and they're taking a second look at that"

DAN LISSER
Marcus & Millichap

These factors have resulted in a lot of uncertainty, with much of the impact being felt by debt funds, adds Jacqueline Meagher, director of capital markets in advisory JLL's Boston office. "In the fourth quarter 2021, we were doing more debt fund deals than ever before – they were very competitive – but they were also more directly impacted by some of the changes in the market than a regional bank, which can hold a loan on their balance sheet and has a different process for what their cost of funds are."

Broken bridges

Many bridge lenders are unable to originate because their warehouse lines are full. "They're unable to monetize the loans because selling them in the market [means] they will take a loss," Lisser says.

There is a difference in the market between bridge lenders who are not dependent on the warehouse line, or are still able to lend, versus ones who are somewhat constrained due to the limited capital.

"In this environment, their exit or their perceived ability of the borrower to execute on the business plan [is in

some doubt], and they're taking a second look at that," Lisser adds.

Since the start of the year, the yield on the benchmark 10-year Treasury has seen significant movement, jumping from around 1.75 percent at the start of 2022 to a level of just below 3 percent as *Real Estate Capital USA* was going to press. In addition to the volatility this has caused for debt funds and lenders using warehouse lines, it has also caused consternation among borrowers seeking to finance acquisitions, refinance existing debt, or lock in long-term rates.

JLL's Meagher notes that while things have been a bit more stable in recent weeks, it has been difficult for borrowers to predict where pricing will be.

"I'm not sure we've seen complete stabilization, but we are seeing more investors are getting comfortable with the volatility," Meagher says. "There is a sense that the 2.5 percent rates investors were seeing a year ago just aren't there anymore. They're underwriting these new rates and there was a little bit of a sticker shock 60 days ago – you used to be able to get 3 percent on every deal. Now 4.5 percent feels like the new 3 percent."

How long the situation will stay like this is not certain, but the consensus among market professionals is that after the Federal Reserve's 75-basis point rate hike in June, there are strong signs of a similar rate hike in July and the potential for another 50-basis point increase in September.

"The best we can do is supply our clients with our data and look at the forward curve," Meagher says. "One thing to note is that when you're looking at the 10-year Treasury, rate hikes have already been priced in by lenders. It's not like we're going to see another rate hike and the 10-year will go up another 50 basis points – that is being priced into the longer end of the curve. Whereas in the shorter end of the curve, we will continue to see continued movement upward."

Future forecast

JLL has been talking with lenders about what the coming weeks will bring, with Meagher noting there is still uncertainty over where loans should be priced.

"There was a period where investors were trying to figure out where their rates were going to be and what they should be underwriting, but lenders were trying to figure out the same thing," Meagher says. "In Boston, where we have a strong regional banking community, they don't tend to react as quickly as the big money center banks do – if there was a bank with a strong client and a strong deal, they'd be aggressive. But there was a period where you'd see a wide range on a quote matrix on where quotes were coming in and that seems to have leveled out and lenders are all back in the same range."

While the current picture might be bleak, the future is looking brighter. "In the short-term, there's going to be a lot of wait-and-see going on in the market, then they will come back," Lisser says. "We're just in a higher rate environment after the 10-year was below 1 or 2 percent for a long, long period of time – it has doubled in almost six months."

Against the herd: How lenders and debt investors are thinking differently

The commercial real estate debt and equity markets have seen a crush of activity in the industrial and multifamily sectors, Anna-Marie Beal writes

Investment activity within the commercial real estate debt and equity markets has been on a swift current in recent years, with the bigger players driving market flows toward a few key sectors.

Amid a record year of deal activity in 2021, a year-end report from Real Capital Analytics underscored where the most capital was flowing: the apartment sector. Indeed, the New York-based analytics provider tracked about $808 billion in deal volume, 41 percent of which was focused on the multifamily sector. Industrial deals made up another $166 billion in volume, with office rounding out the top three sectors at $139.2 billion.

While this kind of herd mentality is not a new concept, investment flows into specific sectors like multifamily and industrial are having a significant impact, driving down cap rates and driving up pricing. There is also a lack of supply of properties.

