

Mesa West Capital

Recently, **Geoffrey Dobrmann**, publisher and editor-in-chief of The Institutional Real Estate Letter – North America spoke with **Ryan Krauch** and **Mark Zytke** of Mesa West Capital. The following is an excerpt of their conversation.

Can debt produce attractive yields to investors in today's low interest rate environment?

Ryan Krauch: Absolutely. Even the more conservative lending strategies are generating in excess of 8 percent and as high as 16 percent gross returns depending on the risk of the underlying debt. The appealing part is that the bulk of the return is current and immediate since loans typically pay current starting the first month — this is a great offset to the “J-curve” of most equity investments. Being able to generate income that meets most actuarial requirements but maintains strong downside protection is a powerful tool for any portfolio.

In the past year, Mesa West led specialty finance firms by originating about \$1 billion in first-mortgage debt, with a number of those loans secured by non-stabilized assets. Why did you adopt that strategy during these tough economic times?

Krauch: The credit crisis and economic downturn have caused many high-quality real estate assets to become undercapitalized or mismanaged. We can underwrite what these assets can and should produce in the current marketplace given proper capitalization and management with a new, high-quality borrower. We believe that by being in a low leverage position in the capital stack that we can, in a very safe way, support the stabilization of these assets and participate in the recapitalization of the institutional-quality real estate markets in the U.S.

How will these assets be able to compete in the current market and reach stabilization?

Mark Zytke: Many assets were purchased in 2005–2007 at very high purchase prices and with very high levels of debt. By entering into a new transaction where either the old owner has received a discount on the debt or new ownership has come in at a reduced basis, capital will be available and incentives will be aligned, so the new ownership entity can improve the asset and attract tenants with competitive leasing terms relative to today's market.

How would you characterize the loans you're making? Would you say they're distressed?

Zytke: No. The underlying assets are high-quality, institutional properties in strong markets. Some are stabilized while others are in a different point in their lifecycle that require capital and/or leasing efforts. Ultimately we do not lend against assets or to borrowers that are fundamentally distressed — this introduces too much volatility in a model that seeks low risk.

Would you consider this to be a high-risk strategy or a low-risk strategy?

Krauch: First-mortgage debt origination is a relatively low-risk strategy because the borrowers are



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Ryan Krauch is a principal at Mesa West Capital. Prior to joining the firm, he led the acquisition efforts for Somera Capital Management, a value-oriented real estate private equity firm. Prior to joining Somera, Krauch served as a consultant for one of the Big Five consulting firms.

investing significant equity into the transaction at today's reset value. Lender's like us are typically lending 50 percent to 65 percent of that reset value. So there is a very large equity commitment in the asset and the lender gets to participate senior to that, earning an attractive return on a current basis.

Speaking of low-risk strategies, institutional investors have always been attracted to core real estate; however, an abundance of capital has driven up pricing on core real estate to near 2007 bubble levels, with cap rates in the 5 percent range or less. What does this imply for this sector?

Krauch: Purchasing at low cap rates could be justified if economic fundamentals were strong and rent growth a real near-term possibility. Unfortunately, except for multifamily and select geographical markets, it is hard to make a case for rent growth given the high current market vacancies and weak economic conditions. Therefore, to generate target returns, core buyers must rely on cap rates remaining low. Historically, core property cap rates are approximately 2 percent above long-term interest rates. If the 10-year Treasury returns to its historical norm of approximately 5 percent, that implies cap rates for core properties in the 7 percent range, which is a significant percentage change in property valuation. The combination of rising cap rates and a lack of meaningful rent growth would be catastrophic for core property valuations.

So what you're telling me is that a seemingly conservative core equity investment may be riskier than we think?

Zytke: Absolutely. However, that doesn't mean investors need to turn their back on core. The objectives of a typical core allocation are high current income, downside protection and high-quality assets. These goals can be achieved through a debt program that focuses on lending against core and core-plus assets. Not only can the debt approach generate outsized current returns relative to core equity today — which in many cases are generating

low single-digit real returns — but the investor's capital is in the lowest part of the capital stack rather than the highest. This creates an outstanding risk-adjusted return and typically meets the actuarial yield requirements of most plans.

