EPISODE 934

[INTRODUCTION]

0:00:00.0 ANNOUNCER Welcome to the Real Estate Syndication Show. Whether you are a seasoned investor or building a new real estate business, this is the show for you. Whitney Sewell talks to top experts in the business. Our goal is to help you master real estate syndication.

And now your host.

[INTERVIEW]

0:00:19.0 Sam Rust: This is your daily Real Estate Syndication Show. I'm your host, Sam Rust. I'm privileged to have with us today, Freddy Johnson. Freddy works at StackSource, has been involved in different areas of the real estate sector, from modelling acquisitions, project management, analyzing REITs, and then most recently at StackSource, on the debt origination side. Freddy's in touch on a daily, probably an hourly basis, with lenders and dealers and deal sponsors, sourcing terms for all different kinds of property types and asset classes. He's working in one of the more dynamic environments we've seen.

Thanks for peeling away a couple of minutes for us today, Freddy.

00:00:57 Freddy Johnson: Yeah, no, really appreciate it. Thanks for having me.

00:01:00 SR: Awesome. Well, let's cut right down to it. We're in a very interesting time. We've got a lot of money chasing deals. We've still got all-time low interest rates, it seems like. There are interesting challenges as you try to model based off of a T-12 with delinquency, especially in multifamily - but I would imagine across many asset classes. Some of your GSCs are changing terms, they're compressing spreads, their missions are changing. You've got banks that are coming off the sidelines, equity funds that are looking to place. It's a really volatile landscape from my perspective. For somebody who deals with acquisitions and in lining up debt partners, I'm curious for your kind of inside baseball take on what's happening in the marketplace. Here we are in the middle Q2 2021.

00:01:49 FJ: Yeah, I know. Like you said, it's definitely an interesting time. I guess I'll start with COVID where there is a lot of money out there. Deposits are flushed in banks and credit unions. You've got a lot of lenders out there. You have some lenders... I mean we were speaking with one yesterday, where they've got the equity lined up. It's just they're having a tough time finding the deals, you know. So, there is a little bit of that going on. Bank lending definitely tightened up in COVID. You had probably 80% of banks and credit unions tightening their lending standards. That can mean anything from lowering the LTV to having stricter requirements on liquidity for the borrower. And now as you just said you've got lenders coming off the sidelines and wanting to get out there. And you also said volatile.

I would say that that's pretty accurate from what I've been seeing as well. At StackSource, we deal with all lenders: CMBS, Life Co., agency, bank, credit union, private debt funds, that are going to be doing interesting assets or your shorter-term bridging construction loans. But when it comes to conventional lenders, I think that there's historically pre-COVD, and obviously, you know, not taking the recession into account. You saw a lot of parity in the market. If you're going to buy a 400-unit multifamily, there's going to be a decent amount of parity between - if it's not an agency loan, - bank A bank B. But now, during COVID, what we've seen is a lot of disparity. And that has to do with the bank's balance sheet, the risk appetite, what they're able to do right now. So, for us, as essentially a mortgage broker and advisor, we've seen an uptick in volume on our platform, which is great, but that volatility has definitely flowed through to us as well.

00:03:56 SR: Yeah. It's been interesting to just watch the fluid situation unfold. Back pre-COVID, at least for deals that I was underwriting and that we were acquiring, we would go out and look at bank debts, and look at Freddie-Fannie debt, which is kind of the standard basket. We weren't completely closed off to recourse debt, either.

But my experience was that generally Fannie-Freddie at the time had slightly better terms, especially when it came to interest rates than maybe some of your banks or credit unions. It seems like that is changing coming out of COVID, particularly if you don't have a small and affordable component in your deal. It seems like the agencies are being more targeted by their government overlords to target those, more workforce housing type deals that have an affordability component to them. Is that what you're seeing in the market as well? Could you speak to that a little bit?

