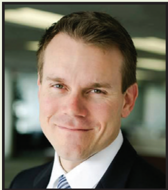
Mesa West Capital



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.

*Recently, **Jonathan A. Schein**, managing director of global business development at Institutional Real Estate, Inc., spoke with **Ryan Krauch** of Mesa West Capital. The following is an excerpt of that conversation*

Many believe we are in the later innings of the current real estate cycle, so is it time to start looking at defensive strategies?

It is never too early to look at defensive strategies, and any well-balanced portfolio will always have defensive elements to it. I do think we are starting to see investors using defensive strategies more actively. Whenever you see high asset prices across the board paired with historically low cap and interest rates, investors get concerned.

What are some of the strategies being used?

Defensive strategies typically involve moving down the risk spectrum and, with most investors, that begins with core investments. The risk to core equity in a falling market is that you own the last dollar in the asset. When the markets cycle, you have risk to the downside. The great part about debt is that you don't have that immediate risk. You are much lower in the capital stack so, by definition, it's a very defensive strategy and provides for a lot of downside protection. The flipside is you don't get the upside, and that is the tradeoff. That's why you have a balanced portfolio, where you have some elements providing upside enhancement and others providing downside protection.

Is the amount of real estate debt in portfolios increasing?

Historically, pension funds were nearly 100 percent invested in fixed-income debt. During the past few decades, however, we have seen portfolios diversified tremendously across equities, private assets and other investment classes. I think now we are beginning to see a renewed interest in debt, although in a different format than a traditional bond portfolio. Specifically, private equity, real estate and infrastructure debt are all of interest to investors, and new funds have been formed to satisfy this demand. So, yes, real estate debt in portfolios is increasing, and I expect it to continue to climb for quite some time, especially since most pension funds are looking for actuarial returns with the lowest risk possible, and debt, whether real estate or otherwise, has that capability.

Cap rates are currently at historic lows. When they begin to rebound, will returns on debt investment be affected?

That's the beauty of debt — it protects the downside. If you are in a low position in the capital stack, and your collateral is high-quality real estate that people desire over the long term, you really should not see material negative impacts on your investment portfolio. In fact, if you are in a floating-rate debt portfolio, you are going to see the benefits of increasing interest rates over time, which presumably would accompany a rising cap-rate environment.

When we started this business 12 years ago, we told investors we were going to create high current income with downside protection — and that's exactly what the model has done. No matter what the economic environment, current return and downside protection is the theme of debt.

Given that current return and downside protection is the theme of debt, how does Mesa West differentiate itself from the competition?

We were one of the original private investment firms to enter the traditional first-mortgage lending space. We don't do distress, mezzanine or rescue financing. We originate very traditional loans that banks and life insurance companies have been making for a long time. We introduced that investment capability to the private markets, institutional investors and public pension plans. Of all the debt funds, we are probably the most conservative strategy out there because we focus on high-quality, first-mortgage loans in the top markets. We have been doing this for a long time, and because we hold our loans on our balance sheet rather than buying, trading or securitizing them, we have built a very good track record and a very good reputation among both borrowing clients and investors. Both have shown their support by providing us with repeat business.

Since the great financial crisis, we've seen a stricter regulatory regime enacted. What challenges and opportunities has this created for Mesa West?

It might seem counterintuitive, but these regulations have actually presented an opportunity to private investment debt funds. As I said before, banks and life insurance companies have been in this space for a long time for the same reasons that public pension plans like the space — it meets their actuarial yield requirements; it's steady income; it's conservative, and the collateral is high-

quality, real assets across the United States. Today, however, regulations are making it hard for traditional lenders to provide the same amount of capital they have in the past at the same cost. In fact, it makes it hard for some to even stay in business. G.E. Capital, which at one point was the top lender in this space, decided to leave the lending business due to the new regulatory environment. The other major players from 2006 and 2007 are lending significantly less today than they were then, even though the demand for debt today is the same as it was back in that period. This creates a tremendous opportunity for private investors to come in and backfill some of that space. So the supply/demand perspective looks very good for private investors, and we expect it to stay that way as the regulation continues to roll out through 2019.

So does that mean there is less competition for the high-quality assets you pursue?

It depends on the asset. If you are focused on 10-year, fixed-rate lending on Midtown trophy assets in New York, for example, it's very competitive. There is an oversupply of capital for that space because it is one of the few spaces that banks and insurance companies can now participate in confidently. But that is a small portion of the market, and there is plenty of room for other lending structures, geographies and asset types that might not fit into the regulators' strict requirements for banks but are still very good investment opportunities.

Can you give us a little insight into what those other loans look like in your world?

It's not so much about the properties as the product. Traditional lenders like to focus on 10-year, fixed-rate loans. So if you have a really high-quality property, but you don't want 10-year, fixed-rate financing, it's actually much harder to find a lender. For example, we recently made a loan on Chicago's John Hancock Tower, one of the most prominent buildings in the Chicago skyline. For various reasons, the owner did not want to lock in 10-year fixed-rate financing. It is very hard to find lenders that can make those loans on a floating-rate, shorter-term basis, even though the asset quality obviously is very high.

Looking at the asset side, trophy office buildings may be hotly competed, but if you look at high-retail or urban value-add multifamily product, you will find excellent properties that fall just outside of the scope of what the banks have deemed acceptable under these new regulations. That's where the private side of lending can come in and take advantage.

Do you see your side of the business being similarly regulated in the future?

We are already regulated by the SEC, just like any other fund manager. We are also regulated by the California Lenders Bureau, so it's not that there aren't regulations. It's just that we don't engage in the type of risky financial engineering that some of the banks did before the financial crisis. Our investors are very sophisticated, and our investments are neither complicated nor high risk. So I don't see the impetus for regulators to be overly concerned about this space.

How is 2017 shaping up as a vintage year?

2017 is going to depend very heavily on what is going on in the overall economy and broader markets. From a product perspective, we are concerned about valuations of the underlying assets. As a result, we are making lower LTV loans to be even more defensive against potentially inflated values. That being said, we think there are also some very positive signs. The fundamentals behind real estate certainly look very good in the near term. NOIs are growing, rents are growing, supply is generally in check, and the economy is relatively healthy. All of those things bode well for commercial real estate fundamentally. At some point, there will be a correction, but my guess is it will be far more muted than what we've seen in the past, and by lowering LTV and taking some other defensive structural measures, you can mitigate those risks pretty significantly.

Finally, are you seeing more interest in separate accounts from your investors?

We are definitely seeing more interest in separate accounts. Investors are looking for additional ways to diversify their debt holdings and also have greater control over the loans in their portfolio. Given the strong deal flow and favorable supply/demand characteristics previously mentioned, investors have a lot of options in this market, whether in separate accounts or in funds.

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.

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