Assessing Investment Risk: Investors Show an Appetite for Commercial Real Estate

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Paula Tkac: *Welcome to the Federal Reserve Bank of Atlanta's Center for Real Estate Analytics podcast series. I'm Paula Tkac, senior financial economist and assistant vice-president with the Federal Reserve Bank of Atlanta. Today we are talking with Ken McIntyre, managing director and head of strategic initiatives at MetLife, to find out more about commercial real estate activity.*

Ken, thank you for joining me.

Ken McIntyre: Glad to be here.

Tkac: *During the heat of the financial crisis, we heard a lot about the large volume of commercial real estate loans that would need to be refinanced in 2010 and 2011. Can you give us a quick update on how those refinancings are proceeding?*

McIntyre: Sure. For MetLife, we are having a very big year this year. We had a fair number of loans refinancing and we've actually successfully refinanced everything, with a fair number of loans actually rolling off our books, which was a little unexpected.

In general, the markets have come back pretty well for debt on good-quality properties. Properties that are of lesser quality, and maybe have weaker locations or are in smaller markets, are having a tough time attracting capital right now. But for the good properties, we're seeing refinancings happening very readily.

Tkac: *And what would make a good property? You mentioned location. Are there other aspects of a property that would make it a better credit risk?*

McIntyre: Yeah. Where we're seeing debt capital flow these days is into the top-tier markets, predominantly New York, D.C., San Francisco [and], to a lesser extent, LA, Chicago, and Boston. Those are the ones that are constantly attracting capital, both domestic and international. And then the other things that are important are most of the properties [that are] what we call "institutional" in quality—and those are CBD office buildings, high-quality regional malls or strong, dominant retail centers, or top-tier apartment complexes, multi-family properties—that have strong demographics in any of those markets, generally newer stuff, although stuff that has had a long track record of high occupancies and consistent rent growth will continue to also attract debt capital.

Tkac: *Now, commercial real estate activity typically lags a broader economic recovery; it's what we've seen in the past. Is that pattern true of this recovery as well, or is the depth of the recession actually causing a change in that relationship?*

McIntyre: Good question. I would say that the economy still hasn't really recovered yet, but real estate financing kind of has, and I would attribute that to the low interest rates. Low interest rates are allowing properties with cash flow to survive and roll over into new loans with lower interest rates, which are very attractive to borrowers. Again, for properties that are higher quality, the low interest rates are attracting fresh equity capital, so you're seeing some of those start to sell at relatively high prices compared to where we are in the macroeconomic cycle.

Tkac: *Perfect lead-in to my next question, which has to do with interest rates. So, what is the current appetite among the buy-side investors for commercial real estate? Are low interest rates really helping to get deals done, and is there an appetite out there for commercial real estate risk?*

McIntyre: There's a tremendous appetite for commercial real estate risk, and low interest rates are a big driver. For many of the capital sources, like ourselves—MetLife, an insurance company, where we hold the assets on our book—we allocate capital on a relative value basis. So we look at where we can get a spread today in real estate versus where we can get a spread or a coupon in another asset sector. Many other investors are making similar decisions.

So, when you look across the spectrum of various available financial instruments, low interest rates are everywhere. Corporate bonds are trading in the 2, 3, and 4 percent range, so if we can do mortgages in the 4, 5, and 6 percent range, that's an attractive way for us to put capital in. Interest rates at 4, 5, and 6 percent for real estate investors, if they can borrow at 4 percent, 5 percent, or 6 percent, it's a very attractive rate, historically. So, we're seeing equity capital come in because they can get positive leverage and get much greater returns on a leveraged basis for investing in real estate than they can investing in bonds or other assets.

Tkac: *So, we have seen some migration of capital flows from other asset classes in this environment?*

McIntyre: I can't say absolutely, but I would say on a relative value basis, investing in real estate is at an attractive place right now. I can also say that we are seeing pension funds reallocate into real estate again, whereas in 2008 and 2009, a lot of them had curtailed the amount of capital they were putting into real estate. But now, they're reallocating to real estate. One, the returns are attractive. Two, it's a cyclical good point to buy into real estate because prices have come down and you can ride them back up. And, three, you can get the positive leverage.

Tkac: *Now, in terms of the recovery, you said you didn't think the economy has necessarily begun a solid recovery yet. What are you looking*

for in terms of signals that the commercial real estate market in particular might solidify and turn into a positive upswing?

McIntyre: The biggest macroeconomic indicator for commercial real estate is employment growth. And so until we see solid, sustainable employment growth, it's going to be tough for real estate investors to get very positive on how they feel about the asset class. Conversely, though, as I said, well-located properties in top-tier markets maintain their occupancies and attract tenants even in weak environments. So, those properties have continued to be attractive as an investment type. But, the first thing we would look for before we start to spread our capital into either second-tier markets or lesser-type properties is we would like to see employment growth on a broader basis and sustained over time.

Tkac: *Now, if we look across the landscape of whole loans to syndications to securitizations, what do you see as the future of commercial real estate financing?*

McIntyre: That's a great question. I tend to be a bit of a traditionalist. I see that the commercial banks have traditionally done construction loans, insurance companies have traditionally done permanent loans, pension funds have traditionally owned properties, and I see that what's happened through this financial crisis is a bit of a reversion to that type of scenario whereas, through the past 15 years, everybody had gotten to each other's, sort of, territory as everybody was chasing assets to just try to grow.

So what's been good for us is that securitization right now isn't a major player on the debt side. So as a real estate lender, insurance companies—and MetLife in particular—is having a high-volume year on quality real estate.

Do I see securitization coming back? That's the big question. Clearly, there are several—I would say more than 10—securitization shops [that] have become up and running during the course of 2010. And then, the prospects are for $8 to $10 billion of CMBS in 2010. The numbers vary from probably $25 billion to $50–60 billion for 2011. That, I think, is going to be a challenge because I just don't know where all the deals are going to come from, but I would think that the shops are set up to do that type of volume. So, if you ask anybody on Wall Street, they would tell you that CMBS is coming back.

Tkac: *Well, wonderful, that was really informative. Ken, thank you again for joining me.*

McIntyre: Thank you for having me.

Tkac: *This concludes our podcast with Ken McIntyre, managing director and head of strategic initiatives with MetLife.*

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