CrossHarbor Capital Partners

Building in the path of growth

Financing multifamily and industrial opportunities where population and job growth fuel demand

A Q&A with CrossHarbor Capital Partners' Richard Flohr

Where do you see opportunity in commercial real estate credit today?

When you think about lending opportunities in today's environment, everybody thinks the higher return, the better the opportunity. In our experience, that's not the case. You should measure returns against risk to determine if you are getting paid commensurately with the risk you are taking. In our view, lower-leverage senior mortgage construction lending on multifamily and industrial properties currently offers an opportunity to achieve superior risk-adjusted returns.

Conventional wisdom tells you that construction lending is risky. This is a simplistic view that lumps all property types together. In our view, there is more risk financing the construction of offices or hotels than multifamily or industrial construction loans. Our thesis is that this "lumping together" results in the mispricing of multifamily and industrial construction loans. As lenders, we believe we can capitalise on this and get paid attractive current-pay returns relative to the risk we are taking.

What about the housing market makes construction lending attractive?

There are a lot of headlines about multifamily fundamentals softening. A meaningful amount of supply is undoubtedly coming online in certain cities, but it will likely be concentrated in the near term and delivered during the next 12 months. With a lack of available project financing, it's our view that a significant number of "planned" or "proposed" projects will not get capitalised or be built. So, our outlook for supply in 24 to 36 months is much more muted than what we're seeing today.

A multifamily construction loan we finance today will fund a project delivering units in 18 months to 24 months, depending on the size of the project. By that time, existing inventory should be absorbed, and there will be little to no new inventory being delivered, as a result of the slowdown in construction starts, as I described. Said another way, our collateral for the construction loan should be the newest game in town at a time when there will be very few new competitive units.

Demand remains strong because homeownership for many in the United States is prohibitively expensive and financially unattainable today. Population growth and household formations are still positive, and we believe these trends will increase the "renter by need" cohort, furthering the demand for multifamily rental units. At the same time, rental supply is declining, creating a favourable supply/demand imbalance.

How can industrial still be attractive after the run it has had?

When people think of industrial, they often think of one big asset class that's all the same. Yet, within industrial, there are subtypes that perform differently. In some markets, demand for large, bulk warehouses is softening. Meanwhile, there is tremendous growth in logistics-focused demand in certain markets with continuing growth of ecommerce, onshoring and just-in-time delivery.

The industrial inventory is ageing. According to JLL, 75 percent of the industrial inventory in the United States is at least 20 years old, and more than 25 percent is over 50 years old! That's significant because 25 years ago we were building to 24-foot clear heights. Today, those clear heights are potentially obsolete for many tenants who use racking systems that require a higher minimum clearance.

So, tenants are demanding features and higher clear heights that meet their logistics needs. Tenants such as Home Depot, Walmart and Amazon will drive demand for new class A space. We think this supply/demand imbalance should mitigate the lease-up risk for industrial construction lending.

What are the risks in construction lending and how do investors mitigate that risk and earn a healthy premium?

The main risks you take with construction lending are lease-up, which we talked about earlier, and completion.

When you make a loan on an *existing* building, you don't have to worry about whether it will get built. When you make a construction loan, you do. CrossHarbor typically requires personal guaranties of completion from well-capitalised and experienced borrowers/sponsors to mitigate this risk. With a sizeable net worth – often in excess of US$1 billion – these guarantors put meaningful equity at risk in the project, which aligns interests and ensures the property will be built.

In addition, our loans require Guaranteed Maximum Price [GMP] construction contracts. Under a GMP contract, the general contractor tasked with building the property guarantees that development hard costs will not exceed a certain amount. Importantly, CrossHarbor monitors construction progress monthly to ensure sufficient capital remains to complete the property. If there is a cost shortfall, the borrower must fund any deficiency before we fund additional loan proceeds.

What impact is inflation having on new construction?

The biggest impact has been on the costs of materials and labour. Prices for both labour and materials soared due to inflation and supply-chain challenges. As inflation stabilises and supply chains return to normal, we anticipate material costs will come down, and we're already seeing signs of that. When construction lending slows, construction work also slows, lowering demand and cost of construction labour.

