The Changing Landscape of Commercial Real Estate Finance

How M&A and new investment trends are changing the industry

GEMMA BURGESS
Manging Director
Ferguson Partners

FPL Ferguson Partners

The financial system continues to evolve after the 2008 financial crisis altered the regulatory and operating environment. Banks, typically the first place many in commercial real estate (CRE) turned for financing, have decreased their CRE lending to the lowest levels in at least three years[1]

The slowdown comes as banks face increased competition from nonbank lenders, such as private equity firms, who began moving into the space after the crisis when liquidity was not as available from banks. As more money pours into the space, investment managers have shifted their businesses to meet demand for CRE investments, particularly in credit.

New and returning investment vehicles are beginning to emerge as alternatives to bank loans. These include real estate investment trusts (REITs) focused on debt, collateralized loan obligations (CLOs), dedicated debt investing funds and other ways to take advantage of investment opportunities in the industry.

Nonbank lenders have raised dedicated CRE credit funds, hired teams, expanded into new geographies and positioned themselves to compete for business. As more investors put money into credit and competition drives down borrowing costs for developers, the industry is approaching pre-crisis levels of activity.

1 https://www.americanbanker.com/news/whats-behind-the-slow-down-in-cre-lending

Industry M&A

Commercial/multifamily mortgage debt increased by $44.3 billion in the first quarter of 2018, up 1.4% from the prior quarter, to a total of $3.21 trillion. This marked the largest increase for a first quarter since before the 2008 financial crisis.[2]

With more money coming into the space, investment managers are expanding to take advantage of this opportunity. Diversification is the key to competing in the new environment. Investment managers want to be able to provide public and private equity and debt across the world. Firms that do not have credit strategies are acquiring businesses or adding teams of experts to help manage new strategies. Many nonbanks are moving into different types of credit financing to become one-stop shops for those looking to raise capital for commercial real estate projects.

One of the first to move into the space was KKR & Co. The private equity giant started a dedicated real estate business in 2011. In 2015, the company hired debt experts from Rialto Capital Management to invest in equity, mezzanine debt and other types of junior credit in the CRE space.[3] KKR has $5.5 billion of equity committed or invested in real estate and credit.[4]

2 https://www.mba.org/2018-press-releases/june/commercial/multifamily-mortgage-debt-outstanding-posts-largest-q1-increase-since-before-great-recession

3 https://www.wsj.com/articles/kkr-hires-real-estate-debt-team-1420684878?mod=wsj_nview_latest

4 http://www.kkr.com/businesses/real-estate

Other large firms are also taking advantage of capital invested in CRE credit. In March, Morgan Stanley completed the purchase of Mesa West, a commercial real estate credit platform. Mesa West will keep its brand and operate as a separate business unit within Morgan Stanley's real asset group, which manages $48 billion in client assets.[5]

But companies are not only sticking to their home geographies. Australian investment manager AMP Capital bought a 24.9% stake in PCCP, a Los Angeles-based real estate investment manager last year. The company said it was planning to expand its debt capabilities as well as diversify investments outside of Australia and New Zealand.[6]

Even firms that specialize in real estate investing are adding to their portfolios, particularly on the credit side. In January, Clarion Partners announced it was buying AlumCreek Holdings, which managed a $200 million portfolio of performing and non-performing commercial real estate mortgage debt.[7] Even more recently, CBRE Global Investors announced they hired the Narrative Capital Management team to lead their credit strategies platform.[8]

5 https://www.morganstanley.com/press-releases/morgan-stanley-investment-management-completes-acquisition-of-me

6 http://www.pionline.com/article/20171218/ONLINE/171219835/amp-capital-to-take-249-stake-in-real-estate-manager-pccp

7 https://www.clarionpartners.com/News/CPNewsLibrary/Don%20Sheets%20Cropped.pdf

8 https://irei.com/news/cbre-global-investors-expands-credit-strategies-platform/

Expanding investment vehicles

Mergers and acquisitions are not the only trend driving the industry consolidation and creating new kinds of competitors. New investment vehicles are gaining favor while others that lost their luster during the financial crisis are starting to make a comeback.

