EPISODE 1346

[INTRODUCTION]

Phillip Block (PB): So we can hit double-digit cash-on-cash in a rising interest rate environment, in an inflationary environment that we see today. We haven't found other asset classes where those dynamics are true.

Sam Rust (SR): This is your daily Real Estate Syndication Show. I'm your host Sam Rust. Joining us today is Philip block who's one of the managing partners of LBX investments. Formerly, Philip was a senior managing director at realtymogul.com where he created the commercial lending business and led institutional capital market efforts. Prior to that, he was VP of Corporate Finance and capital markets at Centerline Capital Group has a BBA cum laude from George Washington University, and graduated from the general course at the London School of Economics with a degree in finance.

Phillip, welcome to the show. Thanks for joining us today.

PB: Hey, thanks so much for having me. Great to be here.

SR: So for our audience get to set the stage a little bit if you haven't run across Phillip before. Normally, we have folks who are more embedded in residential real estate, whether that's single-family or multifamily, but I was really excited to see Phillip pop onto my booking screen. We're gonna be talking today quite a bit about retail, which is not something that is maybe front of mind for a lot of retail investors, no pun intended.

But in my research, retail is one of the most under-the-radar real estates plays out there, especially over the last five or six years, multifamily has been the sexy beast. And if you were willing to dig a little bit, maybe you went self-storage, or maybe you went industrial. But there were a lot of what seemed to be prevailing macroeconomic factors that were headwinds for retail. But maybe the story is a little bit more nuanced than just "Hey, the internet is here. Amazon is king and shopping in person is dead." Maybe I'll let you kind of kick it off there,

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Philip. But if there's one myth that you would like to dispel today about investing in retail, specifically shopping centers, what would it be and why?

PB: Well, I don't want to get the word out too wide prices might start going up. And what you just said is absolutely true. We are contrarians by nature. Rob Levy, my partner, and I think we understand multi, we come out of a large multifamily platform underlined was largely a multifamily lender and investor. And what we've found is when everybody rushes to one side of the aisle or one group of capital, you know, and everybody's running away from retail, or, frankly, any bucket, there's opportunity. And so when we set out to figure out where we wanted to place our capital personally and where we wanted to invest, this is going back six years or so, all the talk was the retail apocalypse and CNN headlines about the death of retail and Amazon taking over and what we found is that there's nuance to that. And, frankly, the last two years and COVID has proven out our thesis because we're able to buy shopping centers, you know, we bought from 7, 9, to 10 cap type pricing, depending on the asset, location and kind of the makeup. And we've collected 100% rents, we've had a crazy leasing momentum, almost all of our shopping centers are full. In certain cases, you know, we're kicking tenants out and bringing in kind of better tenants or replacing things selling out parcels.

So we can hit double-digit cash-on-cash in a rising interest rate environment, in an inflationary environment that we see today. We haven't found other asset classes where those dynamics are true.

SR: That's certainly not the case in multifamily. You mentioned on your website that you're pursuing both a value add and core-plus investment strategy. And so in multifamily terms, those are very familiar value add, we're going to renovate units, we're going to invest some capital and then core plus, you know, maybe we're buying 90's, the 2000s, even newer vintage in high growth markets and just kind of let them sit and work or function mostly as an annuity. What's the difference or the nuance of shopping centers? Where are you guys adding value? Is that primarily on lease up? Is that turning over tenants some combination of the above?

PB: Yeah, no, that's a really good question. And you're right some of this is semantics and how people wanted to find things I think of it in kind of overall return profile and the way we think about all frankly, all real estate investment across the board is what to us feels like an

appropriate risk adjusted return what's the return? How much risk are we taking? When I think about kind of core plus and value add how much stuff are we doing? So you ask what's the value add, there's typically what I'm looking for is in place cash flow with some ability to some combination push rents lease up vacant space or kick out tenants that are paying low rents and bring in better credit tenants, higher rents, and our parcel development and our parcel sales are a big part of what we do is it's really interesting overall shopping centers with and when I say all parcels for all your listeners that you know, the McDonald's or the Chase Bank and Chick fil A sitting in front of a grocery anchored shopping center or target anchored shopping center, and the whole thing gets priced kind of as one, so maybe you buy the whole thing now parcels and the boxes behind.