Have you changed your lending requirements given the environment?

The biggest change is that we're lending less and facing less competition from banks. This lower loan-to-cost level is also a big mitigant for some of the risks previously discussed, as lower loan-to-cost ratios provide larger cushions for market shocks and help create very attractive risk/return opportunities. The last several loans we've originated were at 65 percent loan-to-cost, significantly lower than the 75 percent levels we provided one year ago.

What market conditions do you look for when considering a construction loan?

We target markets that have attractive population and job-growth metrics. More people mean more housing is needed, and more jobs means more space is required. We also target markets with limited for-sale housing supply and higher housing costs, as these dynamics combine to increase the need for rental housing.

In addition, a growing population means higher demand for goods. We focus on target markets with low industrial vacancy rates, and demand from industrial occupiers, such as Home Depot or Amazon, where the demand/supply imbalance supports new industrial construction. So, for both multifamily and industrial, we follow the jobs, and the people moving for jobs.

What effect is the interest-rate environment having on the market today? What effect might it continue to have?

No consumer wants to pay more. But your tolerance to pay more isn't always the same. What I mean by this is, if you take out a mortgage to buy a house today at a higher interest rate than it was one to two years ago, you have a higher cash expense you must pay the bank out of your available income.

A construction loan is a little different because interest is capitalised into the total project budget (i.e. the loan also finances the interest payments). So, higher interest rates will increase the cost to complete the building, but a borrower is not coming out of pocket each month for the higher interest expense, as it has already been accounted for in the overall construction budget. Generally, this leads to less price sensitivity among construction borrowers who need to finish their project.

Is this just a short-term opportunity?

Right now, a confluence of factors is creating attractive investment opportunities we believe will persist in the longer term. Banks have pulled back from construction lending due to increasing capital charges required for construction loans. Additionally, banks are not getting the payoffs they expected as existing loans continue to be extended, which clogs their balance sheets and makes it difficult to free up capital for new construction loans. According to Trepp, CRE loan originations fell from US$4.7 billion in the first quarter of 2023 to US$2.5 billion in the third quarter of 2023. This represents more than a 50 percent drop in origination volume. This means there is less competition, and private lenders are in a position to negotiate better terms than they were historically, driving lower attachment points [LTC/LTV] and stronger covenants in favour of the lender.

We don't anticipate banks will return to construction lending for the next couple of years, and when they do, we believe the regulatory pressures will continue to make construction lending less attractive. We also believe future bank construction lending will be at significantly lower loan-to-cost levels than where private lenders will be. So, this presents an attractive longer-term opportunity with a very positive outlook for investors.

What's the most valuable characteristic in a manager in a market like this?

Experience. CrossHarbor was founded 30 years ago by professionals with a commercial real estate banking and lending background with expertise in finding opportunities in downturns, such as the S&L crisis and the GFC. As a firm, we have been lenders and investors through multiple cycles. Half of our US$16 billion of investments have been in real estate debt. That makes us lenders, and there is a big difference between having capital to lend and being a lender.

Why isn't everyone using a similar multifamily and industrial construction lending strategy?

Because you have to know what you're doing. Construction lending requires a different level of detail than conventional lending. Every month you're starting from scratch; it's labour intensive, which means you need an infrastructure of people with experience, and a culture of proactively managing and monitoring assets.

CONTRIBUTOR

Richard Flohr
Partner and Portfolio Manager
CrossHarbor Capital Partners LLC

Richard Flohr is a partner and portfolio manager of CrossHarbor Capital Partners LLC. Prior to joining CrossHarbor in 2018, Flohr was a managing director at Prudential Mortgage Capital Co, where for 28 years he worked in a broad range of roles on the equity, development and debt sides of Prudential's real estate business.

COMPANY OVERVIEW

CrossHarbor Capital Partners LLC is a Boston-based real estate investment firm with offices in Big Sky, Chicago and Los Angeles. Since its inception more than 30 years ago, CrossHarbor has invested in more than US$29 billion of core-plus, value-added and opportunistic debt and equity commercial real estate transactions, and the firm currently has US$9.6 billion in assets under management in several investment programmes along the risk-return spectrum.