Mesa West Capital

Ryan Krauch is a principal at Mesa West Capital. Krauch is active in all areas of the company's activities and is a member of its investment committee. 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 Four consulting firms.

Mark Zytko is co-founder and co-CEO of Mesa West Capital. Prior to forming Mesa West, he served as head of Credit Suisse First Boston's West Coast region. Previously, Zytko was vice president at GE Capital Real Estate and head of its Seattle office.

Jeff Friedman is co-founder and co-CEO of Mesa West Capital. Prior to forming Mesa West, he was head of capital markets for Maguire Partners. Previously, Friedman was a director at Credit Suisse First Boston.

Recently, ***Geoffrey Dohrmann,*** *president and CEO of Institutional Real Estate, Inc., spoke with* ***Ryan Krauch, Jeff Friedman*** *and* ***Mark Zytko*** *of Mesa West. The following is an excerpt of that conversation.*

Why has there been so much interest from investors in real estate debt in the past few years?

Ryan Krauch: The short answer is risk-adjusted returns. Following the downturn, investors shifted away from a risk-tolerant, total-return mentality and instead looked to maximize current income and overall return for the lowest unit of risk available. Many have found this trade-off in the debt space because it provides access to the same real assets, but at a safer position in the capital stack. Debt also provides additional product diversity within an investor's commercial real estate portfolio.

Given the market changes, can investors still find attractive yields in real estate debt?

Krauch: Even the more conservative debt fund strategies can generate in excess of an 8 percent gross current return to investors — a very healthy spread to the risk-free rate without taking much risk in the debt position. And by adding incrementally more risk, investors can see yields in the 10 percent to 12 percent range, which compares favorably and often exceeds the benchmark.

Where do you see interest rates heading, and how does that affect debt strategies?

Jeff Friedman: We structure our investments such that interest rate movements in either direction do not have a large impact on returns. This means good downside protection for our investors, and they are in effect getting a hedge against interest rates. The sacrifice is that there is not a huge upside in a debt vehicle, but most of our investors get that upside from other areas of their portfolio where the risk tolerance is higher.

Is debt a cyclical opportunity and, if so, where are we in that cycle?

Friedman: It depends on the specific debt strategy. Clearly strategies that focus on distressed and opportunistic debt are cyclical by definition, and there are probably fewer opportunities in today's market for that approach. But the more conservative lending strategies have been a part of the long-term allocation for banks and life insurance companies for decades — and this approach is not as affected by market cycles. Mesa West provides this same long-term strategic debt allocation to pension plans to further diversify their portfolio and generate high current income and capital preservation regardless of market cycles.

What advice do you have for investors who are looking at real estate debt investments for the first time?

Krauch: It is important for investors to understand what role they want debt to play in their portfolio. For most of our investors, it is a way to generate very high relative current income per unit of risk. I think all investors have a home for investments that generate immediate income and have lower volatility. So the question becomes: Where do you allocate within the universe of debt, and which managers are best equipped in that particular space? We encourage investors to focus on originations-oriented strategies, where managers can hand-select and custom-tailor the opportunities. Importantly, investors should identify managers who have a background in underwriting credit and holding and managing risk, as opposed to selling that risk to others.

Mesa West launched an open-end fund exclusively dedicated to core real estate debt. Why?

Krauch: Many investors are looking for alternatives to the traditional core, open-end equity funds given the high valuations and low relative current returns of that sector right now. A core, open-end debt fund can achieve all the same objectives of a traditional core allocation: high-quality real estate in strong locations, high current income and downside protection. Plus, it provides the liquidity of an open-end fund that allows LPs the opportunity to have more control in their portfolios.

Can you explain how liquidity works in the context of an open-end debt fund?

Friedman: Investors can invest in, or redeem from, an open-end debt fund every quarter, similar to open-end equity structures. The unique aspect is that the liquidity is generated because loans are contractually obligated to pay off at specified dates, usually every four to five years on average. This means that 20 percent to 25 percent of the portfolio will repay each year, providing significant liquidity. Moreover, this removes the potential conflict that is inherent with equity funds where the manager could choose to sell assets at inopportune times to generate liquidity.

Does this open-end structure allow investors to make allocations from different parts of their portfolio?