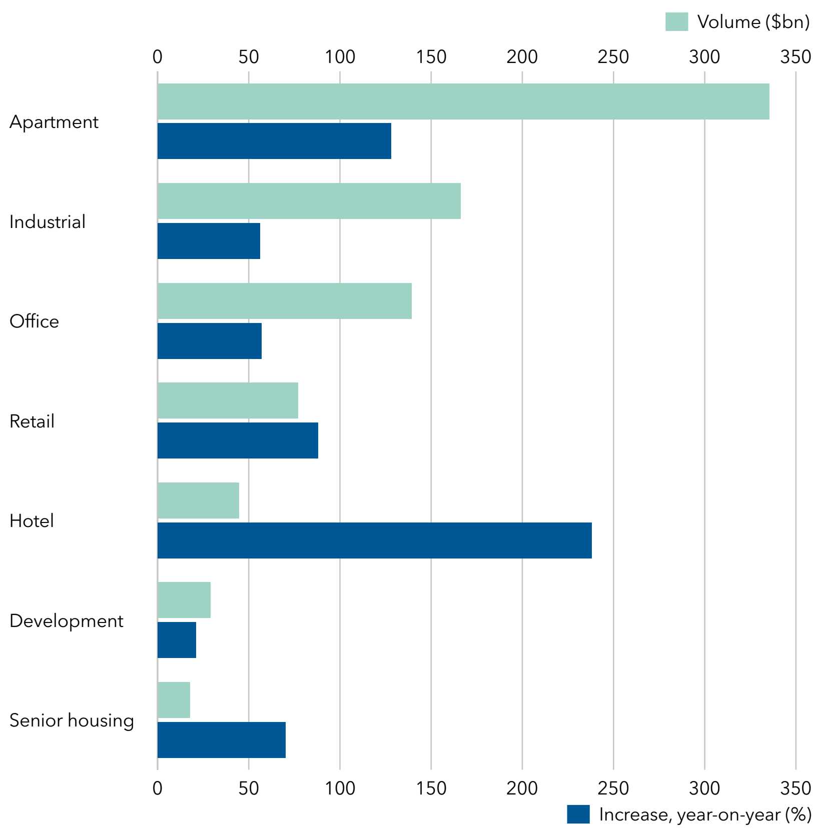
"The bottom line is you've got the leaders, and then you've got the followers," says Emanuel Grillo, a partner at global law firm Allen & Overy. "As much as you want to follow the herds, what's interesting about the [bigger firms] is that they have so much money they need to do really big deals. But this has led to a dispersion of the market such that there aren't as many [opportunities for] big deals."

In multifamily, heightened appetite can be attributed to the broader supply/demand dynamics for housing, which are real and generational, says Brian Ward, chief executive of Seattle-based real estate investment company Broadmark Realty Capital.

$808bn

Total US CRE deal volume in 2021, according to Real Capital Analytics

2021 US transaction volumes and year-on-year growth, by sector



Source: Real Capital Analytics

"The overemphasis [on these asset classes] has been going on for a while – they have been the darling asset classes," Ward adds. "[For that reason], certain markets are overinvested, and yields have compressed to a level that will not be deriving adequate returns in relation to risk."

The covid-19 pandemic has led lenders and borrowers to think outside of their typical markets, chasing migration to new urban areas.

"You have so many different urban areas with so many different types of appeal for investors," Ward explains. "And so that kind of explosion where you had migrations out of the larger urban areas… That creates value and opportunity on the real estate side."

This dispersion of the market will affect where investment goes. "It is harder for the [largest managers] to deploy as much capital as quickly as they have done historically because they're chasing smaller deals with smaller teams to find opportunities to invest that several years ago would have been off the beaten path," Ward says.

Outside the herd

Stephen Stein, managing partner at Los Angeles-based Tauro Capital Advisors, thinks that the commercial real estate lender's focus on the mid-market allows it to feel less pressure from what the bigger institutional groups are doing. One example where Tauro has found value is ghost kitchens, which prepare and deliver food but have no physical restaurant or dining space.

