LaSalle Debt Investors

Real estate debt is a steady craft for navigating a choppy market

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Glenn Sonnenberg,** president and CEO of LaSalle Debt Investors. Following is an excerpt of that conversation.

Share a little bit about your firm and some of your competitive advantages.

We have been highly focused on U.S. first-mortgage debt – the most secure place in the capital stack – since 2000. Continuity of our management team is one of our strengths, with the newest member of our senior team joining us more than 14 years ago. We've been through multiple downturns, together with periods of appreciation, so we're familiar with more than just how things can go right, but also how to mitigate risk for volatile times.

Having a strategy and sticking with it is important. We stay away from debt/equity hybrid products, and we avoid being little more than opportunity funds in the debt space. In the first instance, our focus is first-mortgage debt. On the second point, we think rigid adherence to a pure debt strategy where the manager isn't dipping into multiple strategies under the aegis of a debt fund fills the need of investors' asset allocation objectives.

Another differentiator is that we are focused on growth markets, which are where people are moving and jobs are being created. Real estate is a market laggard – there is no "intrinsic" value to a piece of real estate. Cash flows and real estate valuations will follow where people are going and where jobs are being created. Migration patterns around the country indicate there's a net migration away from traditional "gateway" markets and toward more attractive markets in the mountain states, the Southeast and the Southwest.

Additionally, we originate loans in an inefficient space – ranging from $5 million to $35 million. This size range exposes our portfolio and investors to secure product types, as well as risk-mitigating granularity. Our focus on transitional real estate finances assets at cash flows below the market, with a business plan to improve to market – yet not dependent upon significant market improvement.

Historically, two-thirds to 85 percent of our portfolio is multifamily, depending on the market. That's a strength, as multifamily is the most liquid real estate asset for a fixed-rate refinancing, and demand remains high. There is a sizeable market for bridge lending in this space, particularly in growth markets where many properties have not kept pace with capital improvements, amenities, energy efficiency and marketing. These properties benefit from short-term bridge financing in order to stabilize, to market mean occupancy and rent.

Often overlooked today are risks associated with concentrations within a portfolio of tenant credit, local economic exposure and single-asset underperformance. With a portfolio in the $5 million to $35 million loan size, there are many assets. This granularity ensures no single asset's or region's underperformance can significantly affect the portfolio. In this day of more frequent and severe weather events, it is even more important to ensure geographic diversification within a portfolio.

One more differentiator is that we don't focus on refinancing but rather on new acquisitions. More than 90 percent of our loans are new acquisitions, where someone is investing in a first-loss position in front of us, with a proven business plan. Even in refinancing situations, we typically require investment of new dollars.

What is the philosophy behind LaSalle's strategy?

We see ourselves as a private credit alternative and a real estate alternative. We sit in the space that benefits from the strengths of both. Debt should be a cash-flowing strategy, and it should provide uninterrupted cash flow from interest payments, which means we're focused on assets that produce cash flow and we make sure that we have sufficient interest reserves – funded by borrowers at loan origination, to ensure continuation of interest payments. We invest in strictly down-the-middle main street real estate that generates cash flow, and our loans provide the structure necessary to control that cash flow.

What markets sectors are you investing in?

We love multifamily because the country remains underhoused in many markets. It's still cheaper to buy than to build. There are headwinds against producing alternative supply, including political ones and the rising cost of labor and materials. These suggest apartments are and will remain a highly desirable investment type. Apartments also have the benefit of deep comparison sets, so you can value them regularly, and the value-add required is fairly straightforward. The other asset type we love is multitenant industrial warehouse and distribution. Last-mile distribution is important, and that sort of local contractor or operator – the local contractor, the local plumber, the local distributor – will always need space. Both of these asset types have the benefit of having a low fixed cost of operation.

We still like limited-service and extended-stay flagged hotels with a new property improvement plan, and we are scanning that market for opportunities. We typically avoid more volatile product types and non-cash-flowing assets, such as high-rise office, most retail and single-tenant assets.

What economic trends are influencing the debt sector?

Interest rates and inflation are at the top of the list. As rates stay high, cap rates are under pressure. This trend means that loan-to-value levels will remain lower than in recent years, as lenders ought not be increasing their basis at this time. Underwriting finally is tending to be moving in line with reality. As opposed to some, we have never looked to market improvement, where we have thought rental-growth assumptions were aspirational, rather than realistic. We're always looking primarily to asset improvement, and for assets that can perform in line with the current market rather than betting on the future. As rates rise, it means the fixed-rate, long-term financing exit is going to be more conservative, and that there will be downward pressure on pricing. We're less likely to see in the future the growth in pricing we've seen in the recent past.

Climate risk has also become a much bigger issue. People are only now starting to realize the cost of a major event is significant,

and the cost of insurance is much higher. This dynamic materially affects the underlying value of the real estate. Diversification will increasingly be important to investors. If I said, we only originate loans right along the San Andreas Fault, you would say I'm nuts. By the same token, if I said everything we do is in the Carolinas – well, a big hurricane comes through, and you have significant exposure. We have a very granular portfolio, with our last fund having 189 assets.