00:04:49 FJ: Yeah, a little bit. We've seen some of that. We've seen it with other assets as well and then pulled out of it. I mean, student housing is obviously... that's one example where you know, you've seen... like, as far as multifamily goes, like student housing, assisted living, - two sectors that were hit during COVID, right? So now, we're speaking to one letter yesterday who does equity pieces for their back. They're doing private equity, where they have a license to work with Fannie and Freddie debt. They were talking about how, as far as, student housing used to be something where it was like 80% done by Fannie Freddie. And now it's down to like 10, 20. And so that money is going elsewhere. You've definitely seen tighter restrictions by Fannie and Freddie in terms of their liquidity requirements and I think those are coming down as well. Their LTVs are coming up, but I'd say that that's overall true. I can't speak to specific numbers as far as Fannie and Freddie and what they're putting into affordable housing, but I've definitely been hearing that.

00:05:50 SR: It's really interesting on the student housing that it would flip so quickly.

00:05:54 FJ: Yeah. COVID was definitely a killer for a lot of different student housing. There's... I'm out of Chicago, there's one group here that is probably the biggest private student housing investor in the US. They've been able to remain pretty healthy because of their bathroom to room ratio. And that was one of the things that scared a lot of people on the financing side, apparently. It was a kind of community living. You know, how many bathrooms per floor, etc. and so forth. So, things like that. And then also just people not being on campus, right?

00:06:29 SR: Well, hopefully come this fall semester, things will be a little bit more back to normal on that front. I was curious, you mentioned a preferred equity provider that has a license to work with Fannie-Freddie debt. I know a lot of folks that locked in long-term debt on some sort of either pre-pay or deficit style structure, maybe three or four years ago when rates were in the fours. And just thought, you know, how could this bet not work? And now here we are. And even though we've bounced off the bottom a little bit, you can still get rates three and a half, three and three quarters. How competitive are those equity providers with traditional supplementals put on by the GSTs themselves.

00:07:07 FJ: I think that they are fairly competitive. The equity has been in... As I mentioned earlier, the equity has been easier to raise, in some cases than getting the deals out. But the majority of what I do... So there's different kinds of pref equity, right? There's going to be the kind that acts more like a mezz debt that is going to be some, you know, it's gonna be given to you by a group that is traditionally a lender. And debt prep equity is going to act more like a mezz piece in the stack and maybe it's got a lien against the equity piece that the sponsors have.

Then you've got your private equity that is more in the syndicate world. That is more provided by LPs and that's more like those LPs that are getting that prep equity - and that's something that I just wanted to kind of differentiate because you know a lot of your listeners are in the syndicate world. But that's going to be a little bit different because those LPs don't really have a lien against the equity piece that the sponsors have or you know and and sometimes even...I don't think pref equity is ever going to even buy the other lenders. It's going to have a lien against the property whereas like mezz debt can sometimes have a lien against property, all depending. But, you know, those LPs that's more of just like they're getting a preferred rate. They're not necessarily preferred equity holders from a technical standpoint.

00:8:29 SR: If you could define for our listeners... because I hear these terms thrown out a lot. And in some people's minds, they're interchangeable. And I know they're not. But preferred equity versus mezzanine debt or mez debt as you often hear it referred to, specifically in the context that we've been talking about. Could you just provide a brief definition for our listeners?

00:08:48 FJ: Yeah. So, preferred equity is... Essentially, it's in the capital stack. It's pretty low on the capital stack. It's going to be, you know, basically, money invested in the sponsor group. So, in the group that's putting the deal together, it's going to pay back a return annually. And then the entire piece will be paid back. So, it's kind of like an interest only loan in a way. Mezz debt is a little bit higher in the capital stack. It kind of bridges that partner money to the most senior loan. The mezz debt is going to be something that is pretty tough to do these days, especially in post-COVID. And it's definitely tough to do if you're a first time...Like, someone who's seeking mezz debt. But mezz debt is going to be debt. It's less senior than the senior debt and has a claim, generally speaking, against the equity piece of the project.

00:09:52 SR: I appreciate you shedding some light on that. So, both of them are secured by some claim against the equity, but they're usually placed in different places in the capital stack and mezz debt maybe has less claim than a preferred equity piece. Again, we're speaking in generalities here. A lot of the devils are in the details. Is that a fair statement to make broadly?