"We probably have the most active intermediary in the ghost kitchens," Stein says. "When we are all sitting at home, ordering from a restaurant, there is a good chance that the delivery company picked your food up from some industrial building. And the food delivery business has been really picking up, covid or no covid."

There can be more creativity in the mid-market, Stein says. "There is going to be some sort of herd mentality, of course, but I think there is, generally speaking, more acceptance of other ideas, with people always trying to figure out how to get ahead of the curve. The mid-market is perfect for that."

"The bottom line is you've got the leaders, and then you've got the followers"

EMANUEL GRILLO
Allen & Overy

41%

Multifamily's share of total US CRE deal volume in 2021

Where the herd is headed

Will Robson, global head of real estate applied solutions at New York-based research firm MSCI, believes there is a lot that goes into understanding where the herd is headed.

"Herding is an interesting topic. In private asset classes like real estate, the transparency of markets, the data availability and the ability to understand the asset class and get comfortable with it is a big factor in how much capital flows into that asset class," Robson says. "As the first moves going into a particular sector become more well-known as transactions happen, they get recorded, and then people can understand more about the asset class, such as how prices move."

Often, it is the opportunistic players that can take more risk and make that first move — helping assess and mitigate potential risks before smaller lenders and investors move in. "Then, as the bigger pools of capital getting invested in those [sectors] becomes more transparent, other operators can follow in afterwards," Robson adds.

Research from CW Capital's RealInsight proptech tool suggests data is driving the decisions of many participants within the real estate debt space, as lenders and borrowers require a more thorough understanding of specific nuances of the market.

"There is a real need to understand what the top private equity firms, investment banks and hedge funds lend on, and what's the makeup of their portfolio – and technology is just becoming more and more necessary," says Dan Linder, senior vice-president at RealInsight. "There's a lot of data out there that, if used properly, would absolutely help make decisions, and if you see things happen, that can help to drive what people should or shouldn't do." ■

Capital watch **Debt strategies abound in first half of 2022**

Commercial real estate debt-focused strategies gained significant traction in the first half of 2022, with 40 percent of the capital raised in the first half of the year allocated to the sector. That level is an increase from last year, when debt strategies made up about 20 percent of all capital raised and 14 percent in 2020.

The rise in activity was driven by a number of substantial fundraises from managers that include Bridge Investment Group, Kayne Anderson Capital Advisors, Pretium Partners and Berkshire Residential Investments. All told, the managers raised $9.8 billion for debt strategies in the first half of the year.

The largest fund closed in the first half of the year was Bridge's fourth iteration of its debt strategy, Bridge Debt Strategies Fund IV. The Salt Lake City-based firm managed closed the fund with $2.9 billion of equity commitments and an investment strategy that will focus on originating first mortgages, investing in Freddie Mac K-Series B-pieces and other commercial real estate backed debt, including commercial real estate CLOs. The firm closed the fund about two-and-a-half years after its predecessor, the $1.6 billion Debt Strategies III.

Other funds raised included Madison Realty Capital's Madison Realty Capital Debt Fund V, which raised $2.08 billion and Kayne Anderson Real Estate Fund IV, a $1.88 billion offering from Kayne Anderson Capital Advisors.

