

Episode 103

The Takeaway with Troy Gayeski: Become the bank

[00:00:00] **Troy Gayeski:** If you can be the bank, most importantly, earn an attractive return well above cash without taking uncomfortable levels of risk, while at the same time playing some small part of helping economic expansion and mitigating the risk of economic contraction, what a wonderful outcome.

Harrison Beck: This is The Takeaway with Troy Gayeski, a podcast from FS Investments. We sit down with Chief Market Strategist Troy Gayeski to get the latest on what's happening in the economy and what investors may want to do about it. I'm Harrison Beck, FS Investments Content Strategist. I'll take Troy through today's top questions so that you can get The Takeaway.

[00:00:47] **Harrison Beck:** Welcome Troy.

[00:00:49] **Troy Gayeski:** Hey, Harrison, how are you?

[00:00:51] **Harrison Beck:** I'm doing good.

Speaking about these larger trends in the market. You have a new strategy note, it appears on forbes.com. It's all about the opportunity set in a particular corner of commercial real estate, mortgage REITs.

And the headline here is that there are both regulatory and macro trends that are favorable to investing in commercial real estate debt and mortgage REITs in particular. And so today we're going to talk about what these favorable conditions are, where they came from and what they mean for how investors might pick an opportunity.

But first let's be specific about the strategy we're discussing here. There are lots of different ways of investing in CRE and lots of different kinds of REITs. Can you just define what a REIT is and what's unique about the kinds of debt-focused instruments we're talking about today?

[00:01:39] **Troy Gayeski:** Yeah. So when you think about REIT, which stands for Real Estate Investment Trusts, the vast majority of client capital that has ever been deployed in real estate is in the equity part of the capital structure. Think about owning a home. You own the equity, the bank is the senior lender. It's you and them. Maybe they've sold that loan off to Fannie, Freddie or Ginny. Then you think about commercial real estate, focused rates, vast majority of capital, over 95% has been invested in the equity part of capital structure. And, just like corporate equity, you have a lot of upside when things go well, but a lot of downside when things go less than well.

And so, I think it's a real tribute to our senior management team, Michael Foreman and Mike Kelly. When, when they looked at the real estate landscape, this is years ago, long, long, long before this recent commercial real estate downturn, the thought process was, everyone else is doing equity REITs, focused on taking that capital appreciation plus a little bit of tax advantage income and distributing it to clients to give you a little bit of income plus upside, the background of our firm was always focused more on income and grinded out type returns. So, hey, why don't we launch the first non-traded public mortgage REIT?

And so, when you think of REITs simplistically, mortgage REITs are there to provide competitive income, right. To grind out a consistent return well above cash.

Obviously, the outperformance relative fixed income the last five years has been tremendous because fixed income has just been so tragic, right. The Barclays Agg still roughly flat over a five-year period, whereas the better managed mortgage rates have annualized—tax equivalent, high single-digit type, annualized returns.

Much, much higher compound rates over time. And it became very apparent to many at the end of '21, early '22, that you had to roll up the capital structure, go from your equity position to your debt position.

And well-managed mortgage REITs that don't have an overabundance of poorly located office towers, which are in the midst of secular decline, that have dry powder to lend, are in a very enviable position. And the last thing I'll say there is, I often talk about an efficient frontier and the whole point of an efficient frontier is in order to make more return, you have to take more risk.

If you want less risk, you're going to sacrifice return. Right now, the efficient frontier is turned upside down in commercial real estate, or in, some would say, all real estate, including residential housing, where you have higher total return than you do in equity part of the capital structure while taking far, far less risk if things continue to go down. That is unusual. That is not something that happens often.

Really from 2009, 2010 to the end of '21, it was the complete opposite the way it should work. You want more return. You go in equity part of the capital structure, you're taking way more risk, but you're comfortable with that. So what we're urging clients to continue to do is when you're looking at income solutions, maybe one of your first steps away from cash should be something like senior secured commercial real estate lending, where you have as little risk of loss as we know of in any economically sensitive strategy. And you can earn a low-high to high-high single-digit return, which is a meaningful improvement tax equivalent from what you earn in cash. But the mortgage REIT versus equity REITs, a very central point of the whole equation.