00:10:13 FJ: Mezz debt can have a little bit more claim because sometimes mezz debt can actually have a claim against the property, all depending on what kind of intercreditor agreement they have with the senior lender. So, when you do a mezz debt piece.. and the reason that people do mezz debt pieces is because they have to bring less cash to the table. So, if someone is investing in, you know, a million-dollar building and they want to do 70% senior loan and they want to get, you know, instead of bringing 30% of that capital to the table, they want to do, you know, 24...they want to bring away 10% so they want to get a 20% mezz piece. Their cash-on-cash yields on that at 10% they're bringing in are going to be better with mezz debt. Now, with that mezz debt though, they have to get an intercreditor agreement. And that is going to stipulate what they're able to claim, what they're able to have. Basically, if the project goes bust, like, who gets what in what scenarios?

00:11:13 SR: That makes sense. So, a lot of what we've been talking about here for the last couple of days is Freddie is more geared towards sponsors and people are putting deals together. But I'm just putting my mind, or myself, in the seat of somebody who's looking at a deal deck from somebody like us, you know. They're looking at a possible opportunity to invest in. They say, "Hey, there's a mezz debt piece in here." What does that usually mean if you're looking at it as an opportunity to invest?

00:11:39 FJ: So, generally what it means is...I mean, I don't really... So, I get a lot of offering memorandums. I see a lot of placement memorandum. It's because not only on the debt side with StackSource, but I do some equity stuff as well, where we're looking for deals and then hopefully tying that in and providing equity to those sponsors seeking it. And then tying that into the debt piece of stacks up. So, I see a lot of that. But if I'm seeing a mezz piece, usually I'm kind of taken aback in a good way. We're saying, "All right." Well, usually, you know, to do a mezz piece, you have to definitely be around the block a few times. You have to have a really good relationship with your senior lender to get them to be able to say, "All right, we're willing to have a mezz piece behind us in this deal. A lot of times they don't want that. They just don't want to deal with scenarios where they have to give you things up and deal with all the legalities of who gets what when. But if you see that as an investor in a syndicate deal, or any other deal for that matter, it generally is going to mean that there's potential for greater returns on your investment. And that's just generally speaking.

00:12:56 SR: Does it correlate at all in your mind to the risk profile as well? Like when I think of mezz, I hadn't quite put together that "Hey, that's a good signal for a strong sponsor. That's a really good tidbit." In my mind, I go more towards, "Well, why are they trying to push the cash flows that much? Is this maybe a riskier deal?" Is that a fair statement, as well?

00:13:17 FJ: I think that could be a fair statement. Yeah, I mean, usually... Especially in the investing world today, there's equity out there. There's money to do deals. And so I would definitely say that. From your point of view, you're thinking exactly how the senior lenders are thinking these days, especially post-COVID. Lenders don't like sponsors, generally speaking, with mezz debt because they want sponsors that are sitting on a ton of cash. It's just burning a hole in their pocket. That's who they like. And then they see it as riskier as well. So, how you're thinking right now is definitely how one investor could look at it, right? And then definitely how the lenders are looking at it.

00:14:03 SR: Take us back to where we started on this rabbit trail, Freddy. You've got a sponsor or a syndication group that's got a lot of equity locked away. They can't really dispose of their asset, and they're trying to unlock some of that equity in the interim. Is a supplemental the best choice? What other options are out there that are both achievable and palatable given the current markets?

00:14:25 FJ: Yeah. They've got a massive prepay. That's less than ideal. We don't really see a lot of those massive prepays these days with a four year in. But I would, as far as unlocking some of that, probably the only thing that we see is generally kind of your standard refinance, that's... and we do a ton of those these days because of the interest rate environment...You know, for the deals that you guys are doing in the major multifamily syndicate world. I think that when it comes to a 30-year amortization deal with maybe a five or 10 year term, maybe you're getting interest only for a little bit. I think the most that we see in the pre-pay world is going to be a 54321. So, that means in the first year, it's 5% of the principal, 4% of the principal in the second year, and then trickling down to 1% is the penalty in the fifth year. We do work on deals with prepayment penalties. And, I mean, we just asked for the best terms possible where the loan is just doing more than...The new refinances doing more than just... they're covering the prepayment penalty, they're cashing out. And, you know, cash outs were four-letter word during COVID, but now lenders are warming up to it again. And we're doing them.

00: 15:52 SR: Do you have any insight that you could share on COVID reserves that were required by a lot of lenders, but particularly Fannie and Freddie during COVID and when those might be released back to the owners if they were originated a year ago or nine months ago at the beginning of the pandemic?