So maybe you've got a Kroger grocery store, a nail salon and at Bed Bath and Beyond, or you know, pick your friend Elena, and you buy all of that for any cafe, right? So you have positive leverage they want you borrow at four and a half percent now 5%, five and a half depending on what it looks like so versus multifamily, where you probably don't have positive leverage they want to you're clipping high single digit type of cash-on-cash and then sell those outparcels to 1031 buyer at four and a half cap or a five cap.

And so your net cap rate on what you're left owning is maybe a 10. And your leverage is still at 5%. And suddenly, you look pretty good. You're flipping 12, 13, 14%, you can refinance and get out all of your capital. It's been a nice arbitrage choice.

SR: Yeah, finding those unique value matters is a pathway to success and you guys have obviously found that. Do you guys tend to market those out parcels yourself? Do you guys go through brokerage, I know there are some brokerages that specialize in those 1031 opportunities? Have you guys taken those to market?

PB: Yeah, always through brokers. I mean, especially the in the 1031 market, you got to be in it. I think every day I'd love to sell without paying brokerage commissions. But they've got it's like who's in the market this week versus last week? It's pretty rare. I think we were able to do it yourself.

SR: One of my questions Phillip was related to COVID. And you kind of touched on this in your opening monologue. You know, in the multifamily side, we were all worried that our tenants

were not going to pay. And then for better or for worse, the government stepped in and guaranteed rental payments or gave massive amounts of assistance. And delinquency was never as bad as we feared. And really never even concerning certainly did. But not that big of a deal. I was under the impression that retail as a whole, it really depended on what kind of retail you were in. And so it was kind of a mixed bag. I'm curious the direct impacts that you guys saw from COVID. And how that has informed your acquisition strategy since?

PB: As I said, I mean, you're right, it really was kind of confirming for what we've been doing, we and I wanted to be clear retail, again, retail gets painted with kind of a broad brush, there's bad retail, like, and there's too much retail and a lot of them. Somebody's on a lot of that stuff. And you know, when I say it, I'm talking a sea mall anchored by JC Penney and Sears in the middle of America, that's like the fourth mall and area with a shrinking population, right? Like, I don't want that either. And by the way, we get asked all the time, I'm going on a kind of a tangent, but I get asked all the time, you know, why don't you buy that and redevelop? And I'm like to what like and, and then I have some investors tell me, "Well, we're buying this because we're at land value or below land value." And I said "what's land value? If What do you mean? Isn't land value less than zero? You have to pay taxes if you can't do anything with it." So I stay very far from that.

Well, we saw through COVID is I think what similar in a sense to multi that you have kind of your mom and pop tenants, they got some level of government assistance. And you have a bunch of service you know, if you if you own kind of good meat and potatoes service type guys and grocers. Grocers have done an unbelievable like the sales across the board at grocery stores, which you'd expect, right? They people can't go out to restaurants. So they started shopping more there. And what you've seen is like a Publix, I don't know if you're familiar with public spending and where you are but quite cute like throughout the southeast in the biggest game in Florida, their sales, and they've said this publicly, they don't expect a decline back to the levels of pre-COVID, we're seeing it because a bunch of our tenants report sales, they've done tremendously, and they continue to.

So I think that what it's taught us is kind of stick with that if you buy you know, Target has done tremendously if you're in the best retail and the best locations with growing populations, you know, a good grocery store with term and you own shop space, that's what you want. I think

where people got really hurt in retail is kind of the sea malls that I mentioned and the wrong box space. There are big boxes that have struggled, there's no doubt and that's what's meant a lot to headlines. So there are boxes that do fine.

But the general trend is a shrinking number of users and a shrinking size kind of footprint for those boxes. You have to be careful that you don't overpay for too much rent and the wrong size. And I think you know I mean kinda to your point earlier, there's not that many like most people are familiar with multifamily syndicators probably not retail as much and this is hard. We're professionals at this I think kind of anybody can go buy an apartment building and get some friends to put some money in and you buy hire manager right and kind of clip. You can't do that in retail unless you want to lose all your money. Like you really need to be in the space every day, know exactly what the rents are, know how much it's going to cost to replace those tenants, who needs to be in that market, who's leaving the market. Those are the things we kind of focus on every day.

