ConnText Podcast

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TRANSCRIPT

Commercial Real Estate with Steve Quazzo, CEO, Pearlmark Real Estate L.L.C

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

SEGMENT 1 – OPENING

[Rich Sega (RS)]

Hi all! Welcome to the Conning ConnText podcast for 2024's third quarter. And what a quarter it is - seems like we've had a year's worth of news in the past couple of weeks.

I'm Rich Sega, and joining me in our Hartford, Connecticut office today is Pearlmark CEO Stephen Quazzo. We'll be talking about where commercial real estate fits today in the broad mosaic of the market and in insurance portfolios.

SEGMENT 2 – ECONOMIC/CAPITAL MARKETS OVERVIEW

[RS] (Time stamp – 0:42)

As we move through the third quarter of 2024, policy uncertainty, both monetary and fiscal, continues to feature prominently on investors' minds. Laser-focused on the Federal Open Market Committee, market participants pore over each Fed official's comments looking for clues to the timing of the first rate cut. We have long expected that to happen very late in the fourth quarter. The market forecast is now for two cuts, down from seven earlier this year. We don't expect inflation to get much below 3% and that would suggest no imminent rate reduction. A significant weakening in the jobs numbers is what could trigger a September move.

Risk markets have performed well despite the very high perceived level of geopolitical strife. FBI Director Christopher Wray, in testimony to Congress, has said that while there are always threats out there on the world stage, he's never seen "all the red lights flashing at once." Yet capital market returns have been remarkably resilient in the face of all this, with the S&P 500 Index up over 15% year to date, NASDAQ about 18%, and even bonds, despite rising rates, have turned in positive excess returns across most sectors, with high yield leading the way.

One of the biggest geopolitical events of the year, of course, is the U.S. national election. With a major political party changing horses in mid-stream just under four months away from election day (and barely two months to the start of early voting in a few states), much turmoil and volatility is in the cards. Markets will no doubt be buffeted by these events. I'll turn now to examine how one of those markets, commercial real estate, has weathered these storms.

SEGMENT 3 – COMMERCIAL REAL ESTATE DISCUSSION

[RS] (**2:25**)

Joining me in Hartford today is Steven Quazzo, CEO of Conning's affiliate Pearlmark. Founded in 1996, Pearlmark is headquartered in Chicago with offices nationwide focusing on middle-market commercial real estate investments in both equity and debt.

Great to see you, sir, welcome to the podcast!

[Steve Quazzo (SQ)]

Great to be here, thanks Rich.

[RS]

Well Steve, let's get right into it. Despite what feels like an almost unprecedented degree of threats and tension in the world these days, risk markets seem to have shrugged it off and have performed well, with U.S. equities making new highs and credit spreads at cycle tights. Has the real estate asset class followed suit?

[SQ]

I would say "not exactly" and let's put the whole office sector to the side here as we all know that's sort of facing the proverbial "existential threat."

But if you think about real estate, it's a notoriously interest-rate sensitive investment and from 2022 to 2023 it experienced a rapid upward change - rates doubling. Couple that with excess supply in a lot of markets, where we've now seen rent growth flatten out and go down; we've seen costs, like insurance, particularly in coastal markets, go way up; property taxes go up; and just other inflationary costs go up. Financing is in short supply. And so you put all that together in the soup and you've seen a big value drop in real estate. So, no, being in the stock market would be a lot better trade over the last few years.

[RS] (**3:56**)

You brought up office and that's what our clients think about a lot when they read in the paper about real estate and listen on the news. Your team has de-emphasized office for a long time now, to the benefit of Pearlmark's investors. What's the firm's current office sector outlook?

[SQ]

So office is pretty much a disaster – right? – as you pointed out, and I think it's been dying for a while; Covid was really the last nail in the coffin. Companies were getting way more efficient about their space, people were realizing that they didn't want to spend all their time commuting, and so there's a lot of obsolescence in the office market. Think of a lot of these downtown sort of gateway cities' older buildings: vacancy rates are 30 percent-plus, certainly in San Francisco and in Chicago, particularly when you factor in sublet space.

So there's sort of a bloodletting going on. The top 20 percent of the office stock will be fine but for the rest of it, it's a little bit like what happened to the mall business over the last 15 years: we just need a lot less of it.

[RS]

There have been some big trades in urban centers with scary outcomes that have made headlines lately - 1440 Broadway in Manhattan, Burnett Plaza in Fort Worth - where valuations are cents on the dollar versus their peaks, and there's just two examples. The Wall Street Journal this past April headlined a story called "The Real Estate Doom Loop," citing delinquencies at seven percent, which is a decade high. That sounds to me like a market nearing a bottom. Are there opportunities out there for risk-sensitive investors like insurers?

[SQ]

Well I would say not in office, following up on my last answer. And probably not yet in a lot of downtown gateway cities that are wrestling with issues like public safety and school systems that aren't really performing at a high level.

But I do think that in the suburbs there are opportunities. I do think in product segments like apartments and industrial the underlying fundamentals are good. And because of what's happening in the financing markets and because of some oversupply, there's definitely some opportunities for risk-averse investors to be investing on the equity side as well as the debt side of real estate.

[RS] (6:23)

So that's a good segue to a part of the market that you've liked a lot: multifamily. The U.S. has a housing shortage so this has been a fertile area for investors. But recently Morningstar reported that, due to higher interest rates, "real estate loans in this area are looking especially wobbly." What's your current view?