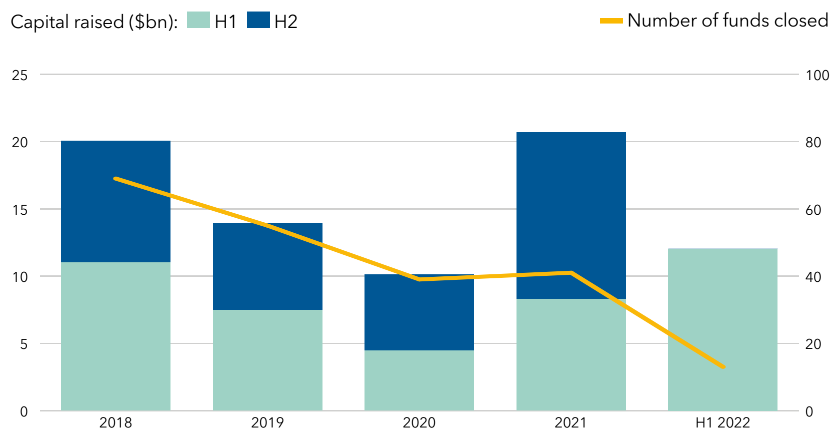
$9.8bn

Capital raised for debt-focused funds in the first half of 2022

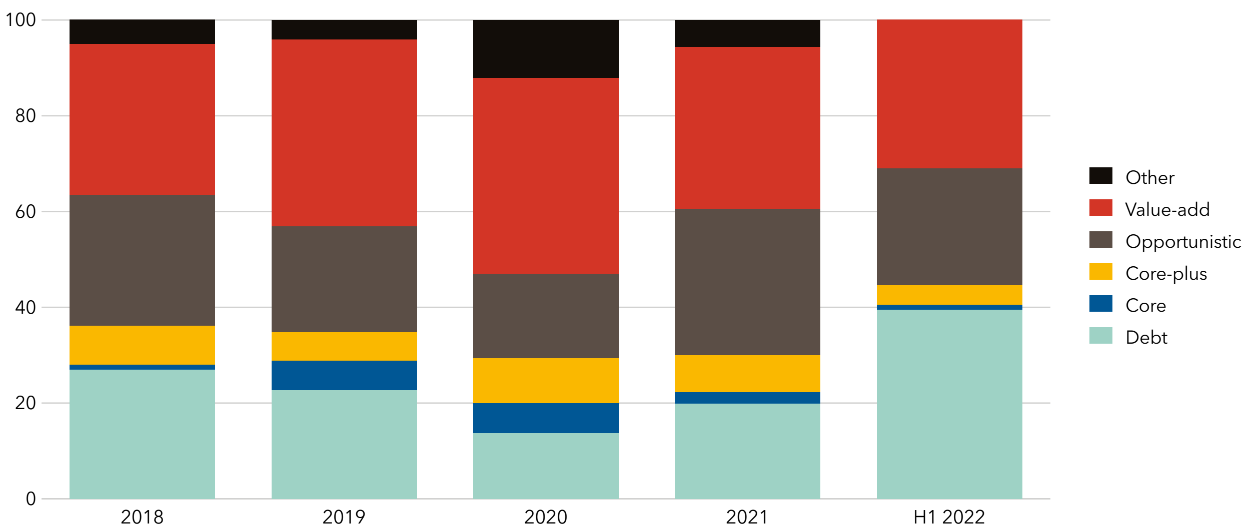
$2.9bn

Capital raised for Bridge Investment Group's latest debt fund, closed in June

Capital raised by US real estate debt funds, 2018-H1 2022



North American real estate fundraising by strategy, 2018-H1 2022 (%)



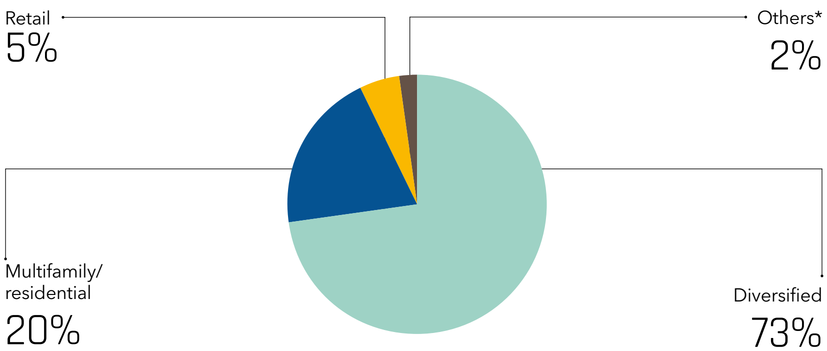
Top five North America-focused private real estate debt funds closed in H1 2022

