PEMBROOK CAPITAL MANAGEMENT

Real estate mezzanine: a sustainable opportunity

Pembrook Capital Management founder **Stuart Boesky** explains to *Private Debt Investor* why mezzanine debt is fulfilling a valuable role in financing commercial real estate in the US.

Pembrook Capital Management's origins lie in the Related group of companies in the US. Initially a principal at Related Capital Company, Stuart Boesky became chief executive when Related took its real estate financial services business public under the name CharterMac. Boesky explains to *Private Debt Investor* how that business grew into two public vehicles that focused on financing all parts of the capital structure for CRE deals, with an emphasis on apartments. During his time at CharterMac (between 1997 and 2005), Boesky and his team grew the business from around $300 million of assets under management to $19 billion. At that point he left, and Pembrook was born.

The thesis for the new firm was simple: replicate a lot of the things he had been doing at Related, and build a "top notch" CRE business based on private rather than public equity.

Six years on, the firm has just shy of $300 million in AUM across two funds, the second of which is just reaching the end of its investment phase. Although Boesky declined to comment on fundraising plans, market sources confirmed the firm had just launched its third fund with a target of $450 million and a hard cap of $750 million.

"Even through the great financial crisis our credit losses are almost non-existent and we have produced what we believe are top quartile returns. What we've found over time is that the market has grown more and more supportive of our business model," Boesky says when asked about the firm's progress since inception.

There are several reasons for this beyond the firm's ability to deliver attractive (risk-adjusted) returns, Boesky adds. "The market opportunity has come to us. There are pure short-term cyclical reasons: the banks repairing their balance sheets and reducing their exposure to commercial real estate.

Boesky founded the Pembrook Group in 2006.

"But the more meaningful changes are structural in nature. They relate to regulatory changes associated with Dodd Frank and Basel III. As well as the massive consolidation of the US bank industry, which greatly accelerated during the crisis. If you look at those structural changes, Dodd Frank for instance dictates that banks cannot participate in certain businesses. Major banks used to sponsor funds, and they became meaningful competitors for high yield CRE debt. Furthermore, Basel III has increased the risk weighed cost of capital for certain CRE lending from 100 percent to 150 percent, forcing some banks out of the business and causing others to lend on a much more conservative basis. As a result, traditional sources of real estate balance sheet debt have contracted significantly."

Finally as a result of consolidation, nearly 50 percent of all US deposits are controlled by just four banks, Citibank, Bank of America, Wells Fargo and JPMorgan Chase.

"We believe that these banks may neither desire nor be able to adequately service mid-market borrowers. It requires a lot of boots on the ground and it requires a lot of local knowledge to originate and asset manage these loans. I am not sure that smaller loans ($5-$50 million) move the needle much at these banks." he adds.

As such, Boesky believes there is a major void that's opened up in the market. He also believes that as monetary policy changes, commercial real estate will be re-priced.

"It's highly unlikely that the kinds of prices that have been paid over the last two years, particularly in the gateway markets, will sustain themselves," he argues. So we'd rather be in mezzanine and preferred equity, and perhaps bridge financing, than equity. If we are right and cap rates move up, the equity serves as top loss that protects our position on the capital stack. On a portfolio basis we stay under 75 percent LTV so we have a 25 percent equity cushion. As a result, we feel our returns, on a risk-adjusted basis, are more attractive than equity and depending upon how high cap rates go, maybe higher than equity on a nominal basis as well," Boesky says.

He accepts that some investors believe the debt opportunity has already disappeared, but contends that their definition of the opportunity is narrowly defined and focused on distressed investing. That segment of the market didn't, he believes, live up to expectations.

"The business of alternative lending though... that we feel is a sustainable opportunity."

There's also less competition than on the equity side. There are roughly 500 private equity funds in market at present targeting CRE (equity) investments, looking to raise $150 billion collectively, Boesky says. On the debt side, there are just 23 funds chasing $12 billion.

For an investor, a private equity fund structure may prove to be more prudent in the long run than a public vehicle, he believes. "There are enough guard rails and the investment parameters are more narrowly defined to prevent the manager from style drift to chase returns. The weakness of the public structure is that managers can become very short-sighted, while many end up over-levering their portfolios. If that coincides with a tightening of monetary policy, and a recession, then you have problems," he says.

LP sentiment is slowly changing, Boesky believes, but not fast enough for his liking. "In 2010 when we raised our second fund, most investors didn't really appreciate the opportunity. Today there are more who understand it, but not as many as we think should be interested given the high price of equity and the relatively broad opportunity set in debt. CRE debt investing is still rather new for private equity and not that well understood. Their expectations can be quite varied so some come with pre-conceived notions about whether the opportunity has come and gone or not.

He dismisses senior debt opportunities in core real estate – the banks are still active in that space because it involves larger transactions at very low LTV, and they're able to price private debt funds out of the market. "It's never a good idea to compete head to head with the lowest cost of capital in the market," he comments.

Pembrook's investments include a $7m mezzanine loan to the Plaza at PPL.

"Where we see the best opportunity is in the mid-market space; those developers and owners who do one, two or three deals a year. He's not institutional. He's an entrepreneur, he's successful, he knows his markets and his banking relationships may be on the sidelines. Maybe he was a client at one of the larger banks, or another bank that is less excited today about doing commercial real estate. So now he's looking for a new lending source or if he can find a loan, it's so conservative, the amount of (expensive) equity you would have to scrounge together from partners makes the deal unattractive."

Back in a more 'normal' market environment, a bank would have lent 70-75 percent LTV on a transitional property, leaving the developer to raise 20-25 percent in equity. Today, Boesky says, banks might not go beyond 50-65 percent LTV.

"So now he has to raise significantly more equity," he adds. And equity is costly, plus it has to deliver a larger multiple so the expensive equity must stay in the deal for many years.

Pembrook offers a solution. A mezzanine loan may be expensive – "We price it according to what the market will bear, but it's cheaper than equity," Boesky says – and it's more flexible. "We will give the borrower the optionality of repayment after 18 months, for example.

"A developer says to himself, 'I'll buy this deal, I'll bring in Pembrook, they'll be 10-15 percent of the capital structure, I'm paying them a lot of money, but once I improve the property and optimize the revenue, I'll pay them off.' He can then go to the CMBS market and get a relatively aggressive and well price fixed rate long term loan." Boesky says.

The firm likes deals where there is incontrovertible demand for the underlying asset, urban markets with high barriers to entry, and a sponsor or developer who has a proven positive track record in that segment of the market. "We're willing to take a little bit of construction risk where necessary, because we believe it's manageable. We've learned during our 25 years at Related how to manage risk associated with transitional properties and I suppose that's why, since starting Pembrook, we have controlled credit losses in our portfolio."

The market opportunity is established and the firm's track record is largely proven. The litmus test of course will be the firm's latest fundraising, but Pembrook looks well-placed to win the commitments it needs to continue to play a meaningful role in the US CRE landscape. ■