Commercial mortgage real estate investment trusts (REITs) are one vehicle seeing more adoption as firms look to take advantage of favorable tax and regulatory policies and capture investor capital. Last May, KKR netted $191 million in an initial public offering of KKR Real Estate Finance Trust (KREF) to invest in debt and preferred equity backed by commercial real estate.[9] TPG also raised about $220 million in the IPO of TPG RE Finance Trust in July 2017 to focus on commercial mortgage loans and other debt in the space.[10]

And they are not the only firms putting money into commercial real estate REITs. Well-known names such as Blackstone Mortgage Trust, Apollo Commercial Real Estate Finance, Ares Commercial Real Estate, Ladder Capital and Starwood Property Trust have all raised funds to invest in CRE debt.[11]

Collateralized loan obligations (CLOs) ran into big trouble during the crisis, but firms are

9 https://www.businesswire.com/news/home/20170504006868/en/KKR-Real-Estate-Finance-Trust-Announces-Pricing

10 http://investors.tpgrefinance.com/file/Index?KeyFile=389521725

11 https://www.forbes.com/sites/bradthomas/2017/05/08/batter-up-the-commercial-mortgage-reits/#1e46f0e916f3

once again inching into that segment of the market. In May, LoanCore, which is owned by two sovereign wealth funds, offered a CLO backed by $1.1 billion in first mortgages, one of the biggest CLO offerings in recent years.[12]

CLO issuance is expected to be between $13 billion and $18 billion this year, up from $8 billion in 2017. That's nowhere near the $35 billion a year offered in 2007 and 2008 before the recession.[13] Yet is does signal an increased interest in CRE-backed debt and creates another alternative for borrowers to obtain financing.

Other firms, such as Brookfield Asset Management are moving down the risk/return spectrum and launching open-ended lower yield debt funds. In February, Brookfield announced it was seeking to raise $1 billion in an open-ended real estate debt fund to invest mainly in senior mezzanine loans, as well as select first mortgage and single borrower commercial mortgage-backed securities.[14]

Investment manager PGIM's plan to raise $2 billion during the next three years for an open-ended real estate debt fund signals that others are also looking to take advantage of the benefits of investing in debt over core assets.[15]

12 https://www.globest.com/2018/07/09/cre-clos-are-back-heres-what-borrowers-need-to-know/

13 https://www.globest.com/2018/07/09/cre-clos-are-back-heres-what-borrowers-need-to-know/

14 https://realassets.ipe.com/real-estate/brookfield-raises-capital-for-open-ended-real-estate-debt-fund/realassets.ipe.com/real-estate/brookfield-raises-capital-for-open-ended-real-estate-debt-fund/10023040.fullarticle

15 https://realassets.ipe.com/news/pgim-real-estate-seeks-2bn-for-open-ended-us-debt-fund/realassets.ipe.com/news/pgim-real-estate-seeks-2bn-for-open-ended-us-debt-fund/10023627.fullarticle

How boards and executives can respond

As more nonbanks restructure to add capabilities and investments, they will need to hire professionals beyond their core teams. Diversifying the skills, backgrounds and experiences of new hires will be critical for competing against other large providers of capital and showing returns for investors.

Many firms have the ability to make significant investments but still struggle with finding the right talent to manage their expanding portfolios and businesses. As firms build out new offerings, they should search for executives with experience managing transitions, integrating acquired businesses and entering new markets.

Executives should have a grasp of global markets and fundamentals as well as an understanding of how to create a sound corporate culture and build a cohesive team. Firms should also consider adding those with regulatory and risk management experience to properly manage new lines of business.