Wouldn't investors be forsaking core investments' upside by investing in a core debt fund and locking in yields for the five- to 10-year duration of the loans?

Krauch: There is no doubt that debt investment lacks significant upside. However, I would argue that the upside of core investments purchased at a 5 percent cap rate is limited at best, and in fact there is more risk to the downside than the upside in this current low cap rate/low growth environment. Importantly, the core allocation of a portfolio is intended to be defensive rather than offensive — so generating stable yield and protecting downside is typically the purpose of core investments. If interest rates do rise, a core investment could get crushed because rising cap rates will follow, whereas a debt investment will generally produce its expected yield in the same scenario.

We're seeing some improvement in the economy and have been seeing it for a while. It's slow though. Do you think now is a time for investors to be on offense or on defense?

Zytko: Now is a time to be offensive on things you can control and be defensive or protected against things that you can't control. We like to seek out first-to-lease buildings in strong and diverse markets with well-capitalized sponsors that we have confidence in. We like to be on the defense against things like interest rate changes, which imply exit cap rate changes.

Do you think the Federal Reserve is going to be able to preserve low interest rates to the end of 2014? What role does real estate debt play for institutional investment in a low interest rate environment?

Zytko: I don't know how the Fed is going to keep rates low, but I also don't see the impetus for rates going up. Job growth is not strong, so I don't see a real push for rates to go up in the near term. What real estate debt can do in this environment is provide a lot of current income at a time when other pieces of institutional investors' portfolios are not providing income. Fixed income is paying 2–3 percent, so a debt program that can distribute 7–8 percent current income has a real role in meeting long-term pension liabilities.

You lend on the five main commercial real estate food groups, but have recently been avoiding multifamily. Why is that?

Krauch: That is correct — traditionally, a significant portion of our portfolio has been multifamily, and today that is much, much lower. Most lenders and investors view multifamily as a lower volatility investment. In general we would agree with that, but right now there is a massive supply/demand imbalance of capital in the multifamily lending space from Fannie Mae, Freddie Mac and others. There is too much capital chasing too few deals, which is a proven recipe for disaster whether in debt or equity.

A few years ago, it was almost unheard of for institutional investors to place capital in debt funds, but now the market is starting to get a little crowded. What sets Mesa West apart from the alternatives?

Zytko: We were one of the first to try to make commercial real estate loans in a private equity context, so one thing that sets us apart is our long track record and great depth of experience. The second factor is we showed great discipline through the run-up and through the downturn. Other platforms and lenders grew faster than us in 2005 through 2007. We saw risk, and we stayed disciplined.

Krauch: Within debt, we are one of the few groups that are lower leveraged, income-oriented lenders. The bulk of debt funds are focused on distressed, mezzanine or higher leverage lending strategies. Our approach is by design an unsexy, straightforward strategy that prioritizes income generation and downside protection. So the product itself is differentiated from the market.

How can investors be confident that you guys understand the risk you're taking and that they're going to get paid appropriately for that risk?

Krauch: Strategically, in equity funds, investors can take risks from core to opportunistic and evaluate the corresponding return. It's no different on the debt side. We usually counsel our investors that debt is typically limited in upside, so they should invest in the safer, more income-oriented debt strategies focused on high-quality, well-located assets. The other part of the analysis is track record. Investors need to evaluate what sort of decisions managers made relative to their strategy as compared to what they told investors their approach would be. A lot of managers got into trouble because either they didn't understand or appropriately convey the risks involved in what they were doing, or they promised one thing and took a different path. Both of those scenarios resulted in bad outcomes, and a lot of those groups are not going to see investors recommit as a result.

Zytko: No institutional investor on the corporate side of their investments would be all in public equities or all in fixed income, yet people for years have approached commercial real estate and basically have been all in equity. The fact that they haven't invested in commercial real estate debt until now in a meaningful way is kind of surprising to me. ♦

CORPORATE OVERVIEW

Established in 2004, Mesa West is a leading commercial real estate debt fund manager originating loans throughout the United States. With offices in Los Angeles and New York City, Mesa West's team actively sources and manages its loans from origination through repayment. Mesa West manages capital on behalf of institutional public and private pension plans.

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