Fund	Manager	Target ($bn)	Current size ($bn)	Sector
Bridge Debt Strategies Fund IV	Bridge Investment Group	3.00	2.90	Diversified, multifamily/residential, office
Madison Realty Capital Debt Fund V	Madison Realty Capital	1.75	2.08	Diversified
Kayne Anderson Real Estate Debt IV	Kayne Anderson Capital Advisors	1.50	1.88	Industrial, multifamily, residential, office, student housing
Pretium Residential Credit Fund II	Pretium Partners	1.50	1.70	Multifamily/residential
Berkshire Bridge Loan Investors II-A	Berkshire Residential Investments	1.00	1.25	Multifamily/residential

Top 10 North America-focused private real estate debt funds in market as of July 1, 2022

Fund	Manager	Target ($bn)	Current size ($bn)	Sector
Cerberus Real Estate Debt Fund II	Cerberus Capital Management	4.00	0.35	Diversified
AllianceBernstein Commercial Real Estate Debt Fund IV	AllianceBernstein	2.00	0.90	Industrial, multifamily/residential, office
HGI Multifamily Credit Fund	Harbor Group International	1.80	0.24	Multifamily/residential
VWH Partners III	VWH Capital	1.50	0.23	Diversified
Marathon Secured Private Strategies Fund III	Marathon Asset Management	1.25	0.85	Diversified, hospitality, industrial, multifamily/residential, office, retail
Sabal Strategic Opportunities Fund	Sabal Capital Partners	1.00	0.46	Retail
Mesa West Real Estate Income Fund V	Mesa West Capital	1.00	0.87	Hospitality, industrial, multifamily, residential, office, retail
BIG Real Estate Fund II	Basis Investment Group	0.55	0.40	Industrial, office, retail
Pearlmark Mezzanine Realty Partners V	Pearlmark	0.50	0.14	Diversified
Medalist Partners Asset-Based Opportunity Fund III	Medalist Partners	0.50	0.00	Multifamily/residential

Capital targeted by North America-focused private real estate debt funds in market as of July 1, by sector



*Includes hospitality

Source for all data: Real Estate Capital USA. Figures are rounded.

40%

Debt strategies' share of total capital raised for private real estate in H1

$19.83bn

Capital targeted by North American-focused debt funds in market as of July 1

Lending US transactions recorded between June and July 2022

Lender	Borrower	Loan size ($m)	Asset(s)	Debt adviser	Other detail
July					
NewPoint Real Estate Capital	Ascent Westminster	69.0	Ascent, a 255-unit apartment property in Westminster, Colorado	Carlton Group	The sponsor was able to lock in the HUD loan once the 2019 vintage property was stabilized. The property is close to Denver and Boulder
Fortress Investment Group	Forest Development	269.0	Nautilus 220, a planned condo development in Florida	Concord Summit Capital	The proposed property is located in Lake Park, Florida
Northwind Group	SHVO	162.4	The Mandarin Oriental Residences in New York	Walker & Dunlop	The loan will be used to refinance existing debt and for any remaining construction costs that will allow the borrower to convert the former Gucci headquarters in New York
Churchill Real Estate	Omega Real Estate Management	100.0	The Gardens Residences, a 358-unit mid-rise apartment community in North Miami, Florida	Berkadia	The property is located at 1155 Northeast 126th Street, close to Biscayne Blvd
Thorofare Capital	Undisclosed borrower	48.0	A 246-unit luxury apartment building in Houston, Texas	Concord Summit Capital	The property is 92% leased
Knighthead Funding	Elmington Capital	29.0	A pair of class A office buildings in suburban Nashville	N/A	The 180,000-square-foot property is located at 455 Duke Drive in Franklin. Loan proceeds will be used for tenant improvements
Greystone	Chelsea Seniors I	11.6	Chelsea Senior Community, an age-restricted affordable housing community in Houston	N/A	The property is comprised of five mid-rise buildings
Allianz Real Estate	MetLife Investment Management	117.6	Intersect, a four-building creative office campus in Irvine, California	JLL	The property totals 452,975 square feet and is located less than three miles from John Wayne Airport
Deutsche Bank	Gatsby Florida	90.0	Divosta Towers, a pair of luxury office towers totaling 217,000 square feet in Palm Beach Gardens	Berkadia	The properties at 3825 and 3835 PGA Boulevard, Divosta Towers were completed in 2019 and 2020
Insurance company lender	Undisclosed private investor	68.9	Three-property retail portfolio in Costa Mesa and Fullerton, California	JLL	The properties are fully leased to tenants that include Rite Aid, Target and Ralph's
ACORE Capital	Tortoise Properties	88.5	740 and 840 North Dixie Highway, a pair of eight-story residential properties in West Palm Beach	N/A	The properties will be connected by a floor-to-ceiling glass skybridge
Natixis Corporate & Investment Banking	Rialto Capital Management	126.7	555 Aviation Boulevard in El Segundo, California	Cushman & Wakefield	Tishman Speyer sold the property for $205.5m after acquiring the building for $45m in July 2015
ACORE Capital	Western Wealth Capital	79.4	Villetta Apartments, an apartment complex in the Phoenix area	Berkadia	The property is located at 1840 West Emelita Avenue, close to Arizona State University
Stonehill	Churchwick	79.8	Extended stay hotel portfolio	N/A	The portfolio is comprised of 1,432 rooms
June					
Parkview Financial	EPT Holdings	22.5	2225 3rd Avenue North in Birmingham, Alabama	N/A	The five-story property has been shuttered since 1999 when it was vacated by the American Red Cross. It is now fully entitled to be transformed into Market Lofts on 3rd, which will consist of 192 small affordable apartments averaging 438 square feet, and one 4,000-square-foot retail unit with 60 parking spaces