[00:05:36] **Harrison Beck:** So you're saying that there is a portfolio function that this kind of investment can solve or can work towards, which is this goal of income. And you're saying that there's this unique change in that whereas previously, investors had been looking towards equity, there is a potential opportunity within the debt side of commercial real estate investing.

Where has that shift come from? What are the trends both historical and current that are pushing that potential opportunity to come into the foreground?

[00:06:09] **Troy Gayeski:** I'll discuss that in a second, but before we even get into that, I just want to also be clear with the audience because there are a whole host of different mortgage REITs out there, and some are really well run by very smart people. But unfortunately, prior to anyone understanding that office was going to enter this horrific secular trend, I'd refer to poorly located office towers as the second great secular, slow motion train wreck in commercial real estate.

The first was what happened to bricks-and-mortar retail. The second is now it's secular, not going away. It's slow motion and make no mistake, if you're the owner of those properties, it's a train wreck.

There's other newer mortgage REITs that have launched that are clean vintage and are focused on the right sectors. Like we are industrial, multifamily, hospitality and far, far, on the fourth, retail. And that's not a bad strategy. However, the thing to remember in mortgage REITs is it's not like RICs or perpetual BDCs where you have to meet certain level of diversification tests before you actually launch as a public fund. So, you know, if you have three or four or five loans, you better hope nothing goes wrong in one of those three or four or five loans. By the way, it very rarely does, typically loans default closer to maturity unless they're terribly underwritten, it shouldn't happen.

But if it does, you're just taking a very different risk. Investing with a diversified mortgage fund that has de minimis, poorly located office tower exposure that's leaning into the best sectors that has dry powder to lend. And then of course, there's always the difference between listed versus unlisted. Obviously, listed mortgage REITs, yeah, they have income, but they got a lot of vol. I mean just wicked levels of volatility.

But the unlisted REITs do not have that same level of volatility, which puts the timing of the entry and exit completely back on the client. And that's really, really hard to do. So, sorry, I didn't mean to cut off your question. I just wanted to get that because it's a big space. And, you know, sometimes when you say mortgage REIT, people think listed mortgage REIT or they look, hey, this one just started. It looks cool, and again, a lot of this is skill. A lot of it is luck, quite frankly.

[00:08:29] **Harrison Beck:** I think that's a great point and I'm glad you brought it up because listed versus unlisted is really important when an advisor is talking to a client that might not be frankly as familiar with private markets to understand how that's going to change their experience. And it sounds like, give them more flexibility.

[00:08:47] **Troy Gayeski:** Yeah, exactly. So back to your question on one of the trends that are driving this. A lot of it is driven by the long-term and now shorter-term regulatory reform, of the banking system, where after the GFC, banks effectively got out of transitional real estate lending completely. There's other sectors that are still involved. They still lend in commercial real estate, still the largest lender by far, even today. But where we are today is you have a lot of banking institutions that are in good shape, but they'd like to be in great shape. Right.

And so one of the ways you move from good shape to great shape is if you're heavily lending historically to commercial real estate, you may be fine, right. But it might serve you better to, the term is rebalance. That's a euphemism by the way, rebalance some of that exposure, and maybe have more commercial industrial loans, more single-family loans, more agency pastors where pastors are very, very wide now.

[00:09:45] **Troy Gayeski:** So when banks are more reluctant to lend, that leaves some more opportunity for private lenders, that's point one. The second is that you have a whole host of high quality banks that have no real danger of failing, but have been heavily allocated to certain sectors that they prefer to rebalance from. And by rebalance, I mean, if you're 35%, 40% of loan books to commercial real estate, the regulators would like it to be 30% or 35% or 20% or 25%, or from a business standpoint, you would just rather emphasize commercial industrial or buy more agency pastors, which are very wide spreads.

