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Stuart Boesky, Pembrook CEO and founder

COUNTRY FOCUS
AUSTRALIA

PERFORMANCE
THE ART OF BENCHMARKING

NUMERICABLE
A BOX OFFICE BOND ISSUE

SPACE AT THE TABLE

PEMBROOK CAPITAL MANAGEMENT

PLUS: DISTRESSED REAL ESTATE DEBT | PDI'S 1ST BIRTHDAY PARTY | RECEIVABLES FINANCING | ALLIANCEBERNSTEIN'S NEW LENDING UNIT | THE RISE OF UNITRANCHE | AND MORE…

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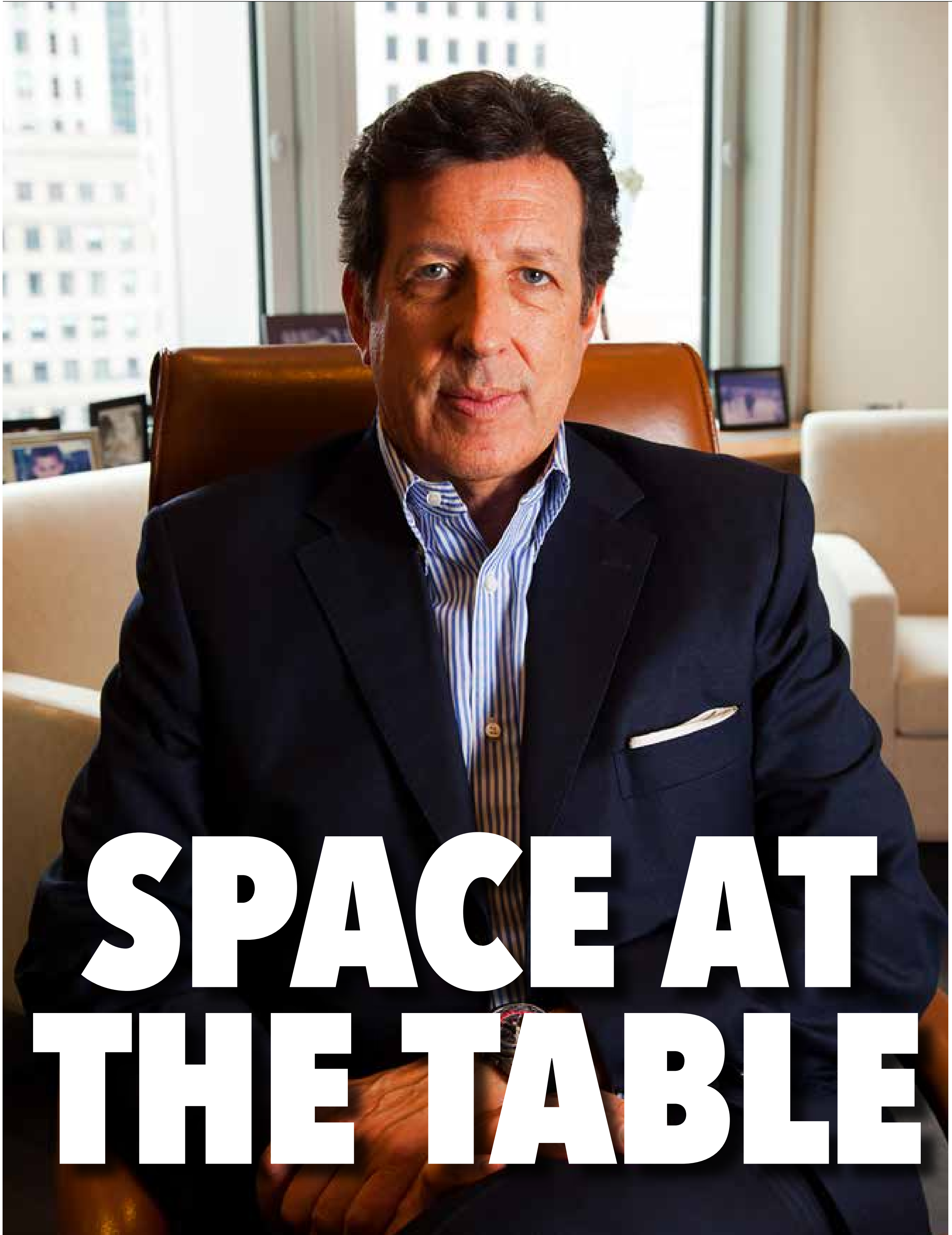

SPACE AT THE TABLE

In the wake of the crisis, Pembrook Capital Management has carved out a lucrative niche for itself as a lender to transitional commercial real estate properties in the US. **Sam Sutton** speaks with **Stuart Boesky** about how regulation has been a catalyst for opportunity.

