Amherst Capital Management

U.S. commercial real estate still undervalued compared with U.S. stocks

Recently, **Jonathan A. Schein,** managing director of global business development at Institutional Real Estate, Inc., spoke with **Abbe Franchot Borok,** head of originations at Amherst Capital Management, the commercial real estate lending business of Amherst. The following is an excerpt of that conversation.

CONTRIBUTOR

Abbe Franchot Borok
Head of Originations, Commercial Real Estate Lending
Amherst Capital Management

Abbe Franchot Borok is a managing director and head of originations for the commercial real estate lending business at Amherst Capital. In this role, Abbe is responsible for the origination of mortgage debt on all types of commercial real estate assets.

Prior to joining Amherst Capital, Abbe was a senior member of the commercial real estate lending team at CapitalSource, a division of Pacific Western Bank. Abbe has broad experience in sourcing and underwriting commercial real estate debt, with a focus on interim senior loans backing transitional or value-add business plans.

What trends can we expect to see for the remainder of 2019 in the commercial real estate space?

In the early part of 2019, price and rent growth remained positive, but these metrics have started to moderate across asset classes, particularly in the office and retail segments. We expect continued growth in commercial real estate (CRE) prices in 2019, but at a slowing rate, as new supply and slowing rent growth constrain prices. According to RCA, we've already seen some of this take place, as price growth has slowed to 5.8 percent year over year through January 2019, from 14 percent to 15 percent year over year in 2015. We expect supply to remain elevated in 2019, as the current construction pipeline is completed and brought to market. In addition, we expect that tight cap-rate spreads may limit the potential for strong CRE price growth this year. As a result, Amherst Capital continues to prefer a more defensive approach, focusing on the senior portion of the capital structure for more attractive risk-adjusted returns.

How will tight cap rates affect commercial real estate price growth? Which markets will they impact most?

Expensive primary markets, such as New York; Los Angeles; San Francisco; Boston; Washington, D.C.; and Chicago, and specifically their central business district (CBD) areas, already have tight cap-rate spreads to Treasuries. We expect these areas will have less room to absorb potential rising interest rates. So we expect those areas to see minimal price growth. Tight cap rates in the medium term, a two- to five-year horizon, will incentivize new supply, and this could eventually slow rent growth. We've seen this to some degree already in New York City, San Francisco, Los Angeles and Boston.

What do rising interest rates mean for commercial real estate pricing and supply? I imagine this is something you're watching pretty closely.

We expect fewer interest rate increases this year, as has been broadly reported, which will contribute to slightly slowing price growth across CRE markets. However, we believe the effect of rising interest rates won't be felt equally across all areas. Cap rates have historically been poorly correlated with Treasuries, so the risk-free component of cap rates should rise along with increasing rates, but we expect that trend will likely be countered by the positive correlation between NOI growth and inflation. These two forces are expected to push prices in opposite directions, likely leading to mixed results. The primary markets with tight cap rates will have less room to absorb growth, which we're already seeing in CBD office growth slowing to 1.1 percent, year over year, through the first few months of the year based on Amherst analysis of Treasury and RCA data.

Do you see that increasing construction?

Tight cap rates incentivize new supply. On the lending side, we need to be sensitive to rising interest rates as we evaluate take-out financing on construction projects. Rising construction costs and rising debt costs can be restraining factors on supply.

Opportunity zones have created a lot of buzz, but they still only make up a small portion of commercial real estate units. Does Amherst expect investment in opportunity zones to pick up?

Yes, there is a lot of focus on opportunity zones, and we expect investments initially to pick up in these areas. We're already seeing signs of gentrification as investors look for lower-risk environments within these zones.

Where are investors finding value within qualified opportunity zones?

We think the immediate benefit may be in some already high-profile zones that have already been gentrifying and driving significant real estate investment, such as Long Island City or Washington, D.C. These areas tend to have higher income levels than other qualified opportunity zones (QOZ) and are very closely located to dynamic urban centers with diverse employment opportunities, and we're seeing a substantial initial focus on these areas. Given the tax incentives associated with opportunity zones, we continue to expect investment will pick up in these areas, and we believe there will be increasing levels of institutional equity being raised with a focus on investing in opportunity zones.

Another key factor is that there has been a significant amount of capital targeting U.S. real estate overall. This trend will continue to support some aspects of price growth in the face of slower growth overall. Investors are showing increasing interest across real estate private equity strategies, and, according to Preqin, about $180 billion of dry powder is currently targeted at U.S. real estate. We also believe that a proportion of that interest will drive some of the QOZ interest. QOZs provide really interesting tax incentives for a portion of that capital, making it another growing subset of increased investor focus on U.S. real estate as an asset class.

Last year was a challenging year for retail. Will retail rents hang on in 2019? What's the retail story from your perspective?

