Mesa West Capital Talks Debt

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

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, 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.

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

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.

Can you further diversify within the debt space?

Zytko: Absolutely. Similar to the equity side, there are many different types of debt risk ranging from core to value-added to opportunistic.

Which of these do you expect to be in favor in the near term?

Friedman: We are seeing a lot of interest in the core lending space. Investors have been seeking the current income and safety of core equity funds, but have been frustrated by queues to get into those funds. Once they are in, they are finding it takes a long time to get the capital deployed and ultimately are disappointed in the low cap rates and weaker product available in today's environment. Investors are asking, "Can we invest in the high-quality core assets from the debt side of the equation?" and our answer is yes.

But can investors get the returns they need from core debt?

Friedman: Yes. In fact, given current cap rates on high-quality assets, investors can achieve better going-in yield and 10-year average cash-on-cash returns by lending on core assets than they can by buying those assets, even in this lower interest rate environment.

What about the overall yield of core debt relative to buying core assets?

Zytko: It obviously depends on the assumptions you make in the growth of rents and where you think cap rates will be in the long term. Undoubtedly, by investing in debt you are capping your upside potential, but you are also significantly protected in any downside scenario. That said, with some fairly conservative assumptions, such as cap rates go up 100 bps on exit from current low levels, debt can meaningfully outperform the equity position.

So investors today are willing to forgo some upside in exchange for safety and current income?

Krauch: At the end of the day, core debt can provide a safe way of achieving immediate current income levels that satisfy most actuarial return requirements. I believe many investors are willing to sacrifice some possible, and often nominal, upside in exchange for the stability of current cash flow. But a well-balanced portfolio should have room for debt and equity, and many of our investors use debt as the anchor for high current income and enhance the overall yield with equity investments.

You were over-subscribed by more than 50 percent in your latest fund, which was raised during a time when most could not raise any capital. To what do you attribute that?

Zytko: I think investors were attracted to our discipline during the period of hyper liquidity. In a time where many of our competitors were chasing yield at the peak of the market, we avoided higher-volatility assets like condos and land, and we were willing to make fewer investments. What resulted was a superior track record during a very difficult investment vintage.

We've seen over 80 investment vehicles enter the market since 2009, but very few have been successful in raising capital. Why?

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, though investors are certainly craving the safety of debt, they are also looking for managers with proven track records. Mesa West is one of the few that has been around long enough to have a track record of solid performance, particularly against the backdrop of one of the worst economic recessions of our time. Plus, debt is not just one of many products for us — it is our *only* product, and investors appreciate that focus.

What about your strategy and products themselves, 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 manage a loan portfolio. We hold all of our loans on our balance sheet instead of selling or securitizing them. This means that we are aligned with our investors in terms of holding and managing risk.

You tend to 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.

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.

What excites you about the current market?

Friedman: The lending opportunities we are seeing are tremendous in terms of the quality of the assets, the borrowers, and the low absolute basis. The industry has been waiting since 2008 for the great opportunities resulting from the market meltdown. At least on the debt side of commercial real estate, we are finally seeing them come to fruition. With few direct competitors, we are excited about the portfolio we are assembling in this environment.

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. ❖

Jeff Friedman is co-founder and principal 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, where he led the largest origination group, and a vice president at Nomura Securities.

Mark Zytko is co-founder and principal 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.

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

Corporate Contact
Ryan Krauch, Principal
11755 Wilshire Blvd, Suite 1670 | Los Angeles, CA 90025
rkrauch@mesawestcapital.com | +1 310.806.6323 direct
www.mesawestcapital.com