"THERE ARE PROBABLY HUNDREDS OF FUND MANAGERS WHO HAD TO SELL ASSETS AT THE BOTTOM OF THE MARKET TO PAY BACK BANK DEBT, AND WE DIDN'T HAVE THAT SITUATION"

A ceremonial groundbreaking shovel sits in the corner of Pembrook Capital Management founder Stuart Boesky's Madison Avenue office, its handle resting just below a photo of him and his son at a baseball game.

Boesky has been spending a lot of time with the game recently. His 11 year-old son is a Little League pitcher with a fastball clocking in around 10 mph faster than average for a player of his his age.

"I'm so excited about this pitching thing, he's living my dream right now," says Boesky. "I was a pitcher as well. When I got into high school, in the early-to-mid 1970s, the Vietnam War was just over, and people were still rebellious.

"I had a massive head of hair. My coach basically said, 'You can keep playing but you better cut your hair,'" he laughs. "I said, 'I'm not doing it!' Like an idiot!"

In case this reference to his follicular rebellion wasn't evidence enough, a conversation with Boesky can get you to interesting places, and he's good at it, too. He doesn't rush through his answers and moves seamlessly across topics and tangents before eventually returning to a deliberate and succinct point. And right now the point he's feeling strongest about – baseball aside – is that it's a good time to be a lender to mid-market commercial real estate developers.

A NEW VENTURE

Boesky launched Pembrook in 2006 with the backing of New York hedge fund Mariner Investment Group. He had spent the bulk of his career at real estate investor The Related Companies, where he led CharterMac, a subsidiary specialising in equity and construction lending.

Boesky's tenure as chief executive of CharterMac - now known as Centerline Capital Group - occurred during a period of rapid expansion from $300 million to $19 billion of assets owned or under management, according to his Pembrook biography. In a 2005 statement announcing Boesky's departure, Related Companies founder Stephen Ross said Boesky's leadership had cemented CharterMac's reputation "as a driving force in our industry".

Even so, Boesky was ready to strike out on his own. "I felt it was the right time in my career for me to tackle some new challenges and opportunities," he said at the time.

"I left [Related and CharterMac] in '05 and had a two year non-compete," Boesky tells *Private Debt Investor*. "I was doing things like getting my pilot's license and also thinking about what I was going to do after my non-compete burned off. People called me as soon as they heard I was leaving Related, and they sort of planted seeds in my head."

One of those phone calls was with Lewis Sachs, a former Bear Stearns executive who had previously served as an aide to former Secretary of the Treasury Robert Rubin and later became an economic advisor to President Barack Obama. Sachs had since moved on to Mariner, which was planning to launch a commercial real estate lending business.

"Lee said, 'Look, when you figure out what you want to do, why don't you talk to me? We'd like to start a real estate business at Mariner,'" Boesky recalls. "We ultimately made a deal, essentially a joint venture, and that's how it got started."

The original plan for Pembrook called for investments in structured real estate debt.

"At that time, as you might recall, almost everything was getting securitised, be it construction loans or bridge loans, and the market was fairly overheated," says Boesky. "We raised a fund in '07 but we structured it very conservatively. Instead of using a lot of leverage, we bifurcated the structure of our equity, so we had preferred equity in our private equity funds."

The decision to forgo heavy leverage proved fortuitous. The rapid decline in real estate valuations which precipitated the global financial crisis spelled trouble for firms that

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had geared up their funds with debt. When the banks marked down their real estate loan books, the firms that lacked the cash to back up those loans were forced into panic sales.

"In the crisis, spreads got so wide, so fast, that many of these loans were marked down severely. So my peer group is getting margin-called to death. Many of them ended up getting sold out of their positions," he says, adding that the structure of Pembrook's investment funds provided a safeguard. "There are probably hundreds of stories of fund managers who had to sell assets at the bottom of the market to pay back bank debt, and we didn't have that situation."

To the contrary. Most of the loans Pembrook made prior to the crisis repaid at par, Boesky says. Furthermore, the timing of the firm's initial fundraise - Pembrook closed on $119 million for its debut fund in 2007 - allowed them to emerge as a source of capital for borrowers once the crisis hit its apex.

