EPISODE 1581

[INTRODUCTION]

Whitney Sewell (WS): This is your daily Real Estate Syndication Show and I'm your host, Whitney Sewell. Today we have packed a few different shows together that we call Highlights to help you to get the most bang for your time and educating you on the topics that you want to learn from. We would love to hear from you. I am grateful that you are with us today. Have a blessed day.

[INTERVIEW]

WS: Our guest is Vick Mehta. Thanks for being on the show, Vick.

Vick Mehta (VM): Thanks for having me, Whitney.

WS: So, as you say, the biggest reason you got into retail is because you already had some small businesses in retail and retail spaces so you understood that type of real estate, and maybe what that tenant would look for as well.

VM: Yeah, absolutely. That's why, you know, I was able to actually fill some vacancies with my own businesses, which you know help propel the centers that I was buying back in 2009 2010 that were vacant. You know, we put our own store in there and all of a sudden phone will start ringing from other users that would want to take up space so we kind of just help accelerate the, bring life back to the center, let's say if you will.

WS: Nice. Well, let's dive into retail, in general, a little bit. Maybe you can speak to that change you are talking about. You mentioned it's not dead, but it has shifted. Can you just speak to that in a little more detail?

VM: Yeah, and more specifically I mean let's be clear, I'm not out there buying 1 million square foot shopping malls, you know. So, I have some concerns with that space as well. But you know when you start talking about an Outland Center to a grocery chain or to a Walmart, there's always going to be a need there. There's always going to be internet-resilient tenants or pandemic-resilient tenants that require space. Like I said, the medical users in particular are one that stand out. But then there's also retailers that people just can't wait to get their Amazon package, let's say. And they need something right away. There's always going to be a need for that retail space.

WS: Okay, so, you know, so those spaces you're looking for, you know - Are you mostly looking like next to a Walmart or next to something like that? Can you show us or help us build a vision of the kind of location of where your retail is or your ideal piece of real estate in retail?

VM: Yeah, absolutely. My average building size right now is about 11,000, square feet. It's in an outline of a Walmart. It's become a destination location for the community that it serves. So, it may have users such as hair salons or nail salons in it, and then again you know maybe 25, 30% of the users might be local, some sort of medical users. Like a dentist, for example, is one that really stands out. So that's kind of my niche. And then the other piece that I like to look for that where we could add value for our investors is an opportunity to add some tenants in it. So you know maybe the building's 90% occupied, 85% occupied. We've got great cash flow. We're certainly able to cover the debt. We're able to pay a healthy return to our investors and still add value to where we can turn the property around.

WS: Could you walk us through a little bit, the listener and myself, just thinking through, 'Okay we see this piece of retail real estate for sale. Maybe it is next to a Walmart or next to something like that.' Just thinking through like the comp process and, you know, determining the value, maybe what you could possibly get there. When thinking through something like this you don't know what your tenants are going to be maybe at first if it's vacant, right? Could you just walk us through that, just a few steps of that process so we could get a better understanding, just know maybe upfront, maybe the napkin-type underwriting for a property like that? How do we do the first pass on to ensuring it's something we want to pursue or not?

VM: Yeah, I mean typically, we're looking at the cap rates to start high level but then once we start diving in, we want to see what kind of leases we're looking at, what kind of term is left on the leases, and more importantly, who's guaranteeing those leases. So if they're corporate bank leases like the Starbucks, of course, that puts you a little bit at ease. But then if you're dealing with a mom and pop, maybe a franchisee of a national brand, you know, what's their experience, how many locations do they have. So diving into each individual tenant would be key because yeah, we're not trying to go out there and then you know have people vacate and then we have to backfill the spaces. We want to buy centers that have a steady track record. Again, when you're looking at the building itself, obviously the surrounding businesses help like we talked about the Walmart's, but then also the access to the space. How easy is it to get in and out of the center? What's the visibility like as you drive by it because that'll help determine the success of your tenants and it will help determine how long they're going to be able to stay and will, you know, ultimately determine the value of the asset.

WS: I know we briefly discussed it, but I wanted to ask you specifically, you know, the ideal piece of retail real estate right now for you. Who would be that tenant? Briefly, what would be the location? What is that ideal piece of retail real estate that you see that has the least amount of risk?

VM: For me, ideal would be 40% occupied by medical users, especially dentists, there's you know urgent care facilities are taking on more and more space in retail centers. And then from there, national name brands, ideally, would be the best fit for what I look for. And then, on average about 15% of vacancy I actually like because I like to help pick out you know my own tenants that I want to see in there and that's what adds value to the building.

WS: So you're saying that there's value in actually having some vacancy so you can pick that next tenant?

VM: Yeah, absolutely. I mean I've been able to build some great relationships with some brokers here that represent the tenants that have national name brands, a lot of franchisees that are looking to expand. So, being able to go in and add value with them is what really helps me provide a return for my investors.