You know, one of the ways you can get to that outcome as efficiently as possible is find private lenders like us that have dry powder that can lend into a liquidity vacuum, like we've been doing for the last two years. And instead of originating a loan, we can buy those assets right off their balance sheet at a modest discount.

So it's win win win and an attractive spread at a very attractive LTV. And so, to me, it just speaks to what a core solution private credit has become for the entire economy.

[00:11:01] **Harrison Beck:** Sure, absolutely. And I think it's a really powerful idea for investors and advisors to hold on to, is that private credit is good for the economy and that it serves this function. And then that in turn is good for investors.

[00:11:16] **Troy Gayeski:** A hundred percent. And if you can be the bank, most importantly, earn an attractive return well above cash without taking uncomfortable levels of risk, while at the same time playing some small part of helping economic expansion and mitigating the risk of economic contraction—what a wonderful outcome.

Harrison Beck: Absolutely. Well, let's take this moment to think about investor sentiment a little further, especially when we talk about commercial real estate. You know, the news coming out of commercial real estate so often these days is about the office tower sector, and it's often not very good. And some investors might be turned off by a market that's been experiencing such a public challenge. So are troubled office towers a reason for investors to avoid CRE or avoid mortgage rates?

Troy Gayeski: Certainly not. Although you have to be...this is why I discussed earlier...you have to look through the balance sheets and at least ask the tough questions of how much poorly located office tower exposure do you have?

I think the good news for any mortgage lender, regardless of whether you're a bank, an insurance company, the CMBS market, a REIT, whether you're publicly traded or not, is the vast majority of losses through the second great secular slow motion train wreck will be borne by equity investors, which is how it should be.

I mean, that's the whole point. Equity gets the upside, equity gets the downside, but just like we saw in the GFC or in the savings and loan crisis, there will be some modest losses that bleed into senior loans, but it should be nothing disastrous. You'll just give back some of your income from that outcome.

[00:13:00] Furthermore, if you look at the other sectors, multifamily, lodging, you think of retail, industrial, the fundamentals of those sectors all look very, very good. The price declines we've seen are mainly caused by higher borrowing costs, which again work to the benefit of a lender, right?

But it means that you've had price declines as an equity owner, higher borrowing costs and higher cap rates, right. Cap rates got exceptionally low. They've had to normalize back to something more in line with where borrowing costs are or capital structures don't work. So we've always viewed the downturn in industrial prices, multifamily, lodging as really having de minimis downside—even retail less than industrial, multifamily, as being primarily a borrowing cost and cap-rate driven problem.

So make sure you're focused on the senior part of capital structure. You have de minimis, poorly located office tower exposure, and whoever you're investing with has the capability to lend to the more robust sectors. And let's also get back to basics here. Even if you originated a loan at the end of 2021, and you did it to multifamily at a 70 LTV in Austin and that multifamily property is down 20%. Well, if you're the equity owner, you've taken quite a substantial mark-to-market hit on your value.

But as the lender, we still have 10 points of subordination beneath us. And furthermore, the properties are performing very, very well. Cause they're great assets. They've just gone through a very predictable price decline after a massive borrowing rate move and also a substantial cap rate move. And then the last thing I'd say is you all know that we've been in a stronger for longer, higher for longer camp for years.

And I know this has caused angst, particularly for real estate equity owners, like, oh my goodness, like the Feds never going to cut and rates are never going to go lower. And oh, the 10-year was at 3.75. Feels great. Gaps back up to 4.5. Doesn't feel as good, but there is relief. Like we've always told people, the way you normalize the spread between borrowing rates and equity cap rates over time is twofold.

One, the rent growth you get, the net operating income growth will not reflect in price appreciation. Instead, it will reflect in a gradually higher cap rate. The second is eventually the Fed will gradually take the front end to three over many years and the 10-year will settle in around 3.5-4.

So you get some borrowing cost relief and then your NOI gradually builds or your NOI growth gradually leads to higher and higher cap rates. And that's exactly what's playing out. We're just very happy we're senior lenders and not equity owners right now.

