Amherst

Transitional properties offer a nuanced opportunity, from a first-mortgage lender perspective

This interview was conducted by the managing director of *Institutional Real Estate Americas*, who recently spoke with **Gabe Boyar,** managing director of Commercial Real Estate Lending at Amherst Capital Management. Following is an excerpt of that conversation.

Even before the COVID-19 pandemic, we have seen tremendous growth in the industrial market over the past few years. What was driving this pre-pandemic growth?

Over the past few years, the industrial sector has morphed from a sleepy property type to arguably the most essential commercial real estate property class. Last-mile industrial properties, which provide supply lines into major metropolitan cities, have been the clear winners as logistics users secured real estate that makes delivery as accessible as possible in urban areas. In New York City, for instance, well before the pandemic we saw a sea change beginning to occur in the occupancy of retail space. Essentially, vacancies increased for retail properties that were poorly located or mispriced. These vacancies were largely driven by the "Amazon effect" where consumers opted to purchase a significant amount of their consumer goods online as opposed to in-store. As a result, supply moved out of the main parts of the city to industrial properties and warehouses due to the decreased need for local supply in retail stores. The pandemic only exacerbated this effect, as many people avoided in-person retail in favor of online shopping.

Just how resilient has industrial been as an asset class?

In 2020, the pandemic caused a decline in transaction volume across all property sectors. Data from Real Capital Analytics reveals that industrial fared the best, with transaction volumes down only 16 percent, as compared with the 32 percent decline across all commercial property types in the country. In fact, the industrial sector led the way in price growth among all property types in 2020 with warehouse properties being a particular bright spot — price growth was around 10 percent, the highest in the commercial space. Amherst data found that, as of third quarter 2020, the industrial sector had also posted the strongest rent growth among commercial real estate asset classes at 3.5 percent year-to-date, driven by the massive upswing in ecommerce. Additionally, Costar data shows that industrial new construction, measured by square feet, remains at an all-time high at 333 million square feet, as of third quarter 2020. The Amazon effect similarly drove an increase on the construction side in the price of joist and girder — raw material — which has increased by $140 per ton since November 2020.

What trends do you anticipate as properties adapt to new industrial demands?

I come to this question as lender rather than an owner, but I am especially interested to see what the owners of failing malls do with their properties and whether there is an opportunity to convert some of those to industrial uses. Malls are complicated because the inline space and the anchors are often owned by different entities, so any mall redevelopment project would require strong owners with deep retail connections to determine whether it can be converted to multifamily, industrial, office or something else. However, their proximity to public transit, abundant parking, and the fact that their infrastructure is already primed for mixed-use development make them very interesting candidates for transitional business plans.

As the economy recovers, there likely will be a dislocation between the desired characteristics of the available supply and the new demand that emerges. How can lenders be effective in getting commercial assets back in line with market conditions?

At Amherst, we are in the transitional lending business, which we believe provides optimal risk-reward opportunities over the long term. Our data and analytics help us to see emerging trends in the market, showing a common misperception that transitional properties will remain in transitional status for an extended amount of time and, conversely, that a stabilized property will remain stabilized forever. However, there are institutional groups that buy these underperforming assets that can implement value-add business plans to bring property performance more in line with market conditions, thus creating additional value and unlocking an attractive, long-term investment opportunity.

Which of these demand trends would you say are more short term, and which do you see as long term?

As the vaccine rollout continues and our country sees demand for experiential retail and destination travel rebound, people will be eager to get out and travel both domestically and internationally again, so I would not be surprised to see destination hotels revive. I am also interested to see whether we will return to the pre-pandemic levels of business travel that drove airline and hotel revenues. Will we rely more on technology for communicating with our important business relationships as we have done during the pandemic? Or will in-person business connections still win the day? Likely a combination of both.

A transitional property can be difficult to underwrite and manage. How does Amherst approach the successful underwriting and execution of a transitional loan and value-add business plan, and what makes Amherst different from other lenders in the space?

At Amherst, we primarily lend on value-add assets. That means these assets are being improved, usually substantially, and for that reason we care very much about the sponsor and where their equity is coming from. Most of the sponsors we lend to have aligned themselves with institutional equity providers, and once we develop trust through successful execution, we tend to do repeat business with each other, which is significant. We are currently focused on providing first-lien financing on transitional real estate across the country, basically in the top 35 to 40 MSAs, which we believe is still the sweet spot in today's real estate market. In targeting institutional groups that buy underperforming assets with a plan to make them better, we can create additional value that seeks a greater equity cushion between our loan and the ultimate value of the property.

We have rigorous underwriting and asset management processes, underpinned by our propriety analytical tools and data. As a first-mortgage lender on assets in transition, we make loans up to $100 million in size, which we hold on our balance sheet, and service and asset manage in-house. Because of that, if a business plan changes either positively or negatively, we have the flexibility to make decisions that make sense for the loan and the properties, and evolve alongside our borrowers, which I think is unique in this particular market. We are also generalists, so we work across all property types all over the United States. With these skill sets and deep familiarity of working with transitional assets, combined with our vertically integrated lending platform, we view ourselves as a trusted one-stop shop during periods of volatility.

What are some of the more recent transitional loans you have been doing that speak to these trends in the industrial space?

There has been a flight to quality in multifamily and industrial, which makes winning those loans increasingly competitive. Amherst successfully won several loans in the competitive transitional industrial space, including executing on a $15 million loan in the greater Philadelphia area for a sponsor who partnered with a name-brand, institutional equity group, to programmatically acquire industrial properties. This particular property is a vacant, 235,000-square-foot property — a lease-up story that will be vastly improved following the completion of enhancements to the roof and the loading docks. The deal has all the characteristics Amherst looks for when assessing transitional industrial opportunities: proximity to major highways and easy access to Philadelphia, as well as to the New York/New Jersey metropolitan area.

We were also recently paid off on an interesting industrial loan portfolio, which is part of a larger strategy by the sponsor group to acquire well-located, net-leased, corporate-owned industrial assets. In this instance, we structured the loan with partial release provisions, which allowed the borrower to sell off assets on a piece-by-piece basis, while still maintaining equitable leverage to our loan. The deal was complicated because not only did we underwrite the entire national real estate portfolio, but also the credit of the corporate tenant who was leasing back the properties. The combination of the loan payoff to our firm and the profit to our borrower on the properties it sold is the exact kind of shared success we love to see at Amherst.

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Gabriel Boyar is a managing director of Commercial Real Estate Lending at Amherst, responsible for origination of first-mortgage debt on all types of commercial real estate. He has more than 20 years of experience in real estate finance and investment. Prior to joining Amherst Capital, Boyar was the owner and managing principal of Columbia River Capital Advisors.

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