Amherst Capital Management

Financing transitional real estate assets

Recently, **Jonathan A. Schein**, managing director of global business development at Institutional Real Estate, Inc., spoke with **Chris Kelly,** head of commercial real estate lending at Amherst Capital Management. The following is an excerpt of that conversation.

What is Amherst Capital's CRE lending team focusing on these days?

Right now, we are focusing on debt investments and providing first-lien financing for transitional real estate located in the largest 35–40 MSAs across the U.S. — which we believe is the sweet spot in today's CRE market.

How do you define transitional real estate?

It's important to note that transitional properties are a natural occurrence in the CRE lifecycle. These are properties that are underperforming their peer group, perhaps lagging their competitive set in occupancy or with materially lower rents. While these properties are not operating at a level that is consistent with market conditions, our research and data shows that these assets potentially present an attractive risk-reward opportunity.

Who would be your typical borrower?

Typically, we are providing senior debt to an institutional investor, such as a real estate fund that believes it can improve the operations of these transitional assets and create value. This institutional investor/borrower is usually part of a joint venture with an experienced real estate operator that has an underwriteable track record in successfully repositioning real estate assets.

I understand that you think the market is undervaluing these assets. Why is that?

At our core, Amherst Capital is a research- and analytics-based real estate investment manager, and we pride ourselves on our ability to assess risk in the market. Our research suggests the broader market traditionally overestimates the risk of lending on transitional assets and underestimates the risk of lending on stabilized properties. This results in a pricing inefficiency. For example, our data demonstrates that transitional properties with low occupancy have historically shown clear signs of increasing occupancy over time; these improving occupancies may result in potential value gains for transitional properties. Therefore, we see an attractive risk-adjusted return proposition for lenders, such as Amherst Capital, where we have an experienced and vertically integrated platform to originate and asset manage the loans on transitional real estate.

What are other market players missing that your research is seeing?

We believe it's a flawed assumption that a property that is currently in transition will remain in transition for an extended period of time. And it is just as flawed to assume that a stabilized property will continue to be fully leased for an extended period of time. We looked at commercial properties over a five-year period from Q4 2011 to Q4 2016, and segmented by property type and occupancy level to estimate the long-term value opportunity for each group. In evaluating low-occupancy properties versus high-occupancy properties, we found that there is a strong mean reversion, such that low-occupancy properties over time find tenants to take space, and occupancy levels for these properties ultimately increase to levels that are more in line with the market. We use extensive data and analytics to model numerous variables so that more comprehensive pricing data and risk assessments guide our decision making.

Where do you see the best opportunities in transitional assets today?

We see significant opportunity to invest today through the direct originations of first-lien loans secured by transitional real estate. We're targeting institutional groups that are buying these underperforming assets with a plan to bring property performance more in line with market conditions. The additional value created with these assets provides a greater equity cushion between our loan and the ultimate value of the property. Over time, our loan becomes safer as a result of the borrower/sponsor executing on their value-add business plan. We're financing the top five real estate asset types — office, industrial multifamily, retail and hospitality — and, on a selective basis, we will also consider other asset classes including single-family rental, self-storage and student housing.

We've talked about your research a bit, but maybe you can tell us a little more.

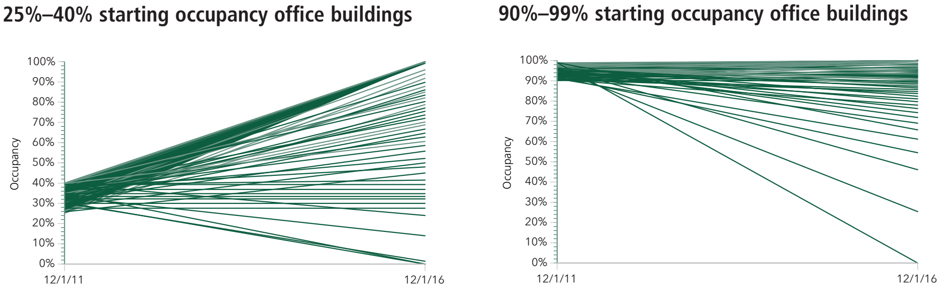
We are attempting to alter how the real estate capital markets leverage information and technology. In addition to the research team here at Amherst Capital, we have an exclusive agreement with our affiliate, Amherst InsightLabs (AIL). AIL has a 36-person team, including PhDs and data scientists, that has developed an extensive real estate database, which Amherst Capital uses to develop analytical tools and models for all of our investment activities. AIL recently developed an option-adjusted

Christopher Kelly
Head of Commercial Real Estate Lending

A 30-year commercial real estate professional, Kelly has extensive experience in real estate debt, mezzanine and equity markets. Prior to joining Amherst Capital, Kelly was a managing director and head of real Estate at CapitalSource, a division of Pacific Western Bank, responsible for all facets of the national real estate lending business. Previously, he was a managing director and founding member of Natixis (formerly known as CDC Mortgage Capital), responsible for the origination of senior and mezzanine loans. Prior to this, Kelly held similar roles at Lehman Brothers, and within the real estate division of Heller Financial.