In a precursor to the market conditions that would come to define Pembrook's investment strategy, the banking industry's inability to provide financing through the crisis years intensified the pressure on real estate developers, who were forced to find more expensive capital through alternative sources in order to meet their refinancing needs.

"Many developers came up to us and said, 'We have a great property, but our bank wants to get repaid right now'. It was difficult to refinance in this market, and we were more than happy to do it," Boesky says. "Banks were ultimately, generally taking a loss. So we were getting in at a very good basis, a very safe basis, and we were getting the kind of spreads that we'd never seen on first mortgage loans.

"It was a great period. But again, we don't view ourselves as distressed buyers, we view ourselves as – especially now – a company that takes advantage of the structural changes that have happened in the banking industry, and the repricing of commercial real estate debt, especially for debt that would traditionally be balance sheet debt."

THE TRANSITION

Boesky explains all of this while seated at a small conference table in an office he has decorated with black and white photographs of the Brooklyn Bridge, Chrysler Building and other landmarks of New York City architecture, many of which are within walking distance of Pembrook's headquarters.

The conference table becomes a prop when he describes his firm's investment strategy, which tends to focus on properties located in primary markets such as New York and Los Angeles. Prior to the crisis, risk weightings on commercial real estate loans that determine how much capital banks must keep in reserve were low, enabling banks to provide cheap loans to a broad range of commercial real estate properties - represented, in Boesky's account, by the table's surface area.

"They had very cheap cost of capital and, it wasn't that they did bad real estate deals, but it was a mispricing of risk. In other words, if you have very cheap capital, and everyone around the table has equally cheap capital, and there's a finite amount of business out there, it goes to the highest bidder. And when you're trying to build market share you forget about the risk-reward," he says, sweeping his hands across the table.

Banks' willingness to provide inexpensive funding from deposits guaranteed by the Federal Deposit Insurance Corporation made it very difficult for lenders with a higher cost of capital to compete on balance sheet loans. Borrowers had little incentive to pay anyone else a higher price.

The financial crisis, in which the collapse of commercial real estate values played a key role, prompted banking regulations to tighten. The implementation of Basel III raised minimum tier one capital ratios and ratcheted up risk weighting on commercial real estate loan exposures from 100 percent to 150 percent. Making loans to sponsors or developers of commercial real estate became more expensive. And as costs rose, the bank lost their appetite.

The net result is shaping the market to this day. "The available balance sheet for real estate debt – especially transitional properties – is not nearly what it used to be," Boesky says. "The re-regulation of banks has forced them into a much safer pocket, generally below 65 percent loan-to-value, with that very cheap capital. And if they stay in that safe area with that capital for a very long term, it leaves it open for guys like us with a higher cost of capital to take advantage of that part of the capital stack."

For Pembrook, the implications of Basel III were most relevant with regard to transitional properties in primary US markets, assets in which a developer or sponsor has a plan to increase net operating income over a relatively short timeframe. The duration of Pembrook's loans reflect that turnaround. Most feature two to three-year terms, although the firm's mezzanine and preferred

equity investments can last as long as five years.

Within those primary markets – New York, Los Angeles, Chicago, San Franciso and Miami – Pembrook loans generally range between $5 million to $50 million in size with an average of approximately $15million to $20 million.

"Banks are willing to make loans to good customers up to 65 percent loan to value on transitional properties, but that's where they stop," he says. "We view the resulting gap not so much as a trade – a short term, cyclical trade - but as a longer term opportunity."

RELATIONSHIP SOURCING

Of course, the opportunity-boosting effects of Basel III on Pembrook's commercial real estate lending would be irrelevant if its investment team could not originate loans within its target markets.

The firm has been quite successful in that regard, having provided approximately $760 million in capital across 68 investments as of Q1 2014, according to its website. In regards to pipeline, Pembrook has considered roughly $15 billion since 2007, a remarkable sum given the firm's size. Pembrook's second fund held a final close on $154 million in capital commitments last year, a significant increase from Fund I but a far cry from CharterMac's pre-crisis AUM.

"Anecdotally, you talk to people who say, 'Oh there's plenty of money in the market but there aren't enough deals'. And we don't really understand that, because we're seeing a tremendous amount of deals, and they're really high quality," Boesky says, adding that the firm's active pipeline volume can include as much as $500 million in potential deal flow at any one time.