00:16:08 FJ: So, as far as the reserves, you know, I think that with Fannie and Freddie, it was normally... I think there was nine months of debt service liquidity at closing. And you have to...Net worth equals your exceeding loan amount. And they're...Okay, I'm going to 80% LTV. You had to hit like a 1.25 debt service coverage ratio and then you've got other things. Like, they're going to look at the market, the crime in it, the occupancy for the last 90 days. But when COVID hit, you need to have like 12 or 18 months of debt service. I'm not sure which one it was, and they were going down in their LTV and you had to have that liquidity closing now.

I think that now the debt service reserves are coming back to being nine months of liquidity at closing. And I'm not sure if that's the case exactly, if it's already gone down to nine months. And then I'm also not exactly sure when that would be released. But it was a huge hit to agency financing because nine months liquidity of debt service at closing is already a lot. You've got to be kind of a big player, you know, versus a lot of the guys that are starting right now and trying to get into the multifamily world. But then when you take that up to 12 or 18 months, I mean, that really widdles your pool down of people that are going to be able to do those agency loans. And so, it's good that they're coming back down but as far as when they're going to release, that I'm not exactly sure.

00: 17:48 SR: Yeah, and I think we're all playing the wait and see game, hopefully. Rumor is, what I've heard is that maybe in a year after loan origination, if you can then prove a subsequent three months of covering your VCR, they might consider releasing it. But we're just now starting to hit that time window where we're a year out from some of these first post-COVID loans being originated. I think they're kind of making it up as they go along. Any insight you have there? As we move forward into the rest of 2021, you know ,there's...we talked a lot about volatility and a lot of that is just related to rules changing, different missions, people coming off the sidelines wanting to place capital, you know. But the Fed hasn't raised rates. There really hasn't been a massive structural change in the market other than we're all pretty sure that COVID is going to be in the rearview sooner rather than later, whether it's herd immunity by vaccination or just by enough people who have had it or some combination of the two. The general consensus is we're kind of coming out of the woods from a health standpoint.

From your desk as a lender, what's the next thing that you're keeping an eye on that could change the debt markets significantly? Is it the Fed raising interest rates? Is it inflation running hotter than expected and if so, what is that number? Do you have any leading indicators that you're keeping a close eye on that would impede some further movement?

00:19:13 FJ: Inflation was kind of all the rage in terms of the first quarter of 2021 and...or even into the second quarter of 2021, talking about debt and how that could affect your commercial real estate debt. The bottom line is, though, that it didn't really matter if inflation is okay. And as I was speaking with Whitney a while back, you know with globalization and digitization these days, it's going to keep inflation in check. We won't see it like it was in the late 70s and early 80s. And then as far as rates go, I mean Powell's been fairly clear. And also to avoid a temper tantrum, where you know you've, you've got that volatility in the interest rates. But he has basically said that he's going to keep interest rates low for a while. So while I have those, you know... I'm always looking at those and I've got my Google check set up every morning to feed me news on that stuff. I'm not really paying attention to that as much as I am, you know, more of like the herd immunity, as you mentioned. I'm actually kind of skeptical, as far as if that's going to actually happen. Then, you know, not to be doom and gloom, but I've heard some, you know, kind of scary numbers of people kind of like not even getting their second vaccines and whatnot. But we'll save that for another day.

I would say, it really does come down to people getting back to work in the service industry. It definitely comes back to people traveling more all that just ties into the vaccinations and the health that we, you know, have in this country. And so, that's the main thing I'm really paying attention to. I'm a very macro guy. I think it's, you know, knowledge about the world and how the world works economically is true knowledge. So, I definitely am always paying attention to that. But from what we've seen and the tools that the Fed has to keep rates low, and, you know, with all the Amazons out there and everything to keep prices low, I'm more in tune these days with the health of the country, physically.

00:21:33 SR: Yeah. Yeah. I think that that health thing, and even the perception of health, right, I think consumer confidence is a big thing. And as people gain confidence and are more willing to travel, more willing to go out to eat, more willing to consume goods and services, whatever those may be, we're going to see employment bounce back. I'm very curious to see the jobs report this week. And that I think is the number one leading indicator, while also keeping an eye on inflation and see how long Powell keep saying essentially the same thing. He's been saying it for a long time now. He's been sticking to his guns.

