Nailah Flake

Episode 259: Demystifying Real Estate Credit

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com Podcast. My name's Stewart Foley, I'll be your host. Welcome back and thanks for joining us. We're thrilled to have you. We've got a phenomenal podcast for you today featuring Nailah Flake, managing partner, head of real estate debt at Brookfield. Nailah, we've got a lot of ground to cover, and thanks so much for taking the time and agreeing to be professor for a day here, so welcome.

Nailah: Thanks for having me, Stewart. It's a pleasure to be here.

Stewart: We are just tickled. I've got lots and lots of ground to cover, but before we get going there, can you tell us a little bit about where you grew up and your first job, not the fancy one, and then how do you get from Spelman College to the head of real estate debt at a group the size of Brookfield?

Nailah: That's a great opening question, Stewart. I grew up in New York in Queens, New York, and one of my hobbies growing up was dance. My first job was as a dance instructor. Now, I have to say, I worked for free as a volunteer for a very long time by the owner of my dance school, but in my senior year of high school, she actually hired me to teach ballet and tap to three and four year olds. Even though it's a passion of mine at three and four, you're still taking kids to the bathroom and doing a lot of dirty work in the middle of teaching plies and tap steps. It was a fun job that I had growing up, and it at one point, inspired me to almost want to go to college to major in dance, but I decided to go to Spelman. I majored in economics and my first internship was at Morgan Stanley, and that led into my first full-time job out of college where I did various rotations through investment banking, capital markets, and fixed income. I landed in a group where I was underwriting real estate loans and the rest is history.

Stewart: That's a great story. I'm going to go out on a limb and say that you made the right economic decision versus teaching dance.

Nailah: I think you might be right.

Stewart: Yeah, my daughter was a dance person for sure, and I have a lot of regard for that whole deal, so kudos to you for being a dance instructor. That's cool.

Nailah: Yeah.

Stewart: Can you tell me a little bit about, I did some research and apparently there is something at Spelman called the Founders Day March Through the Gates. Can you talk about that tradition and what that experience was like for you?

Nailah: Absolutely. Spelman College is a historically Black college and it's an all girls college where a lot of our foundation is built on traditions where bonding and appreciating sisterhood is really something that carries out through the legacy of all who have attended Spelman. When we graduate from Spelman College, we all march under the arch and it's sort of our rites of passage from the gates of Spelman College where we were not only educated, but where we were inspired to be successful women and women who impacted the world. It's marching through that gate. That's kind of our rites of passage into the world where we continue to make our mark.

Stewart: That's inspiring. It's really cool. I think education is the great equalizer and I'm a huge, huge proponent of education, which is one of the reasons it's great to have an expert on like you to be professor for a day on real estate debt. Just to kick it off, the world of real estate is so vast and everybody, I think that the knee-jerk reaction is you hear 'real estate' and then you also hear 'office' at the same time, but has been pointed out on this show many times the real estate market is far, far greater than that one sore spot. Can you talk a little bit about what sectors you focus on and are there any that you find particularly exciting right now and anywhere that you're cautious?

Nailah: Well, the great thing about working at a company like Brookfield that has over $275 billion in real estate assets under management is that I can focus on a broad array of asset classes. Brookfield has expertise in all of the asset classes, and on top of that, they've been doing it 400 years and there's not that many companies that have over 100 years of owning and operating real estate. What that really allows me to do is look at market cycles and work with my colleagues that focus on the different asset classes to take advantage of unique opportunities that we see both in sectors and geographies at any one particular point in time.

Right now, I'm really excited about some of the trends that we're seeing in housing sectors such as apartments, single-family rentals and student housing. Also, industrial is equally as compelling given the sustained demand from e-commerce and the ongoing need for efficient supply chains. Then what's really exciting is we're seeing opportunities in some of the alternative asset classes like science and innovation, self-storage and data centers. Again, my ability to look at these various asset classes at a company like Brookfield where we are learning from experience, we have boots on the ground in 30 countries, and I am able to really take that knowledge and apply that to select deals and to decide where we want to make investments.

Stewart: That's super helpful. When you lend against real estate, how does that compare to a traditional mortgage loan that our audience might already be familiar with?

