Pembrook Capital Management

Recently, ***Geoffrey Dohrmann,*** *publisher and editor-in-chief of* The Institutional Real Estate Letter – Americas, *spoke with* ***Stuart Boesky*** *of Pembrook Capital Management. The following is an excerpt of that conversation.*

Stuart Boesky is Chief Executive Officer of Pembrook Capital Management, LLC, which he founded in 2006. Mr. Boesky has 35 years of commercial real estate experience. Prior to founding Pembrook, he was a Senior Managing Director and principal of Related Capital Co., Executive Vice President of The Related Cos. and the Chief Executive Officer of CharterMac, one of the nation's leading commercial real estate financial services firms. Organically and through acquisitions, he engineered CharterMac's growth and diversification from a portfolio investor in multifamily housing bonds to a full-service real estate financial services firm, increasing annual debt and equity origination from $83 million per year to more than $4 billion per year and increasing its total assets owned or under management from approximately $300 million to approximately $19 billion.

When and why was your company founded?

In 2007 we launched a joint venture focusing on real estate commercial debt with Mariner Investment Group, a large alternative asset manager. At that time, Mariner did not have any exposure to commercial real estate. They were primarily a large credit-oriented hedge fund operation, and it seemed like a perfect fit. We launched our first fund in 2007, and followed it up with our second fund in 2010. Prior to founding Pembrook, I had spent 21 years at The Related Companies, Inc. as a principal and CEO of a public spinoff called CharterMac, which was the real estate financial services division of Related, and that company had grown over the nine years I was CEO from $300 million under management to $19 billion.

And how, if at all, has Pembrook changed since its founding?

We have become much more focused on a particular business that came to life after the global financial crisis. Before the crisis, we were broadly focused on commercial real estate structured debt. The crisis changed the way commercial real estate is financed in a fairly significant way. So now we do not buy loans. Today we originate 100 percent of the loans that we make. We underwrite 100 percent and we asset manage 100 percent, and we tend not to participate in complex securitized transactions. So it gives us excellent control over the collateral, the properties that secure our loans.

What is the investment strategy that you are pursuing?

We originate first mortgage loans, mezzanine loans and preferred equity on what we refer to as midmarket properties, generally in primary markets and to a lesser extent in secondary markets. The loans are usually on transitional properties, and therefore they are generally shorter-term and intermediate-term floating-rate loans. We stay away from tertiary markets, unless there is a very clear takeout in our estimation for our loan. We tend to focus on multifamily, office and retail, roughly in that order. We stay away from hospitality because we view hospitality as more of a business than just a pure real estate play, and we do not currently have the skills to operate a hotel.

You mentioned midmarket from a size standpoint. How do you define that?

We define midmarket as $5 million to $50 million, and we like the midmarket the best because re-regulation — such as Dodd-Frank, the Volcker Rule and Basel III — has pushed the banking industry away from a lot of balance sheet lending. There also has been a tremendous consolidation in the banking industry. Today more than 50 percent of all U.S. deposits are in five banks. In addition, there are 50–60 percent fewer banks than there were in the 1980s, and the result is that there are not enough banks that are able to service the midmarket. The large banks that hold most of the deposits in the country are looking to service very large clients, and they are also looking to service clients who can generate other more profitable ancillary business such as investment banking. So midmarket balance sheet lending is a great opportunity because of re-regulation and consolidation.

If you look at our Fund II portfolio, the loan-to-value ratio is approximately 68 percent. In historical terms, these are very conservative loans. Some 65 percent of the loans are in primary markets — such as San Francisco, Los Angeles, New York City, Chicago and Miami — with 35 percent in secondary markets. These are not what people might perceive to be opportunistic loans made by guys who are looking for high yield. If it were not for re-regulation, these

are loans the banks would have been making.

You mentioned that you changed strategy after the global financial crisis because the markets had changed. How else has the recent credit crunch affected your strategy, your focus, your clients and returns?