Retail rent growth is slowing, and retailers are struggling with the effects of both e-commerce and changing consumer preferences, both factors driven by millennials. This can be most acutely seen in certain types of retail, such as class B malls, which will continue to underperform retail as a whole. These malls are struggling due to changing consumer preferences, but also as an aftershock of the larger retailer bankruptcies in 2018, such as Sears and Toys 'R' Us. We expect these challenges to continue for this class of retail into 2019. To date, these bankruptcies have not pushed vacancies higher, due to limited new construction and the rise of the clicks-to-bricks phenomenon, where some online retailers are increasing their physical presence. We do expect that the Sears liquidation will lead to at least some contagion risk in class B malls in some areas across the country.

There are some positive trends in retail CRE, such as the clicks-to-bricks phenomenon, where some of the more successful online retailers are actually creating a bricks-and-mortar strategy. The most obvious example is Amazon's acquisition of Whole Foods. You have Amazon spending tens of billions of dollars to buy Whole Foods' stores and to introduce bricks-and-mortar bookstores and other retail experiments. We're also seeing smaller, more millennial-focused brands, such as Warby Parker, Casper and Glossier, very selectively growing their bricks-and-mortar strategy.

Amherst data tells us that it's important to pay attention to how retail offerings are evolving and adapting due to changing consumer trends. We've seen a real increase in experiential retail. Millennials now eat more than half of their meals out of the home, so experiential retail includes restaurants, as well as fitness centers, bowling alleys, putt-putt golf and new beauty offerings. Consumer preferences are driving the need for those types of experiential retail outlets, and as more of the consumer goods industry moves online, these experiential retail outlets are absorbing some of that space.

Which markets and which asset types would be most vulnerable if another late-year sell-off were to occur?

We expect that less-liquid assets in the capital stack, such as mezzanine bonds, would be most exposed to a potential sell-off. Amherst's view is that the CBD mezzanine bonds generally do not compensate investors enough for the risk profile of the product at this point in the credit cycle. This is another reason why we're favoring senior bonds and senior loans, which we believe offer the best risk-adjusted return. But again, harkening back to retail, the retail sector remains quite exposed to the broader slowdown in economic activity. Hotels are also an asset type that is more vulnerable to a sell-off. Hotels are just historically a more volatile asset class and also one of the first to correct in a market downturn. In certain markets, there's been significant new supply in hotels — New York City, Nashville and Austin, for example — and we think these markets would be more vulnerable to a market downturn.

After the late-year sell-off in fourth quarter 2018, however, markets stabilized in January. The CMBS conduit 10-year AAA spreads widened 35 basis points in late December 2018. They have stabilized and tightened 15 basis points to 20 basis points in the first quarter of 2019, but they remain wider than third-quarter 2018 levels based on JPM data. But the late-2018 market sell-off didn't spill into the broader economy, at the time, and was relatively short in duration. Our data shows that fundamental commercial real estate performance really held pretty stable.

Amherst is known for its data and analytics. How does Amherst use data when evaluating a particular investment opportunity?

We have an extensive database of both CMBS and CRE data that allows us to get a view of the market broader than just market-level reports. Our proprietary dataset helps us see lease, sales and loan comparables for properties when we're underwriting loans and analyzing specific market performance. We also built a credit option-adjusted-spread (OAS) model that analyzes pricing in the market for both CRE loans and CMBS bonds, and helps us provide risk-based pricing of loans as we seek better risk-adjusted returns implied by the prices of these loans. Our tools can give us a detailed picture of how a 70 percent LTV loan should be priced versus a 75 percent LTV loan, which is incredibly useful as we compare the pricing of certain loans across asset class and across geography.

Our approach is to marry our expertise of CRE fundamentals with an overlay of our proprietary data and analytics modeling. This means we collect enormous amounts of market data and property-level data, including a comprehensive dataset for every piece of real estate in the U.S. We use a 20-year data set, cleanse that data, and then we use that data to help develop analytical tools to aid in our evaluation of credit risk and the pricing of that risk.

Where does Amherst see opportunities in 2019?

Adjusted for lower cash-flow volatility and lower capital expenditures over the life cycle, Amherst data shows that CRE is undervalued versus where stocks are trading. That may be more telling for stock valuations than CRE, but we continue to think that there are attractive opportunities to invest in commercial real estate relative to other asset classes. Amherst continues to prefer a more defensive approach, focusing on the senior portion of the capital structure to deliver, in our view, the better attractive risk-adjusted returns.

CORPORATE OVERVIEW

Amherst Capital is the registered investment adviser and a subsidiary of Amherst Holdings LLC ("Amherst"). Amherst Capital's AUM across its investment platform is $1.8 billion*. Amherst is a U.S. real estate investment specialist with $4.3 billion* AUM. It offers a suite of traditional and alternative real estate strategies that span the risk-return spectrum.

*Figures estimated as of December 31, 2018. The Amherst group of companies has more than $15 billion of balance sheet assets and manages $4.3 billion of real estate–related investments for third parties and itself. Balance sheet assets are related to our affiliated broker-dealer. Managed assets include $1.5 billion of leverage.

CORPORATE CONTACT

Jessica Rutledge
Vice President, Marketing & Communications | Amherst
+1 (512) 954-6789 | jrutledge@amherst.com

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