Nailah: Brookfield has multiple capital sources and most real estate credit is some type of financing in the form of a loan or some structured debt. With the different buckets of capital we have, we do invest in the sense of traditional first mortgage, but we also, are more creative at times, particularly when we're investing higher in the capital stack. One of the strategies that we employ is mezzanine financing where we're focused on subordinate debt between 50% and 70% loan to value. In those instances, we're really focused on retaining control. In a downside scenario, we want to have a debt instrument that allows us to preserve capital in the event that there is a situation where we need to step in and take over the asset. One of the structures that we employ instead of just lending through the first mortgage is to bifurcate the loan so that we own a subordinate instrument that allows us to have a clean path to control the property if we need to.

Stewart: Can you give us a quick overview on the real estate credit asset class and some of the key differentiators between that and more traditional corporate credit?

Nailah: Sure, so I know it goes without saying, but since you've licensed me to be the teacher of the day, I'm going to take a step back and make sure that our audience really knows. Real estate credit generally is secured by an underlying physical asset and structured based on the property's cash flow and the ability for that underlying income stream to cover debt obligations. Really one of the key differentiators is real estate credit. You have an underlying asset, corporate credit, you're focused on the credit worthiness of the company.

That said, we think the two asset classes are very complementary, both providing great diversification within a portfolio, with respect to other fixed income products, and both providing strong relative value with attractive risk-adjusted returns. I think one of the unique things about real estate and having that tangible asset is that we underwrite those assets to determine long-term value and we're investing at a part of the capital stack that's more secure than equity. That also, provides a cushion and some ability to really target current cash on cash that's strong, including longer-term attractive risk-adjusted returns. Then the last thing I'd say is over a long period of time, commercial real estate debt benefits from low default ratios as well as high recovery ratios over the long term.

Stewart: With the basics that you've covered at this point, can you share your views and outlook for the real estate debt market right now?

Nailah: Look, there are four factors, in my opinion, that have really affected volatility in the real estate debt markets over the last few years. One, of course, was the impact of the COVID pandemic. The other is the permanent culture shift that we have seen related to work from home. Then you have inflation and you had the regional bank failures. Then I kind of don't include it in my list of four because I think it goes without saying that high interest rates and volatility in interest rates have really impacted the economy overall. What we're starting to see now is market volatility and overall uncertainty in the market that once caused investors to sit on the sidelines.

We're starting to see the tide turn and we're seeing more opportunities now to invest in deals at a more insulated basis in the capital stack. We're seeing liquidity come back to the market and we're seeing borrowers who are ready to transact, because I think they've accepted that although rates are still higher, that they're less volatile at this point. I think what's important to remember about the real estate debt markets is it's a very mature market. Not many people realize that the commercial real estate debt market is a $6 trillion market, and because of the volatility that we've seen over the last few years, we're hitting up against a significant wall of maturities. In the next two years, in 2025 and 2026, we're projecting to see about $2 trillion of real estate loan maturities, and we think that that is going to increase transaction volume while we're seeing more stable economic backdrop.

Stewart: Do you think that the refi wave of that magnitude in just doing rough math, it sounds like that's about a third of all the real estate debt outstanding, which seems like a whole lot. Do you anticipate that to be a period of spread widening that you can take advantage of over the next couple of years, obviously, having the capital that you have currently under management?

Nailah: Yeah, I do think that we will be able to find unique opportunities to find outside risk adjusted return. There are a lot of capital inflows into the commercial real estate debt market, but I do think there's a bright spot for alternative lenders. One of the trends that we're seeing in the market right now is really the retrenchment of the banks, the regional banks. Of that $6 trillion, historically, the banks have been about 50% of market share and already seen in the first half of this year that bank lending is down 26% and alternative lenders are capturing that market share and alternative lenders are up 39%. I think that, although, there's a lot of capital inflows and a lot of liquidity available to lend against real estate, I think that there's a unique opportunity for alternative lenders to capture increased market share as we see these wall of maturities. The one other thing I would add is with this growing market confidence, there's also, a significant amount of dry powder ready to be utilized in terms of real estate equity capital available for deployment. I've seen some statistics that have cited over $500 billion of dry powder. I think the combination of the need for new acquisition, finance and refinancing is really going to fuel this market.

Stewart: You can completely pass on this question, but do you think that a Trump presidency serves to weaken or reduce bank regulation stemming that flow away from banks or is that a few years down the road possibility?

Nailah: That's a good question and I'll pass because I don't have the crystal ball on that one.

Stewart: Yeah, it's interesting though. I mean, I think that the story that, I mean, with the banks clearly not participating and really creating a terrific opportunity for insurance companies to fill. The other nice thing is that you can, the insurance companies have a pretty good sense of their liabilities and you've got a scope of maturities and durations and structures that can match up nicely with what they're trying to fund. It always has seemed to me that the nature of insurance liabilities lends itself well to this kind of thing. It's one of the reasons that insurers have been a player in this space for decades. With the recent and impending rate cuts, what do you think the impact is for real estate credit? Is that a precursor to a slowdown or is the lower rate going to help the valuations?