WS: Nice. Well, I was just thinking through some of this. I want to back up a little bit, I want to come back to our conversation right now but I wanted to back up and say, maybe you could shed, I'm sure there's plenty of listeners that are thinking, 'Well, what about through the pandemic, through last year? What are some of the, you know, some of the things that happened to retail? Maybe your property specifically. Anything you didn't expect or anything that we can learn from?

VM: Yeah, I mean you know with our restaurant users in particular, we did have some rent deferment that we had provided, you know, working with each individual to help them get through it. And you know, we're fortunate. Everything's been paid back and you know, everything has worked out great. So, we got through that just fine. I can't think of one space that vacated because of the pandemic. So, everybody seems like they're doing well and as long as you work through it and you know, are able to be a little flexible, you can get through things like that.

WS: Nice. What a blessing that everything was paid back. What do you, I guess, connect that to? Is that by having great tenants or a specific type of tenant? Or some way you are prepared ahead of time? What was that?

VM: Yeah. I mean I'd say that the business operators themselves were good operators at what they did. I'll say this, I wouldn't go in and bring in a new tenant that's a startup, let's say, you know, whatever the business might be. I like to see people that have some experience in the space that they're in. So you know, I'm fortunate where our tenants that are local operators had good experiences and were able to weather through the pandemic.

WS: Nice. Okay now I just, I know there's people wondering, right? Well, what happened during that time? And how did you get through that? But that's an amazing outcome for sure.

VM: I think the key is the flexibility, right? If you draw a hard line and say, 'Hey the lease is the lease and this is what we're going to hold you to,' then you're going to have problems. That's where you're going to see the vacancies. But if you're flexible and able to work with them, and you know, deferment was the buzzword of 2020, and it's worked out. And very quickly we were paid back by everybody.

WS: And now you've built probably a much stronger, even stronger relationship with those tenants who are probably more loyal to you as well, I would hope.

VM: Absolutely.

WS: So, what about... Let's go back to the improving of some of those properties. Any examples that you could share? Just some things that you've done to improve the properties, increase the return, those things.

VM: Yeah, absolutely. Actually the last acquisition we just closed on, we're able to take a space that was just too large for an average user. So, taking that space, dividing it up, taking it to the market into divided smaller spaces. And I've already got LOIs for both of them and this is we're talking within 30 days. So we're able to fill the spaces much quicker by being able to work with tenants and kind of build them to suit their needs. So, that's one way we've been able to add some value to the building right away.

WS: That's awesome. Yeah, thinking outside the box a little bit. And what about the type of returns investors should look to see, you know in retail, or maybe even it is the deal structure in general versus you know multifamily opportunity?

VM: Yeah, one of the big things, you know I want to touch on when you talk about what we do in particular is the cost segregation study. That's been a huge win for our investors. And what we're seeing is with that accelerated depreciation, I mean, they're able to write off so much of their investment instantly, especially this year with the changes that came out in the Cares Act. Costs seg studies, in a way, that's depreciated. So that's been a huge win. I mean, a lot of my investors are more interested in that than they are in the return. So, you know, they have a huge tax base that they need to worry about. So, this has been a way for them to help offset some of that.

WS: Nice. I always say that that is a first world problem and a a good problem to have, right? We all have to pay taxes but it's a it's a good problem.
So, you're needing cost seg studies. No, that's awesome. What is the typical hold period for a retail investment like that?

VM: So mine is typically forecasted at seven years. So, what you're seeing is that's when all your tenants are going to be in some sort of option periods and they will have exercised their next renewals etc., and they'll still have three to five years left on their term. It's a good time to bring it back to market to sell.

WS: Nice. Are you doing dual class structures, anything like that like we see in multifamily?

VM: No, no. I'm only doing one. Currently, I've been pretty fortunate to be able to raise capital pretty fairly easily so I haven't had to get into that yet.

WS: What are some of the biggest objections, and maybe even, you know, kind of things that aren't true that people believe about retail? Or why maybe investors are not investing right now? And maybe it's just a lack of education. But, you know, anything like that you could share.

VM: Yeah, I mean it's just what you see in the media, right? Retail's dead because they're showing the big boxes moving out of the big mega malls. And that's the impression that everybody has. But, you know, I think the key is you got to look at retail and break it down into different sectors within itself, right? Say, 'Hey, yeah, there's a mall. I'm not telling you to invest in that, but then there's your neighborhood center that you go to on a regular basis. That building is not going anywhere. Those tenants are not going anywhere. You rely on them, they rely on you and that's just the way it's going to be. The landscape of the tenants might change. The type of users might change, but that building is going to stay there and that building is going to continue to be successful.

[INTERVIEW 2]

Sam Rust (SR): 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.

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

Philip Block (PB): Hey, thanks so much for having me. Great to be here.

SR: 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 seven, nine, to ten 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: 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 quite 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 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.

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 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.

[END OF INTERVIEW]

[OUTRO]

Whitney Sewell: Thank you for being with us again today. I hope that you have learned a lot from the show. Don't forget to like and subscribe. I hope you're telling your friends about The Real Estate Syndication Show and how they can also build wealth in real estate. You can also go to LifeBridgeCapital.com and start investing today.

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