At least some of that success can be attributed to the composition of Pembrook's limited partner base, which includes an undisclosed

PEMBROOK BY THE NUMBERS

2006
The date the firm was founded

$15bn
Total value of originations considered since inception

$760m
Aggregate value of investments since inception

68
Number of investments completed

11
Number of investment professionals

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number of commercial banks. Although Boesky is reluctant to discuss Pembrook's coterie of investors in depth, he does concede that the participation of national, regional and community banks in Pembrook funds helps fill the firm's deal pipeline.

"A fair amount of our investors are commercial banks, and therefore we have a lot of interaction with the banking industry on a more intimate level then maybe some of our peers, and that tends to produce transactions," he says, adding the bulk of the firm's ability to source is a function of his team's experience. "My team has deep relationships, whether it be [with] brokers, developers, owners, lawyers, accountants, appraisers, people who are in the deal mix."

With that in mind, Boesky seems unfazed by the prospect of new non-bank lenders entering the market for transitional property loans. The number of firms specialising in real estate debt, particularly in the mid-market, remains fairly limited compared to the size of the void the banks left behind. As such, he doesn't see any immediate threats to his line of business or investment strategy.

Nor does the possibility of real estate valuations falling in the future worry him. "We're taking advantage of this opportunity that the banks have left for us, but the equity is really our top loss. If we're making a loan at 70 or maybe 80 percent LTV, we have a fairly significant amount of equity protecting whether we're actually money good," he says. "That doesn't mean our collateral is going to be quite as good as when we got into the deal, but I'd rather it be more senior on the capital stack than the equity guy if rates do cap out."

The biggest threat to his firm's business model, according to the founder, is the possibility of deregulation.

"Clearly, it's all very political. If you listen to speeches that [Senator] Elizabeth Warren gives, then you'd come away thinking that there's a lot more to do as far as regulation goes. But then there are plenty of people out there who say it's gone far enough, already. I'm not one of them," he says, laughing. "We're watching to see where the banks end up in the commercial real estate business, because there's plenty of good business out there. But if the banks start to revert back to when they were doing transitional deals with very cheap cost of capital at 85 percent loan to value, that's my biggest fear.

"When that happens, we shouldn't theoretically be doing what we're doing."

For now, such a development seems unlikely. Expect Boesky to carry on throwing fast balls in real estate for a good while yet. ■

A DEAL IN JACKSON

Pembrook doesn't typically stray from its core markets of New York, Los Angeles, Miami, Chicago and San Francisco. But when it does, it's usually because the firm sees a clear path to exit for the developer or sponsor they have decided to back.

The preference for major US metropolitan areas is a function of the transactional scope offered by real estate markets in those cities. Major markets offer greater deal flow, which eases execution. Perhaps more importantly, the presence of other real estate debt players improves the likelihood that Pembrook's portion of the capital stack will be taken care of once properties emerge from their "transitional" stage.

"There are enough transactions occurring in New York and the major markets so you know what things are worth. Part of the issue with secondary / tertiary markets is, there aren't enough transactions – it's very hard to determine [value], so you really want to make sure that you understand your takeout," says Boesky.

Even so, Pembrook has seen some success in providing capital to developers in secondary or tertiary markets. A recent loan the firm provided to a Jackson, Mississippi-based development serves as an example of when the firm would consider putting capital to work outside of the cities that have defined its comfort zone.

"Jackson is not even a secondary, it's a tertiary market," Boesky says. "It's a university town, it has a lot of wealth. The loan that we made was for somebody to buy into one of the town's nicest lifestyle malls, [which] has always been 90 percent leased, great high-end local tenants."

A first mortgage lender reached out to the firm to provide mezzanine financing for a developer that had acquired a leasing agreement for a Whole Foods Market franchise, a popular natural foods supermarket. Even though the characteristics of Jackson's real estate market differ greatly from those in New York or Chicago, Pembrook felt the developer's plan for the property warranted an investment.

"The guy who was buying into this deal with a local family was buying in with a Whole Foods lease in his back pocket," he says. "The business plan was very defined. Use Pembrook's money to help him buy the centre, or his interest in the centre, and to build the Whole Foods store. Once the Whole Foods store was done, Whole Foods would begin to pay rent, and now the debt yield on our loan is high enough or significantly high that he can refinance us out. And that's exactly what's transpired." ■