Krauch: Yes. We are seeing investors make commitments out of their core real estate allocations, and for some out of their fixed income buckets. Additionally, many plans are starting to set up separate debt allocations.

We continue to see new debt funds being formed. Will this create a challenge for Mesa West in differentiating its strategy?

Friedman: We have always had a fairly unique approach to lending. Most private equity funds have historically focused on distressed debt, opportunistic lending and mezzanine loans. We have always focused on first-mortgage loans, and more specifically higher-quality real estate in strong markets with experienced sponsors. We have been doing that since 2004. It is not the "sexiest" private equity strategy, but it provides a high current income component to counterbalance the more typical J-curve return profile of other debt and equity investments.

With this increased competition, can debt funds still produce attractive yields to investors, or are you forced to lower your target returns?

Mark Zytko: They absolutely can. Even a core/core-plus conservative lending strategy can still generate mid to high single-digit IRRs while lending on quality properties. There are ways to stretch these returns, such as lending on lower-class properties in tertiary markets, but opportunity still remains to lend on institutional-quality properties in highly sought after areas while delivering the promised return. We prefer to seek assets that fall into the latter category and boost our returns with core equity–like portfolio leverage.

How do investors classify a real estate debt investment — is it real estate or fixed income?

Friedman: We have seen it both ways. Many investors look at the first-lien security and regular quarterly distributions and call it fixed income. Others want their real estate teams evaluating the underlying assets, and so they put it in their real estate allocation.

So how do investors benchmark the returns?

Zytko: This has been a challenging element for some investors. The real estate staff for retirement funds are often compensated against certain benchmarks such as NCREIF or ODCE. However, these benchmarks are not appropriate because they generally do not contain similar debt investments, and therefore do not adequately compare the risk element to the return component. As real estate debt is becoming a more common part of investment portfolios, we are seeing the more savvy investors either benchmark against fixed income indices or create risk-adjusted formulas that equalize NCREIF based on the safer position in the capital stack of debt investments.

We have seen many investment vehicles enter the market over the past several years, but few have been successful in raising capital. Mesa West has exceeded its fundraising goals for the second time in the past three years. To what do you credit to your success?

Friedman: When Mesa West opened its doors in 2004, you could count on one hand the number of private debt funds that were focused on commercial real estate. Today, investors are certainly craving the income and safety of debt, but they are also looking for managers with proven track records. Mesa West has been able to provide top-quartile returns throughout the great financial crisis, which has given our investors tremendous comfort that we can help them achieve their actuarial yields with the least amount of risk possible.

What about your strategy and products themselves — are there any differentiating points from competing debt funds?

Krauch: Our specialty is debt origination. This means we source the deals and underwrite each one individually based on the merits of its credit. This allows us to have intimate knowledge of the underlying collateral and the borrowers, and also allows us to build in the structural features that are so important to successfully managing a loan portfolio. We hold all of our loans on our balance sheet to maturity instead of selling or securitizing them. This provides a great alignment of interest with our investors and keeps us focused on risk mitigation.

You focus on first-mortgage loans. What is your view on B-note, mezzanine, participating debt and other instruments?

Zytko: There are viable investment approaches to all of these instruments. However, we believe in general that they should be used tactically in an investment portfolio. First mortgages can be a longer-term strategic investment where capital can be appropriately deployed in any part of the market cycle. Obviously the first-mortgage position is also the safest in the capital stack, but more importantly the recorded lien also provides important and powerful tools for risk mitigation. ❖

CORPORATE OVERVIEW

Mesa West is a real estate finance company with a capital base of more than $3.5 billion. With offices in Los Angeles and New York City, Mesa West has an established debt platform that continues to provide flexible and reliable capital for real estate acquisitions, refinancings and recapitalizations on office, retail, industrial, multifamily and hotels across the United States. Mesa West has been exclusively dedicated to commercial real estate lending since its formation in 2004. As one of the few lenders to survive the credit freeze and remain active throughout, Mesa West is a leading provider of commercial real estate debt and one of the most active portfolio lenders today. Investors in Mesa West's funds comprise institutional plan sponsors seeking high current income and downside protection.

CORPORATE CONTACT

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