How is inflation affecting this vehicle strategy?

Real estate has historically been an inflation hedge. Rents historically tend to move with inflation and wage growth, so inflation, in that sense, is a positive. The issue with inflation is that the costs of labor and materials, as well as the cost of debt, become higher. Inflation does have an effect on pricing and on the leverage available from the fixed-rate market.

Borrowers have adjusted – nobody is asking us for 80 percent leverage. But inflation with rising rates does produce that risk on the back end, requiring you to take lower risk at the outset, which suggests real estate values will decline modestly. The good news with rates rising is that our existing loans are paying us on a floating-rate basis, so we're getting better returns. But things will settle down – the Fed has done everything it can to pump the brakes. Ultimately, real estate responds better to inflation than most other asset types, and debt responds better to inflation than equity.

How has the debt sector responded to these trends?

We have an example of two loans on two properties that are a mile apart from each other in North Dallas. One closed in September 2021 and the other, in March 2023. What you see is that the loan-to-value ratio has declined. The borrower investment has increased. Where you were doing 75 percent loan to value, now it's maybe 65 percent loan to value. That's very healthy. Borrowers are starting to want to ensure they have, for the duration of their loan, an identifiable source of payment and an identifiable source of repayment, when it comes time to pay off the loan. All the trends today are in favor of lenders.

Dependence upon financing at the portfolio level is much less. We never were financing our loans to stratospheric levels of, say, 85 percent of loan balances, as the recent CLO market would allow. We've found that financing at less than 60 percent allows the fund to negotiate terms and avoid the risks many accepted in the GFC.

How would you describe the investment opportunity in this sector?

Real estate debt allows the fixed-income people to take a more creative stance and be able to get return they couldn't get with fixed income, and it allows people on the real estate side to take a little less risk and trade it off for high current income. You get significantly greater returns compared with the rest of your fixed-income portfolio because real estate is an inefficient market. By not taking any appreciably different risk, you can boost your fixed-income portfolio. On the real estate side, if you want a risk-off strategy but also exposure to some of the real estate fundamentals, you can hedge some of your equity investment by having debt.

How should institutional capital think about this vehicle strategy?

It's a trade-off for current return as opposed to speculative return. Equity depends upon appreciation for much of the return. Real estate debt is more conservative; it offers better positioning in the capital stack, and you have relatively low downside risk. In a down market, debt historically outperforms equity. In a choppy market, debt historically outperforms equity. Only in a growing, appreciating market can equity outperform debt, but not on a current-income basis – only on the appreciation basis. I'm not saying investors should be all in debt; I'm just saying it is wise to have it as a part of an investment strategy.

How specifically does your firm add value?

First, we've been through multiple downturns. Our group experienced the Russian ruble crisis and the GFC and the tech wreck. Second, we have real estate workout and management expertise. The fact is, when you're doing anything in real estate, there is a chance something untoward will happen. You have to be able to deal with things as they come up, and having real estate expertise in addition to capital markets expertise is important.

Lastly, we've been in the market since the early 2000s, and that continuity of working together is important. Being in the market for a long time means people know us. For us, the mortgage brokers are the people with whom we are expanding our relationships. They are the ones looking for certainty-of-closing dependability. Lastly, being part of an institution that has a deep bench of research and people is valuable. If we're concerned about a particular market or opportunity, we can get detailed market analysis we can use.

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Glenn Sonnenberg, President and CEO, LaSalle Debt Investors

Glenn Sonnenberg is president and CEO of LaSalle Debt Investors. He has been directly responsible for the acquisition, management and/or disposition of more than $6 billion of real estate and debt investments in the United States and Canada, as well as the issuance of more than $1 billion in collateralized debt obligations. Prior to joining LaSalle Debt Investors, Sonnenberg served as managing director of Prudential Carbon Mesa, where he was co-CEO and the senior executive for funds management and served as acting-COO of the parent (NASDAQ:WMFG).

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COMPANY OVERVIEW

LaSalle Debt Investors (LDI) is a $1.2 billion debt fund business, known previously as Latitude Management Real Estate Investors. LDI originates new bridge loans for value-add and transitional properties in sustainable growth markets throughout the United States. LDI has managed a series of commingled debt funds, the fourth and most recent having a total equity raised of approximately $480 million. LDI's cycle-tested management team and vertically integrated platform has supported LDI's ability to close more than $4.5 billion in transactions across all primary commercial real estate property types.

LaSalle Investment Management is one of the world's leading real estate investment managers. On a global basis, the firm manages approximately $79 billion of assets in private equity, debt and public real estate investments as of the fourth quarter of 2022. The firm sponsors a complete range of investment vehicles, including open- and closed-end funds, separate accounts, and indirect investments. Its client base includes public and private pension funds, insurance companies, governments, corporations, endowments, and private individuals from across the globe. For more information, visit www.lasalle.com.

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