Spotlight **3650 REIT originates $170m for novel Miami rental development**

3650 REIT has originated a $170 million loan to Newgard Development Group for a 44-story apartment tower in Miami with a unique twist: the property is geared toward short-term renters. Faisal Ashraf's Lotus Capital Partners arranged the financing, ***writes Samantha Rowan***.

The commercial real estate lender believes Miami is a hot spot for multifamily as the city has recently seen explosive population growth as companies and new residents flock to South Florida.

"Despite the national environment becoming more challenging for completing deals, the multifamily sector continues its growth, albeit at a slower clip than last year," Jonathan Roth, 3650 REIT co-founder and managing partner tells *Real Estate Capital USA*.

This is the lender's second lot of financing for the LOFTY Brickell property following a $60 million loan for the land acquisition late last year.

"We believe that the LOFTY Brickell project, with its prime location, walkability, best-in-class amenities and unique business plan, will offer residents unmatched flexibility and help accommodate the increased demand for housing as more people move to the area," adds Roth. "These factors will make the property a change winner following the transformative years of the pandemic."

The deal is a good fit for 3650 REIT, which targets financing well-located multifamily properties with sponsors that incorporate value-add business plans at unique locations.

"We believe that the property's unique business plan to accommodate short-term rental ownership will make it a change winner in the post-pandemic South Florida market as more residents seek flexibility and convenience in their living arrangements, and we expect to see sustained long-term demand for these types of units," says Roth.

