Mesa West Capital

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

This year we have seen spreads compress, but the indicators such as the 10-year Treasury have increased. How has this affected the debt markets and the supply of lending capital?

Jeff Friedman: Rates on a historical basis are still very attractive to borrowers, which have continued to fuel the transaction market. From a lender's perspective, spreads have narrowed but are still, for the most part, maintaining a reasonable floor. Competition is stiff in some areas of lending, particularly for higher quality, stabilized assets. However, some capital has pulled back — most notably CMBS — as the Treasury ticked up. Meanwhile, there remains an undersupply of capital in other areas of the lending markets such as bridge loans.

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

Ryan Krauch: Absolutely. 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 10–12 percent range, which compares favorably to the returns being generated from the subordinated equity.

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 impacted by market cycles. Mesa West seeks to bring this same long-term strategic debt allocation to pension plans to further diversify their portfolio and provide vehicles that are focused on high current income and capital preservation regardless of market cycles.

Mesa West raised more than $1 billion in the past year — a healthy sum in an otherwise challenging fundraising environment. Does this investor interest represent that long-term commitment to debt you mentioned, or do you think it is more tactical?

Krauch: More and more investors are creating specific allocations within their portfolio for real estate debt, which would indicate they are committed to the asset class. In fact, in May, your publication reported that 66 percent of all capital raises in 2012 were targeting debt compared to only 7 percent in 2006. We have seen most of our investors re-commit to our various funds over the past nine years, so I think it is becoming a strategic allocation. The high current income profile of performing debt and relative safety of being lower in the capital stack creates a nice complement to the "J-curve" effect of similar yielding equity investments.

Jeffrey Friedman co-founded Mesa West Capital and is involved in all areas of the company including originations, asset management, investor relations and operations. Prior to co-founding Mesa West, Friedman was a principal at Maguire Partners. He began his real estate finance career in New York City at Nomura Securities in 1994 and later moved to Credit Suisse First Boston in 1996, where he was a director and led one of the largest origination teams.

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 Five consulting firms.

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Mesa West recently launched the only open-end fund exclusively dedicated to 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 limited partners 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 20–25 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 setup 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 continue to focus on first-mortgage loans — and more specifically higher quality real estate in strong markets with experienced sponsors. 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.

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

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.

As the appetite for debt increases, some limited partners are opting to invest through separate accounts rather than through funds in order to have more control over their investment strategy. As a fund manager, how do you respond to that?

Krauch: Separate accounts for debt programs have many of the same pros and cons as their equity counterparts. However, I think one of the biggest differences is that debt, particularly first mortgage, tends to represent the bulk of the capital stack. This means a limited partner needs to commit a lot of capital to get proper diversification in a separate account. There are very few limited partners that have the scale to do this, so I think we will continue to see the majority of debt investments coming through commingled funds. ❖

CORPORATE OVERVIEW

Mesa West Capital is a privately held portfolio lender with a capital base of more than $3.5 billion. Headquartered in Los Angeles with an office in 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. Established in 2004, Mesa West manages capital on behalf of institutional public and private pension plans. Mesa West's team actively sources and manages its loans from origination through repayment.

Established lender

- Relationship-oriented portfolio lender
- Flexible, nonrecourse first-mortgage debt
- Loans held on balance sheet; not securitized or sold

$3.5 billion lending capacity

- Long-term discretionary capital from pension funds
- Local decision making
- Speed and certainty of execution