Quadrant Real Estate Advisors

Investing in real estate debt

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Senior Member and Chief Executive Officer

Recently, **Jonathan A. Schein,** senior vice president, managing director of global business development at Institutional Real Estate, Inc. spoke with **Kurt Wright** of Quadrant Real Estate Advisors. The following is an excerpt of that conversation.

When did Quadrant start making real estate loans?

The Quadrant team has been together for 23 years, which is quite a long time in the real estate industry. We started back in 1993, making loans on property and representing institutional investors for Equitable Real Estate Investment Management. In 2006, we had an opportunity to do a management buyout of the business that we had built. At that time, we formed Quadrant Real Estate Advisors. Thus, we've had a very consistent group of people that has been growing and managing the company over the course of many years and for 10 years now as a freestanding adviser.

How has the industry changed during that time?

The biggest changes are twofold. First is simply the acceptance of real estate debt by institutional investors. Through the 1990s, only the insurance companies and banks invested in debt in any volume. Pension funds, sovereign wealth and other institutional investors deemed it to be a quirky, unusual product. So, for many years, we relied on a small group of investors who were very committed to this niche product. More recently, and especially since the financial crisis, there has been a global surge of interest in the sector from a broad range of global institutional investors. Today, real estate debt is very commonplace, well understood by investors and certainly not deemed to be quirky anymore.

And what is the second aspect?

Real estate debt has become global, both in terms of accessing investors and deploying capital. Historically, it really was a U.S.–only product. Today, some of the more sophisticated institutional investors are looking to make loans on property around the globe. We, for example, focus in Australia, the U.S., the U.K. and Ireland.

Are investors using real estate debt as part of their real estate allocation? Or do they perceive it as fixed-income?

Technically speaking, it's fixed income. There's no question about that. The income is fixed. With that said, every institutional investor in the world has a different way of viewing what they do. So the question I have for the chief investment officer is: Where do you position a product that has a strong income return; which has inflation hedging characteristics; and which has significant downside protection in the event that values decline, but does not share in the upside? Where does that fit in your portfolio? The answers span a range. Many investors allocate it into fixed income. Some say this is a defensive, tactical real estate play. Some say it's alternatives. I try not to lead the witness. I describe the attributes and ask them, "I can see you're attracted by this product. Where does it fit for you?"

How do you invest debt through the cycles?

Since 1993, we've originated more than $22 billion in upward of 500 privately placed loans. And in those 23 years, there have been a lot of property, capital and economic cycles. But the nature of debt is that it expires, gets repaid and gets redeployed. There is always opportunity to be making loans through the cycle on an evergreen basis, but the way you succeed and minimize delinquencies is to be very stringent and systematic in your investment techniques. We're a very high conviction investor. We'll go higher loan-to-value and higher loan dollars on the best property in the best market with the best borrower. Through the cycle, the best property is going to have the best performance. We've learned what works and what doesn't, and we use very disciplined underwriting techniques on a very consistent, standardized basis. As new opportunities come in the door, they either meet our screen or they don't. And if they don't, we move on to the next opportunity. Finally, we put a lot of resources into the ongoing asset management of the loan. It's very difficult to make a good loan, but it's much more difficult over the course of five or 10 years to know what you own on a real-time basis. Therefore, we invest a great deal of resources in the ongoing management of the loan.

Is underwriting a loan different from underwriting an equity investment?

No, because we're making a loan based on the value of the property. Whether you're making a loan on the property or buying a property, you better be really good at valuing the property. When the loan matures and it's time to get repaid, the next lender is also going to be looking at value. If you inflate the value today, you're going to have a difficult time getting paid off. We utilize the exact same underwriting procedures you would use if you were buying the asset. However, we typically value the building lower than the appraisers because we are bearing downside risk without any upside. As a result, we must be very careful that we're modeling realistic assumptions on lease rental rates, growth rates, expense growth rates, and so forth.

What types of returns can an investor expect from real estate debt, and from Quadrant specifically?