The re-regulation and consolidation of the banking industry as well as the withdrawal from midmarket balance sheet lending were clearly a direct and lasting response to the credit crunch. I believe that this paradigm shift has opened up a significant opportunity to directly originate and hold loans. Previously, banks made roughly 90 percent of the balance sheet loans in the nation, and now the cheap, FDIC-insured capital that banks lend is only available at a very low advance rate. That has given us a great opportunity to move in and earn what we believe to be historically unprecedented risk-adjusted returns on commercial real estate lending.

If you are investing today in commercial real estate, you have to be concerned about the prospects of future cap rate expansion. I think institutional investors are looking at that tail risk represented by cap rate expansion. Since we have remained fairly senior on the capital stack, the equity provides a lot of cushion that acts as a first-loss position to protect our loans. And then, finally, interest rates are so low today, you have to assume that ultimately we are going to enter a rising rate environment. While we make loans — and fixed income is ordinarily not considered a very good place to play in a rising rate environment — the loans that we make are short and intermediate term, and they have floating rates. So it also hedges us against interest rate risk.

In executing this strategy, what do you see as your competitive advantages?

Number one, the Pembrook team has an average of 25 years' experience in balance sheet lending. We are not CMBS lenders. Number two, we also have an unusual mix of both balance sheet lending experience and what I call dirt boots real estate experience: ownership, management and construction of commercial real estate. So in the handful of situations where we have had nonperforming or underperforming loans, we have been able to effectively manage those assets. But the thing that makes us truly unique is that we have something that no other sponsor in our area of focus, or perhaps in any area of real estate private equity, has: we bifurcate the equity that we raise into common and preferred equity. The preferred equity we raise is extremely inexpensive and is comparable to our average cost of borrowing, but it is true equity and it has virtually no covenants.

The importance of this should not be underestimated. Generally in a debt strategy there is some introduction of leverage into your portfolio. So you make loans and then you leverage those loans. The Achilles heel of most of these levered debt programs is that if you enter into a period of illiquidity or stress like we had during the crisis, you end up having to sell your loans to pay back your debt leverage at the worst possible time when the value of your portfolio is actually at its lowest basis. The preferred equity, since it has no covenants, allows us to leverage our portfolio without taking on those risks. So, during the crisis, the reason why our first fund performed so well versus our peers was that our peer group had to sell substantial amounts of their loans or they were in the alternative foreclosed out of a substantial amount of their portfolio at the very worst time in the marketplace. In our case, most of our leverage was in the form of this preferred equity, so we did not have that stress. We did not have to sell assets at the worst time. And in fact almost every loan we made pre-crisis repaid at par fairly soon after. Post-crisis, the only loans that we ended up selling at a loss were loans that had a very long duration and spreads that were never going to come back to where they were pre-crisis, so we chose to sell those and take the proceeds of the sales and reinvest in wide spread assets.

So, to summarize, we figured out a way to manage the liability side of our balance sheet better than our competition, and that is a true differentiating factor. Nobody else can say that, and we believe that when you look at what we are doing as a business and you look at the returns we are producing, the risk-adjusted return is far greater than our peer group.

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Looking out over the landscape today, where do you see the opportunities in the next two years or so?

Because of this re-regulation and consolidation, we have a real structural change in the market. So we think this opportunity will exist for an extended period of time, and we expect to continue to focus on this. There are certain areas that we review from time to time, those real estate types that are highly correlated to changes in the economy. And we want to make sure that we are prepared for that going forward. For instance, multifamily generally does well, especially more affordable multifamily, even when the economy becomes slow. While we currently avoid the hotel sector, we are watching it with some interest. We see a tremendous amount of hospitality being built in urban areas without flags, and these are generally boutique hotels that are not well capitalized. Hotel performance is very

sensitive to changes in the economy, and during the next recession we expect that will be a great opportunity for somebody who has expertise in that area. At some point, a few years down the road, should we decide to gain that expertise, that might be an area of great opportunity.