SR: Again, this is from an outsider's perspective, Philip but I'm always curious about multifamily, one of the blessings and curses depending on where you're at in your cycle is your leases come up fairly frequently. So you're able to adjust to the market and your loss to lease factor is not super significant if you're managing it well, it's easy to close that delta. I would imagine when you're buying a shopping center, I mean, a hefty part of your due diligence is going to be on the current lease file and what those look like. But are there ways where you can capture that kind of lost value? If you've got significantly under-market leases?

PB: Yeah, I mean, it's a really good question. So every tenant has you have different structures. The larger tenants have long typically longer-term leases. But even then it's 10 or 15 years with options. And there's typically rent bumps even on your door only guys that don't have rent pumps sometimes would be a grocer, who may have 50 years of kind of flat rent, which by the way, it's great to buy them towards the end of those because then you typically can get you to know, you've got you got leverage, right? It kind of works both ways. You have in the shop space, you may have two or 3% annual bumps, maybe every five years, you get the bump, so you're not experiencing the same type of annual ability to bump brands as you can in multifamily.

But the other side to that is that all these tenants pay our expense recoveries. So if you think about today's environment and inflationary environment where rents are rising, which I'm sure is what you're kind of thinking about. So in multi, you get to reset those rents annually, true, and we get some of that, but on the bigger hit to be higher, the bigger impact in my view, and I think what we've seen historically, is the expenses erode more than your gain in multi in a high inflation environment.

In retail, our taxes, and insurance gets passed through. So if you're well occupied, you have no exposure to that and all of your rent growth is kind of straight to the bottom line.

SR: So I mean, that's a really fantastic way to invest in an inflationary environment. Yes, maybe you're not staying quite up to the market. But if your expenses are flat, and you've got fixed-rate debt, I guess that would be the other key. If all your expenses truly are fixed, then you get to take advantage of that rising tide with very little downside.

PB: Yeah, and a lot less of a lot of our cash flow comes from credit tenants on signed leases, they're not public is not going to stop paying you Home Depot, Target, etcetera, they're not going to just not pay because the market stuff and multi we've had, we've had a 20 year run everything I get why we're kind of comparing to multi. And I'm doing it too, because that's what people know, right that but we've had an unbelievable run. We'll see how that goes over the next five or 10 years, it's when you buy it three caps and leverage at 6%. And everybody's pocketbook feels lighter because of inflation, and the Fed gets it wrong, which you know, are likely to kind of on purpose and you have kind of a harder landing, those dynamics can be tough in multi.

I'm looking forward to hopefully picking things up and multivendor because I think it's a great investment class. But you know, we might be in for some bumpy time.

SR: I remember when I first started, and I've been in this business very long, but you were looking at positive spreads between debt and your cap rate of maybe 100 to 125 basis points, and then that widened out to almost 200 basis points during COVID. And now it's flipped, most of the projects that I'm looking at, you're at least 50 basis points negative.

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If at some point cap rates are gonna have to start reverting back up, there's not really a way that they can stay down as far as they have. Now, there's a ton of capital out there. I think it's still a good investment class. But that's what makes retail intriguing to me is it's a little bit of the redheaded stepchild, it isn't maybe quite as easy, and yet there's significant growth opportunities in the right niches. I'm curious how severely was liquidity affected during COVID. For you guys, just on the acquisition side? Are there lenders that are comfortable continuing to lend during that process getting comfortable with the individual assets? Or was it a little bit of, you know, a go no, or no go? For a couple of months there?

PB: We had a year. I'm thinking, just about a year where we bought nothing. And that was partly lender, I mean, I would say it was kind of lender driven in a sense, but the whole market froze. And so there just weren't transactions now we were cash flowing. And we were doing great. And but I was bored on the acquisition side. And we were talking, we looked at some public companies and making larger plays, we look, you know, we were talking to everybody, but almost across the country you saw no trades during that period. I think there was a fear and thought that maybe there would be distress and opportunity. So there was some kind of element of people holding back waiting for that.