It depends on the type of investor because different investors have different risk tolerances and, therefore, will get different returns. Over the years, we've been appealing to two different kinds of investors. In one group are insurance companies, which view mortgages as a staple of their fixed-income portfolios and make loans because they provide superior returns to similar credit corporate bonds — but they have no tolerance for delinquencies, so all loans must be as near to risk-free as possible. During 2016, we originated over $3.5 billion of loans on behalf of life insurance companies — 70 to 75 percent loan-to-value, with typically a 5- to 10-year fixed rate and a coupon of approximately 4 percent. This might not sound like a great return, but for the insurance company, whose alternative is a corporate bond at 100 to 150 basis points lower than that, it's a great investment.

And the second type?

The second investor groups that we appeal to are pension funds, sovereign wealth and other similar institutional investors. There we're challenged with delivering a return that might be 7 percent or better. Over our 20-plus years, we've delivered in excess of 8 percent net time-weighted returns for these types of investors. Obviously, for an investor that's seeking that sort of return, it's a different kind of loan with a different risk profile than the life insurance company "sleep-at-night" loan. But with that said, it still ultimately comes down to delinquencies. If you don't have many delinquencies, you're going to achieve the return objective that you thought you were going to get. Today we can achieve such returns in the U.S. with subordinate loans, typically mezzanine structures. In addition, today in the U.K., Ireland and Australia, we are earning prudent returns that are in that 6 to 8 percent range on simple "stretch" whole loans. These loans can be originated in high volume. Mezzanine loans offer even higher returns in these markets, albeit these opportunities are more tactical.

Are you investing overseas for U.S. investors or overseas investors?

Both. We started with a couple of separate account vehicles for overseas investors investing in Ireland and the U.K. With that as a foundation, we now have funds that are intended to appeal to U.K. and European investors, who are seeking to invest in their own backyards. In addition, we have vehicles for U.S. investors looking for higher returns on their debt investments than they can get in the U.S.

Why are you focused on the U.K. and Ireland?

There are a couple of reasons. First, the lending law is highly favorable for the lender. We are very comfortable that we can make loans in a prudent fashion and, if we need to enforce on our documents and foreclose, there is a simple path to protecting our clients. This is vitally important. Secondly, these markets have experienced a seismic shift since the global financial crisis, with a lot of the traditional lenders pulling back permanently. This has opened a very large and a very durable capital gap, which allows us to invest in great cities like London, Manchester, Birmingham or Dublin and get very significant returns relative to the U.S. without using any leverage.

But you are still investing in the U.S.?

Of course. We just do it a bit differently. For example, if we find an opportunity to make a loan that meets all of our parameters, we will keep the entire loan if it is for a life insurance client. For a pension fund, we would make the same loan but then, before closing, we would sell down a senior loan position and essentially manufacture a mezzanine position. We can get materially higher returns without a lot of marginal risk because it's the same loan we would have made on a whole-loan basis. We think manufacturing subordinate loans is the best way for pension funds to get closer to their actuarial return needs when making loans in the United States.

Are you seeing more competition?

There is definitely more competition now than ever, but the key to our success is very simple. We maximize our opportunities by maximizing our loan pipeline. We spend tremendous senior-level resources marketing our clients' capital to the key decision makers in the U.S., which are predominantly found in the brokerage community. In the U.K. and Ireland, there is much less of a presence of brokers and, so, we spend significant resources marketing our clients' capital directly to borrowers. It takes time to become a trusted source of capital, but we have been around long enough to develop those relationships. It is this pipeline and relationships, as well as the knowledge we've developed over more than two decades of working together as a team, that makes Quadrant successful for its clients.

CORPORATE OVERVIEW

Quadrant Real Estate Advisors is a registered investment adviser governed by the SEC, with approximately $7.4 billion of assets under management. Quadrant primarily focuses on debt investments collateralized by commercial real estate and has investment capability in the United States, Australia, Ireland and the United Kingdom, via its offices in Atlanta, London and Sydney. Quadrant is owned 100 percent by its management team.

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