PCCP	Pahlisch Commercial	50.8	SE Main Street in Milwaukie, Oregon	N/A	Financing for the ground-up construction of Henley Place, a 178-unit, six-story multifamily community
Undisclosed lender	ScanlanKemperBard	34.5	5900 Airport Way in Seattle, Washington	JLL Capital Markets	Financing for the Original Rainier Brewery, a four-building industrial/office/retail portfolio totaling 193,908 square feet in Seattle
PGIM Real Estate	LCOR, Madison International Realty	87.1	34 Valley Road in Montclair, New Jersey	JLL Capital Markets	Financing of Valley and Bloom, a two-building, 258-unit, mixed-use multi-housing community in Montclair. In addition to the residential units, the property also includes 19,812 square feet of office space, 19,921 square feet of retail space and an attached parking garage
Pelorus Equity Group	Juva Life	11.8	Stockton, California	N/A	Enables Juva to expand cannabis operations, further clinical research
PIMCO Commercial Real Estate Debt Fund II	Myers Apartment Group	65.0	Exchange at Holly Springs in suburban Raleigh, North Carolina	Berkadia	The 316-unit, Class A property, Exchange at Holly Springs, is 30 minutes southwest of Raleigh
Thorofare Capital	LTNG, Crown Acquisitions, and Forest Hills Real Estate Group	16.8	69-30 Austin Street in Forest Hills, New York	Ackman-Ziff	The borrowers will use the loan to acquire and renovate the 42,500-square-foot property
Blackstone Mortgage Trust	Columbia Property Trust	270.0	799 Broadway, a 12-story office building in New York	N/A	The REIT finished construction on the property in April
NewPoint Real Estate Capital	Rose Valley Capital	61.0	Weatherstone Flats, a suburban Philadelphia apartment property	Meridian Capital Group	The property is located in Chester Springs, Pennsylvania
JPMorgan Chase	OKO Group	754.0	The Crown Building at 730 Fifth Avenue, New York luxury hotel and condo property	Walker & Dunlop	The financing is structured as a bridge loan and condo inventory loan
Middlesex Savings Bank	Davis	39.1	38 Upton Drive at Upton Crossing, a Boston-area industrial/R&D building	JLL Capital Markets	The property will be delivered in January 2023

40 Worth Street

Worth its weight

When Jeff Gural's GFP Real Estate acquired 40 Worth Street in New York's Tribeca neighborhood in the 1980s, the submarket did not quite have the panache it has today. But a lot has changed over the years, including the profile of tenants that occupy the roughly 800,000-square-foot building, ***Samantha Rowan writes***.

The New York-based manager in July obtained a loan of roughly $191 million from Wells Fargo, TD Bank and BankUnited to build out a 200,000-square-foot space for The Legal Aid Society. The move illustrates how the building, which once had a tenant roster made up of mostly city agencies, now caters to non-profits, says Roy Lapidus, a senior managing director at GFP.

"Tribeca wasn't Tribeca in 1980," Lapidus says. "And at that time, the building was filled with city agencies and there was a concern around what would happen if these agencies left."

The concern proved prophetic, as the city in 2009 began to consolidate its agencies into its own buildings. And when the Department of Transportation moved out in the 2009-10 era, the building was at a crossroads.

"That was the impetus to upgrade the building," Lapidus says. "We started to ask, 'Do we convert it to a hotel? Or a residence?' But then we were able to get [clothing retailer] Gap to take the top six floors and were able to upgrade the building from head to toe. We restored the lobby to its original state and went back in time to give it an old-world feel."

As the building's tenant roster shifted, the Gural family began to work with its contacts in the non-profit world. Other tenants include Public Health Solutions, Legal Services NYC and Innocence Project, as well as smaller non-profits, Lapidus says.

40 WORTH STREET, GFPRE PHOTO

The Wells Fargo-led consortium provided a seven-year loan with fixed- and floating-rate components. About $35 million of the loan will be used to upgrade the Legal Aid space, with the remainder to refinance existing debt from Capital One. The initial funding totals about $155.7 million, with the remainder to be drawn over the next 18 to 24 months as GFP builds out the site.

The current lenders were able in part to secure the deal by offering a seven-year term with an expiration that coincides with the end of Gap's lease, adds Paul Talbot, a senior managing director at advisory firm Newmark, which arranged the loan.

The sponsor went out at the beginning of the year to secure the financing and was able to lock in prior to the Federal Reserve's move in June to increase interest rates by 75 basis points, Talbot adds. Despite the volatility in the market this time around – and also when GFP went out into the market in 2009 – there was interest from numerous lenders due to the property's performance and sponsorship.

"That was a very difficult time to go and find financing in 2009 but Capital One and TD stepped up, and the net income on the building kept exceeding projections over the next five years," Talbot adds, noting this stability was a draw for the current lender group. "The current loan offers the borrower much more flexibility around making decisions for the future of the building."

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