[SQ]

Well look, whenever you've had sort of a massive price dislocation and obviously the rapid rise in rates, yeah, they're going to be some issues out there. And as I cited, in some markets there is some oversupply. And so we're in a little bit of a digestive phase in terms of absorbing those excess apartments. But underneath that the fundamentals are great.

We have become a nation of renters. People are delaying home purchases to later in life, they're getting married later in life, the cost of home ownership is significantly higher than a comparable for-rent equation. And so as a result, I see all of these units getting absorbed, particularly in the markets where we're seeing job growth and demographic growth - the Southeast, Florida, Texas, the Carolinas, et cetera - so we like the space and we will continue to invest both on the credit side as well as the equity side in apartments.

[RS]

You and others have made the point that banks typically have supported about half the commercial real estate market for funds. Now, due to risk retention, capital requirements and other regulatory impacts, banks have been offloading risk exposures from their balance sheets and leveraged loans are stressed due to the feckless Fed and its policy rate uncertainty. How is the banking regulatory environment affecting the CRE market?

[SQ]

I think the short answer is that it's creating a huge gap and therefore there's an opportunity for private debt funds and, more subtly, for equity investors to sort of fill that gap. And that's in effect what's happening because as construction loans are coming due and banks are no longer willing to "pretend and extend" like they did last year,

borrowers and owners are forced to confront the reality: they have to sort of capitulate and accept. Either that or they're tired of funding the shortfalls out of their own pocket. And so that's where private investors and private debt players that have relationships – both with existing senior lenders as well as with operators - can step in and provide fresh capital struck at the new values that are out there today.

[RS] (9:05)

Inflation - let's talk about inflation for a second. It's been stubborn, causing a lot of investor angst, but the last inflation episode we saw back in the 1970s was a pretty good time for real estate. Do you expect something similar to happen again this time? And what effects do you anticipate when the Fed finally does ease?

[SQ]

So our view obviously is that short-term rates – SOFR - which has stayed stubbornly high, kind of in that five, today 5.3 percent, clearly that's going to come down.

But I don't really see the long end of the curve coming down. I think the 10-year is at a very reasonable 4.3 percent rate today and so we believe that that's where it's gonna stay, within that band, and so our investment decisions are really predicated on that. We're not counting on cap rates compressing.

So going forward we think it's going to be a terrific time to acquire real estate because, to the extent that inflation bumps along, which we expect that to occur, the underlying value of the real estate will increase. We'll have ability to grow rents, particularly in apartments where almost half of your rent roll matures and moves out every year. So, yeah, we think owning hard assets in an inflationary environment is a great investment.

[RS] (10:30)

That's a good story. For a long time, most insurance companies have approached real estate from the debt side - mortgage loans and CMBS - and probably the only equity exposure that many had was their home office. But that's changing so, you started in your last response, but talk a little bit about opportunities and return potential for insurance portfolios, specifically in today's market.

[SQ]

If you look at the last couple of years, apartments and industrial – two of the favored asset classes - were trading at four percent - and even below - cap rates. Today you're looking at 100,150 basis points higher than that, so there's great intrinsic value in buying great, well located, well-constructed properties. Generally, we're a value-add type buyer so we're looking to go in at maybe 5.5, 6 [percent] and grow those cash flows over the ensuing two to three years through either reinvesting in the asset, pushing rents as markets tighten, so we tend to look at a spread between our stabilized return on cost and where cap rates are. So if we think cap rates and multifamily and industrial are in that, let's say, 5% range, if our yield on cost is at the 6.5 percent level, then that's a very healthy spread, and we don't feel that there's a big leap of faith to get to those levels.

So we think for insurance companies that tend to be risk averse, that are very cash-flow oriented, these are great product types and this is a great time in the market because, as I said earlier, there's really a shortage of debt capital.

[RS] (12:18)

Last question Steve: toward the end of last year – Q4 2023 – there was an uptick in foreclosures on real estate mezzanine loans. Pearlmark's been active in that market, recently closing several deals. Would you, for our listeners who might have seen those stories, compare and contrast your specific strategies versus the broader market in mezz funds?

[SQ]

Look, when values drop that precipitously, as I said, no one's immune. But having been through a number of past cycles and, we can go back to – I mean, I came out of college during the highly inflationary environment in the early 1980s - we've put a bunch of risk mitigation policies in place and I'll highlight some of it.

One is, on the mezz side, we're almost all residential, multifamily, some industrial. We don't employ any leverage to our positions. We have a balanced portfolio mix, stabilized assets, bridge transition loans and then opportunistic/development. Our last dollar exposure doesn't exceed 75% of loan to value or loan to cost; we're generally attaching at 55% so it's a very clean, simple structure. And I think our borrowers are highly qualified sponsors, well capitalized, and the assets that we're lending against are institutional quality, and so that tends to withstand some of the cyclical downward pressures.

SEGMENT 4 – CLOSE

[RS] (14:03)

Thanks Steve, for your time today. We appreciate your shedding light on an important investment alternative for our clients.

While there are many risks on the geopolitical front facing investors these days, one event will surely figure big throughout 2024's second half: the U.S. national election. While the opposition Republicans have settled in on their ticket and their message, the incumbent Democrats have much to work out between now and their convention in mid-August. We will be watching and listening for clues to how the potential election outcomes might affect capital markets and the portfolios we manage for our clients.

Thanks for listening in on our discussion.

We hope this information is helpful and we always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

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