How would you characterize the market environment today?

Unlike prior real estate cycles, the market entered the last recession and the crisis with supply and demand that were at relative equilibrium. We believe that there was not a great deal of overbuilding, and therefore we like commercial real estate fundamentals long term. That said, we believe that suburban office and big-box retail in many markets will experience functional obsolescence because of changes in the way we work and shop. People are flocking to urban centers to work, and people are flocking to the Internet to shop. The balance of property types in the United States is at an equilibrium. We do not see a lot of overbuilding, and we do not see a lot of inexpensive capital to create a lot of overbuilding. We are optimistic about the supply/demand fundamentals going forward for the property types on which we are focusing. While we see a lot of multifamily construction, the demand for multifamily is vast. In any event, we are very comfortable with fundamentals over the long term for most property types. We are less comfortable with the capital markets and concerned about cap rate expansion, and we think our strategy addresses that.

Where do you see the greatest opportunities to make money in that kind of environment?

We think being more senior on the capital stack is the best place to be. Also, we love multifamily because multifamily rents react quickly in an inflationary environment. Roughly 40–50 percent of the transactions we have done since we formed Pembrook have been multifamily. We think urban areas are excellent places to invest: infield locations in New York City and surrounding areas, San Francisco, San Jose, Los Angeles, Chicago, Miami. There is a high level of liquidity in the marketplace for those areas, and staying senior on the capital stack protects you from cap rate expansion.

Is there anything else that you think is particularly unique or distinct about your strategy and your approach to investing that you have not talked about?

We are solely focused on originating our own loans and controlling our collateral. I tend to see other sponsors in the debt space as having much broader mandates. For instance, they might focus on originating loans as well as buying CMBS. Part of their returns may be based upon future trading expectations. We do not see ourselves as having a broad mandate from our investor base, and we think by having that focus we can be a better competitor.

CORPORATE OVERVIEW

Pembrook Capital Management, LLC is an SEC-registered investment adviser that manages commercial real estate private equity funds that focus on debt strategies. The firm's management team has extensive experience in balance sheet lending, real estate investment, finance, asset management and development through multiple market cycles. Pembrook has established long-standing relationships with commercial real estate owners, developers, service providers, commercial and investment banks, as well as with federal agencies and state housing authority officials. Since inception, Pembrook's originators have generated more than $15 billion of investment opportunities, averaging $2.2 billion annually. This has resulted in more than 65 investments with an aggregate investment amount in excess of $700 million.

Can you describe your philosophy with respect to risk assumption and risk management?

Capital preservation is a base premise of every transaction into which we enter and the way we structure our funds. We are focused on managing our liabilities because we believe it is as critical as paying attention to the assets side of the balance sheet. We are big believers that, if you underwrite transactions well going in, then short-term reversals in the marketplace or short-term problems with sponsors with which you are doing business can be overcome, but if you do not have the liquidity by virtue of fastidious balance sheet management, it will not matter. The preferred equity we utilize in our fund structure is an extension of this philosophy. As we have already discussed, the preferred was pivotal in our ability to successfully manage our balance sheet through the tough times we all went through.

Can you tell me about a deal that did not live up to your expectations, and what you learned from the experience?

One example is a loan for a limited-service hotel that we made. The market surrounding the hotel had a big reversal. We learned that we were not able to step in and run that hotel, and therefore we were not able to influence the situation in as positive a way as we wished. So the lesson learned is stick to those property types that are within your core competency, because eventually you are going to make a loan that needs your care and attention. In the property types where we have a strong core competency, we were able to deal very positively with underperforming situations and turn them around. So that is why we are staying so focused today.

Yet you said two to three years out there may be an opportunity in some markets where there are undercapitalized hotel properties. What would you do differently to be able to participate in that opportunity?