[00:16:11] **Harrison Beck:** Sure. Absolutely. And these are the really important conversations between investors and advisors about understanding commercial real estate through really knowing what's happening in fundamentals, really knowing what's happening from one sector to another, and having that kind of long-range view. With all of that in mind, you already sort of spoke to this, but what are the characteristics of a potentially well-performing mortgage REIT? What are the market opportunities that investment should maybe be taking advantage of? Is there anything we haven't covered yet?

[00:16:41] **Troy Gayeski:** I think a couple other things that are really important is the bandwidth to source deals, whether they're construction takeouts, property improvement, there are—could, I'll use the term could, I'll be very gentlemanly—there could be entities that might not be able to deploy meaningful amounts of capital. And so you could kind of end up in the same situation that some of the perpetual BDCs did late 2021, early 2022; a ton of money coming in, not an ability to deploy it. Well, that kind of leads to a problem. The other thing, and I'm very proud of our team for this, is the ability to pivot as opportunities present themselves.

And I'll give two examples. One was pivoting from being almost an exclusively transitional acquisition lender, construction takeout lender really up until October of 2022. That's really all we did, right, is focus on these transitional loans. But then once the stresses started to build in the banking system—when commercial real estate started to take a digger early 2022—what we found is, that many high quality borrowers through no fault of their own were having trouble rolling their loans because their current financier just didn't have the capacity to extend credit.

Now that has gotten better. There's no doubt. But what I refer to this as the rolling loan opportunity. Where you have about a little under three trillion of loans rolling through 2029, about half the entire asset class and our ability to sit back in—cherry-pick's a strong term, but target really high quality borrowers and great properties at attractive spreads and attractive LTVs. Again, win, win, win, right. Win for the borrower, win for the current lender, because without us to take them out, they'd have to figure something out. And obviously a win for our investors.

And then, if I may—the whole point of making high quality loans is to minimize the probability of something going wrong. But you're never going to completely eliminate it. Something is going

to not work out the way you had hoped. Whether it's the economy, whether it's the Fed hiking rates, whether it's a borrower that's over-concentrated in a particular sector that just doesn't have the capital to kick in when things are a little dicier, whether it's the source of capital is in a very narrow vehicle that because of regulatory constraints can't take additional capital.

So not if, but when things go wrong, what is the plan for making sure a nonaccrual or a default does not turn into a loss? There's a difference between a nonaccrual. There's a difference between a default and a loss of capital. Right. Obviously, it starts with the equity cushion. But what is the workout team's expertise in monitoring these in real time and then figuring out how to maximize the outcome? And as an example, like we always say, the best outcome is to find a new buyer who comes in and replaces the weaker owner, and then becomes the senior lender to them. But another perfectly fine outcome is taking possession of the property and having equity-like upside over the next several years, particularly in very high quality properties. So there's a lot of complexity to not only minimizing the probability of a nonaccrual or default in maximizing recovery rates or minimizing the risk of loss. Very, very important. And it's sometimes, lost on people.

[00:20:31] **Harrison Beck:** And that experience in the space is so key then. So finally, as we wrap up this episode, it's the name of the show. It's a great way to summarize our conversation. What's the takeaway you want listeners to have from our time together?

[00:20:46] **Troy Gayeski:** Yeah. So central challenge, how do you put these massive cash hoards to work? How do you do it where meaningfully increasing total return without taking uncomfortable levels of risk? One of the prime-time strategies for doing that right now, as has been the case the last several years, has been the well-managed public non-traded, mortgage REITs that can provide, we think, higher income and total return than equity REITs with far, far, far less risk.

[00:21:16] **Harrison Beck:** Well, check out Troy's latest article for the Forbes Finance Council, "Become the Bank, Why Current Conditions Favor Mortgage REITs and How to Pick One." You can find it on the Forbes website, forbes.com. It has some really useful content for shaping a conversation around the current opportunity set in commercial real estate and actionable reasons for why investors may want to consider mortgage REITs. Give it a read. Troy, great conversation with you today. Thanks so much.

[00:21:43] **Troy Gayeski:** Harrison, it's always a pleasure, buddy. Thanks for listening, everybody.