Conclusion

Now is the time to capitalize on increased investor appetite for real estate assets. Investment managers have the opportunity to become providers of financing across markets and locations, as well as across the debt spectrum.

Taking a look at gaps in executives' and board members' skills can help identify areas for improvement when looking for new talent. Consider candidates from other industries or with alternative backgrounds to ensure a diversity of thought, particularly as new businesses are rolled out. Companies will need to complement those skills with industry specific ones to round out their executive ranks.

As CLOs, REITs and other forms of financing reshape the industry, firms will need experts in each type of vehicle. Understanding how to structure and sell a CLO is a different skill set than offering a REIT or expanding an existing real estate business. Finding those with debt market, investor relations, structuring, tax, marketing and regulatory experience can help firms set up new businesses successfully.

Working with a partner who understands the market and how to build well-rounded executive management teams can create a competitive advantage, ensuring these new businesses will be profitable quickly.

GEMMA BURGESS

Managing Director

Ferguson Partners

+1 646-779-6001

gburgess@fergusonpartners.com

Gemma Burgess has over 12 years executive and non-executive search experience and leads Ferguson Partner's New York office. She spends the majority of her time working with Private Equity, Investment Management, Real Estate Investment Trust (REIT), Structured Finance, Hedge Fund and Investment Banking clients.

Relocated from the London office more than three years ago, Gemma possesses a deep understanding of the international markets and the global flow of both institutional and non-institutional capital in the real estate industry.

Prior to joining Ferguson Partners in 2007, she spent two years at Hanson Green working on non-executive appointments and two years at Ramsey Hall working as a generalist within executive search.

About FPL

FPL is a global professional services firm that specializes in providing solutions to the real estate and a select group of related industries. Our committed senior professionals bring a wealth of expertise and category-specific knowledge to leaders across the real estate, infrastructure, hospitality and leisure, and healthcare services sectors.

Comprised of two businesses that work together, FPL offers solutions and services across the entire business life cycle:

Ferguson Partners
With an emphasis on the right fit, Ferguson Partners offers services in executive and Director recruitment. We also offer a full range of leadership services including CEO and senior executive succession planning, leadership assessment and coaching, and team effectiveness.

FPL Associates
Focusing on a wide array of business needs, FPL Associates assists with the assessment, design and implementation of compensation programs. We also provide organizational, financial & strategic consulting, bringing a wealth of industry and category-specific expertise to a broad range of projects.

Our Service Offerings

FERGUSON PARTNERS

EXECUTIVE SEARCH

- Board/Trustee Recruitment
- Board Assessment
- Chairmen/CEOs/Presidents
- Senior Management/Corporate Officers

LEADERSHIP CONSULTING

- Succession Planning
- Assessment for Selection or Development
- Executive Coaching
- Team Effectiveness

FPL ASSOCIATES

COMPENSATION CONSULTING

- Benchmarking
- Program Design
- Contractual & Policy Arrangements
- Surveys

MANAGEMENT CONSULTING

- Strategic Planning
- Organizational Design
- Corporate Finance
- Specialized Research

Our Industry Practices

Real Estate

Private Equity/Real Estate Investment Managers, Public (REITs) & Private Owners/Developers, Property Services (Brokerage) Firms, Commercial Mortgage Investment/Finance, Residential Mortgage Investment/Finance, Homebuilders, Corporate Real Estate

Hospitality & Leisure

Lodging (Brands/Owners), Gaming Resorts & Casinos, Restaurants, Sports & Recreation, Amusement Parks & Attractions

Healthcare

Owners/Investors/Operators/Financiers of Seniors Housing, Hospitals, Health Care Service Providers

Infrastructure, Engineering & Construction

Infrastructure Investing: Transport, Energy, Social Infrastructure; Construction & Engineering

Our Office Locations

CHICAGO · HONG KONG · LONDON · NEW YORK · SAN FRANCISCO · SINGAPORE · TOKYO · TORONTO

FPL Ferguson Partners