But yeah, lenders the one major difference. Multifamily, it will, at least for the foreseeable future, be supported by Fannie and Freddie, you know, when you've got government, effectively government guaranteed by and subsidized debt. It's a tremendous thing. And they and we that center line was a large agency lender, so we were a dust lender, and I mean, it's just an amazing business and it provides so much liquidity in that space. You don't have that in retail, and I'm not a CMBS borrower. We are intentionally, certainly leave money on the table with this but to sleep better at night. We're not seeing it. We don't lock in kind of long term, fixed rate and deal with special servicers just to get leverage, I'd rather always be kind of lower leverage bank, borrower relationship type borrowers, because in retail and commercial things come up, right? If something pops up, I call the relationship and say, "Hey, this is what's going on. And we can sort through it very easily because they're all relationships, we've got big deposits with our banks, and you know, life companies or relationship guys."

So it's been really beneficial to us now because we're borrowing 60, 65%, it's positive leverage, you kind of don't need that. Whereas multi, you know, obviously, you're trying to get

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75, 80 at maximum leverage. It's all about residual value and refinancing and the future. And most of our returns come from cash flow because we're paying 10% a year, it doesn't take that much if you pay 10% a year just doesn't take that much appreciation to hit a pretty good return frankly, not did just fine.

SR: Now most people if you told them, you're gonna get 10% a year, they'd be thrilled.

PB: Yeah. And tax adjusted. It feels really good.

SR: Do you guys do cost segregation studies on your lease?

PB: We do. I wish I understood anything about you got it back. And they like to figure out how to like, what's the lifespan and like the doors and the windows and stuff, I guess, on the shopping centers. But it's amazing, especially after the last tax reform. I mean, you have you take most of it in the first year. And that's typically like three years of income that is that you take as a loss and the first year I mean, it's unbelievable.

SR: Yeah, bonus depreciation. A lot of our investors, it's one of the primary motivators for them to get into real estate is the fact that they can shield quite a bit of income, especially if you qualify as a real estate professional.

PB: Exactly.

SR: So Phillip, you've done quite a bit in the real estate world, what's been a key to your success over the years?

PB: Man. That's a good question. I would hope for more success. I don't want to think of myself as too successful just yet. Honestly, I mean, there are different pieces to it, I think, but fundamentally partnering with good people like, Rob. You know, Rob, just a close friend, and a great guy and has a ton of experience too and working with people that you like and trust and do the right thing and buy good pieces of real estate and put on the right type of leverage. And you do just fine.

And you know, stepping aside from that, I think everybody's done pretty well over the last 10 years or so. And you know, real estate is fundamentally kind of going up. But if you buy good

real estate, and you don't overleverage it, you do well, at all times, right? You weather bad times fine. And in good times, everything's great.

SR: And then last question, you're obviously dealing with a little bit different sector of the broker market than the rest of us. But how are you finding deals these days?

PB: Yeah, I mean, that is the one it's interesting. Like, certainly in other sectors, you can find some off-market stuff. And we've occasionally, we're buying institutional assets. So I'm almost always buying from public REITs, large private equity funds, or banks like pension funds. And on the occasion that type of seller and they across the board will never sell direct or historically have not because they've told their investors, they're going to go to market and get a market price and it doesn't look good for them if they don't.

So we've got really good relationships with only JLL, CBRE, and are kind of the big guys across the board. And then they're, you know, in local markets, there are occasionally guys who do pretty well but kind of fundamentally those are your two largest shops and we're normally competing with five people, you know, three sometimes eat sometimes it's not multi over the last few years where it's, you know, they sent out no one but there are 1,000 people signed up and 100 bid that works to our advantage.

And we're one of the few kinds of consistent guys who we've not closed on a deal we put under contract. They all know that we've been one of the more active groups in our markets. And so we kind of get up first look and early look and a lot of intelligence from the brokerage community.

SR: That's fantastic. Well, so thanks for joining us today. It's been a pleasure to have you learn a little bit more about this underappreciated asset class. If folks want to check you out, learn more about what you're doing, how can they reach out to you?

PB: Easiest way is our website lbxinvestments.com. And my contact info is on there. Reach out anytime we'd love to hear from people.

SR: Fantastic. Well, thank you, Philip. Thank you to our listeners for joining us. This is your host Sam Rust signing off.

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