Kelly is a graduate of the University of Wisconsin-Madison and a member of various real estate organizations including CREFC, ULI, ICSC and WREAA. He is a former board member for the Wisconsin Real Estate Alumni Association.

Change in occupancy: Dec. 2011 – Dec. 2016



Source: Amherst Capital Management estimates based on aggregation of Costar property data.
Note: Only starting and ending occupancies are shown, not the path of occupancy change over the period. Representative 100 paths shown from dataset.

pricing model specifically for our private lending business that enhances our ability to assess credit risk and systematically price loans for their level of risk. It allows us to compare opportunities on a relative basis, and select transactions that provide the best potential risk-adjusted return.

Why are you seeing debt as a better strategy than equity?

The current CRE recovery is starting to get later in the cycle. On average, real estate values are more than 13 percent above 2007 peak levels, according to Real Capital Analytics data as of Q4 2017. So we believe this is the right time to move to a more defensive position in the capital stack, while identifying sponsors who are buying transitional real estate with a plan to improve the real estate over a three- to five-year period.

Is this a change in strategy?

Our goal has always been to develop a best-in-class real estate asset management firm fueled by data and quantitative analytics, which we think is unique in the real estate market. We've hired seasoned investment professionals that are well positioned to execute on the strategies that we're currently pursuing. In addition to first-lien financing on transitional real estate, we have a private equity business that invests in stabilized, single-family rental properties, as well as a third strategy that invests in MBS. Significant analysis and research went into these three investment strategies and we continue to see positive momentum.

Why aren't other firms focusing on the transitional market?

This type of lending requires a very customized approach. Every transaction and every asset is unique and you need an experienced team that knows how to structure these loans to provide lenders with the optimal credit protection, while also providing unique solutions to the borrower. There is thought and creativity that go into every loan that we originate and the structure that supports that loan. Not many firms have the ability to do that.

The retail sector is in a transitional moment. How are your sponsors dealing with the challenges?

The retail market is facing significant challenges, but historically the sector has done a very good job of evolving to meet consumer demands. Consumption, or consumer spending, makes up roughly two-thirds of the country's GDP. Consumers are going to find a way to spend and retail has historically found ways to accommodate that drive. However, right now the retail sector is challenged, and like many other debt capital providers, we're looking at retail opportunities in a much more critical and conservative manner until the market reestablishes and repositions itself to be competitive in this new environment.

Which commercial real estate sectors do you see as less challenged?

Single-family rental housing has quite a lot of momentum. This segment appears to be capturing demand from traditional apartment renters, who are finding themselves priced out of for-sale housing. We strongly believe that single-family rental is a long-term investment opportunity. The other area that we think is poised for growth is industrial warehouse and logistics properties. Industrial is well positioned to grow because online retailers are expanding their distribution hubs and last-mile centers.

What common misconceptions do investors have about the current state of the market?

We think it's a common misconception that good investment opportunities no longer exist as we appear to near the end of the cycle. According to data aggregated by our Research & Analytics team, we estimate that the U.S. commercial real estate market is a $10 trillion asset class, and there is incredible diversity in the property types and markets. So, in spite of the current asset valuations and later-stage cycle, there are still many attractive opportunities. We think that the better risk-reward opportunities are in debt, where you are moving up the capital stack and can obtain favorable returns, particularly if you lend on transitional real estate. We expect there to be ongoing demand for debt to finance the acquisition of assets with transitional value-add business plans.

CORPORATE OVERVIEW

Amherst Capital is a U.S. real estate investment specialist with $6.1 billion* AUM. It offers a suite of traditional and alternative real estate strategies that span the risk-return spectrum.

CORPORATE CONTACT

Scott Barnum
Managing Director, Head of Marketing
212-303-1591
sbarnum@amherstcapital.com
www.amherstcapital.com

*As of June 30, 2017. This amount includes $4.5 billion assets pertaining to certain discretionary multi-sector fixed income clients of our affiliate Standish Mellon Asset Management Company, LLC ("Standish"), for which certain Amherst Capital employees provide advice acting as dual officers of Standish. In addition, discretionary portfolios with approximately $396 million are managed by certain of our employees in their capacity as dual officers of The Dreyfus Corporation. AUM includes gross assets managed in the single family equity and commercial real estate strategies, which include $244 million of leverage and $17 million of leverage, respectively.