00:22:08 FJ: Yeah, exactly. They said manufacturing data might have had a one basis point, you know, like effect on the Treasury yesterday but it was like dialed down. Definitely the employment figures on Friday are going to be kind of the event of the week, or month possibly.

00:22.:26 SR: For sure. When you look at the next 12 months - I know we've talked a lot about some of the macro-factors and what's impacting - but for those people who are looking to place debt or source debt in the next twelve months, any exhortations, things that they should be thinking about now to prepare their packages to be as well received as possible by the marketplace?

00:22:46 FJ: Yeah, absolutely. And this is something that I would say outside of COVID as well, but definitely rings a little bit more true because we're in an odd kind of recession right now, and that is think like a lender, right? You have to know that these lenders have boards of directors, they have guidelines that they have to follow. They aren't necessarily just private hard money. And we work with a lot of private debt funds that are not, you know, your hard money guys, but they're a lot more agile, they're quicker to close, and they're great to work with.

But as far as some of these banks and credit unions go, I mean, there are sometimes people that come to me and they say, "Hey, I got a property in Lafayette, Louisiana, at 10 cents on the dollar." Like, this should be as a home run for you it's an easy deal. And I'm thinking, "Well, tell me about property." And, like, "Well it's vacant and it's retail. And I'm saying, "All right." You got it for 10 cents on the dollar. Great job. That's great. But the bottom line is banks aren't allowed to lend on vacant retail right now. So, think like a lender.

I was working with someone in New York on a, you know, a $7-$8 million-dollar property that they wanted to refinance. And they're like, "Do you know what New York real estate's worth?" I'm like, "Well, it's less than it was a year ago, but... according to... I know what you're going to tell me. You're gonna tell me it's priceless. Yeah, it's priceless. All right, great. That's fine. And then you look at their rent roll, and they decided that they could get more money. They had a very large national corporate-backed retailer slash pharmacy which one in New York on the first floor - taken up pretty much the entire first floor of the, you know, mixed use building. And then they thought it would be more lucrative to do a month-to-month lease with this group. And I don't know who was managing the property but it wasn't a good decision. And it was just kind of like no one, no one gives good terms on a month-to-month lease. Like, how did that happen on an $8 million property in New York? How did that slip through the cracks of some, you know, manager? And so, that would be the one thing I see. It's just think like a lender. We're not out of the woods yet. And, yeah, I mean if you ever want to kind of shop the rates around, get in touch with us.

00:25:20 SR: Oh, that's awesome. Well, I appreciate you. The stories often are what sticks with us, right? I can't believe...I mean I'm not a retail guy. We're focused on multifamily pretty much exclusively, but I know enough to know that going month-to-month on something like that is that meaningful to your overall cash flows is generally not a good idea.

00:25:39 FJ: No, absolutely not. And I sometimes am baffled at how that stuff happens, but you do hear crazy stories in the real estate world. But it's definitely a colorful job. I get to work on a lot of deals. I closed a deal in Alaska last week and then I closed another one in Vermont. So, you know, I really like it. It's a lot of fun. I definitely have a great respect for what you guys do, getting out there and making money for investors, and taking on solid investments, and doing rehabs and everything. It's been a blast. Thank you. I appreciate you having me.

00:26:11 SR: Yeah, for sure. Freddy, thanks for joining us today. I really appreciate all the nuggets you've dropped on us. For folks who are looking to originate debt, how can they get in touch with you?

00:26:19 FJ: Yeah, absolutely. You can shoot me an email or call me. I'll give you both. My email is freddy@stacksource.com. That's freddy@stacksource.com. And if you want to give me a call, that's fine as well. 8475141795 and we'll see what we can get going.

[END OF INTERVIEW]

[OUTRO]

0:26:40.7 ANNOUNCER: Thank you for listening to the Real Estate Syndication Show, brought to you by Life Bridge Capital. Life Bridge Capital works with investors nationwide to invest in real estate while also donating 50% of its profits to assist parents who are committing to adoption. Life Bridge Capital, making a difference one investor and one child at a time. Connect online at www.LifeBridgeCapital.com for free material and videos to further your success.

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