There may be an opportunity in urban boutique hotels during the next recession because we think these operators tend to be thinly capitalized and this is a property type that tends to be highly sensitive to the economy. We do not currently have the capability to take advantage of that opportunity, but because we believe that it may be coming, we are trying to decide how we might take advantage of that opportunity. Is there a way to develop that expertise in-house? Is there a way to joint venture that expertise? If it happened today, we would stand on the sidelines, but if we were able to gain that expertise so that we felt comfortable asset managing distressed hotels, then that would be something we would explore.

Who are your key people?

Our operation has some very experienced key people. Paul Mullaney is our chief credit officer. Paul has a background at balance sheet lending at Merrill Lynch, Heller Financial and doing workouts for BlackRock. He has been in the business for two decades. He has a great Rolodex, has great intuitive real estate skills and he runs all of our credit. Rob Hellman is our head of asset management. Rob goes back to the Shearson Lehman Hutton days. While he was there, he ran asset management and managed several public companies that Shearson Lehman Hutton had sponsored. He has excellent skills, excellent knowledge base and broad industry relationships. John Garth runs our East Coast loan originations operation. He has been in the business for a very long time and has a tremendous Rolodex of business contacts. He was with me at Related and CharterMac. Before that he was credit trained at Prudential Insurance Co. and GMAC. We also have Chris Simon, who runs our West Coast originations and was at Heller Financial and Merrill Lynch also, again doing balance sheet lending. John and Chris generate over $2 billion a year in real estate lending opportunities for us, and the first quarter of this year alone we saw $1.5 billion of lending opportunities. And then Neil Bø and John Ryan head up our investor relations. They both have been in the business raising capital for well over 20 years. Neil raises our preferred equity, and John raises our common equity.

How do you keep people incentivized?

Each of the professionals at Pembrook has an interest in the incentive compensation of our fund. We want everyone to participate in the success of our funds, and we want everybody to be motivated to produce long-term success for our investors.

Can you talk a little bit about your investment processes and investment disciplines?

The team has been in this business of portfolio lending for an average of 25 years, so we have developed and refined the process over that period of time. We have a thorough policies and procedures manual that captures our best practices approach. We are an institutional-quality lenders, and we believe that our process is as rigorous, or more rigorous, than you would find in a bank or insurance company. In our case, when an originator brings in a deal, it is discussed across the whole team because we are a very participatory group. We like input from everyone. If we like a deal, we issue a preliminary credit memo that the loan committee reviews to decide whether we are going to bid on a deal. So if the committee agrees, then we issue a term sheet to the borrower. If the term sheet is accepted, the borrower posts due diligence escrows — which cover the cost of our bottom-up underwriting. Pembrook underwriters go to the market, they shop the comps, and they look at the experience of the sponsor with similar product types. They look at the plan that the sponsor has in place, they determine whether the sponsor can accomplish that plan. We also do credit reviews of the borrower and background checks. We hire third parties to do environmental reports, appraisals and physical assessments of the property, all of which we consider a best practices approach for a lending operation. The underwriters prepare a detailed committee package for the investment committee, which consists of Paul Mullaney, Rob Hellman and me. Barring any outstanding issues or necessary changes to the transaction, the loan has to be unanimously approved by the investment committee.

Once the loan is approved, it is papered by our outside counsel with closing to be had soon thereafter. Upon closing, the loan is transferred to asset management. Based on my three decades in the business, I think it is a disciplined, institutional approach to real estate lending. We do not do primary servicing because it is so inexpensive to outsource and it is merely an administrative function. So we generally hire a primary servicer who will manage collections of interest and monitor the reserves and escrows for insurance and property taxes. The Pembrook team consists of 11 highly experienced professionals who focus 100 percent of our time on our core business of originating, underwriting and asset managing loans. Mariner takes care of all of the back office functions for us, so we can focus our activity solely on producing the best returns for our investors. Our relationship with Mariner allows our 11-person team to operate as if we are 20–25 people; it's been a great marriage. ❖

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