Nailah: Lower rates, in my opinion, are going to provide some relief for the financing markets. I think it's necessary because one of the themes that we saw in the real estate markets over the last couple of years was an inability to refinance at more attractive financing costs, right? Then financing costs also, got high, making it very difficult for borrowers to pay their debt service. I believe lower rates are anticipated to provide relief through cap rate compression and improved debt service coverage ratios. I also believe increased number of lending opportunities are going to be available at these lower borrowing rates, which will be attractive, again, for new acquisition and for refinancing. As we've been talking about, it's hard not to keep leaning on this theme of the decline in bank lending because I think that, also, is going to provide alternative lenders and opportunity to make new loans at attractive spreads relative to corporate credit.

Stewart: Given the market backdrop that you've done a terrific job of sketching out here, what kind of interesting opportunities have you been screening of late?

Nailah: Well, one of the things I try to make sure we focus on here at Brookfield is our competitive advantage that differentiates us from the rest of the lending market. One of those competitive advantages are our access to large scale capital. Another competitive advantage is our ability to leverage the Brookfield ecosystem to find unique opportunities that maybe we have an operating advantage that helps with developing our view of value or giving us confidence in how we're underwriting or valuing an asset, and therefore, enhancing our ability to structure the deal to work best for our investment portfolio. With that said, some of the more interesting deals that we're seeing are larger transactions where there's just not as much competition in terms of other lenders who can step up to do those deals. One example of a transaction that we're working on right now is a $585 million science and innovation deal that we're uniquely positioned to underwriting and analyze because we're developing a neighboring asset in the market.

I think our ability to really understand the trends in the market, the leasing trends in the market, gave us a lot of confidence in our underwriting and valuation of that asset. Another example of some of the things that we're seeing, we're in the process of closing now on a $1 billion transaction to buy a loan portfolio from a regional bank. We talked about this before, some of what we're seeing regional banks, how we're seeing regional banks show up in the market to contract their exposure to real estate loans have presented opportunities for us to buy portfolios. What I love about the one deal that we're working on right now, it's diversified mostly in multifamily and logistics, and it's giving us an opportunity to add to what we already have in terms of a diversified real estate office portfolio and provide investors in one of our private funds an opportunity to get out-sized risk adjusted returns as a result of this bank retrenchment theme.

Stewart: Are there some examples, and maybe that was one just now, but can you give me some examples of how you've partnered with borrowers in the real estate debt space?

Nailah: One of the most important attributes of a lender is to be a lender that borrowers want to do repeat business with. We pride ourselves on the fact that when we look at our portfolio that we have under management right now, about 60% of our borrowers are repeat borrowers. I think that that in and of itself speaks to a partnership, which is not just transacting on one deal, but looking across a portfolio of transactions that need to get done; recognizing that Brookfield is a great partner. And, one of the areas where we've seen this over the last 12 months is really in construction lending. I think construction lending is one of those product types that really require an expertise to understand everything from delivering vacant into a market, understanding, lease up strategies, understanding cost-to-build and carry costs over the term of the construction period.

We work really hand-in-hand with our borrowers, for example, on construction loans so that we have a good handle, although we're not the actual developer, we're working hand-in-hand with the developer as they're developing their project just to make sure that we're prepared to make decisions. Things come up on loans all the time, especially on construction loans, and we always want to just make sure that we're not being reactive and that we're working with our borrowers on real-time solutions as they come up.

Stewart: When you look at a deal, and you've done this a long time, and so has Brookfield, are there characteristics that you look for consistently over time that has proven to be things that are more likely to work out than others?

Nailah: Well, first, we really do seek to finance high quality assets within supply constraint sectors and regions. That may sound very simple, but I think the differentiator in identifying those assets is really our approach to underwriting real estate as if we would otherwise own that real estate. When we curate our portfolios, we want to be strategic and make sure we're focused on assets where we have a view of long-term stable cash flows, where we can underwrite those assets, stress those assets, and then structure loans to appropriately account for the risk that we would see and the ability for the underlying asset to achieve that performance. I think that is key to building a portfolio where, again, we're not just looking at today's trends, we're looking at long-term trends. We're not just reading a broker report, we're talking to our boots on the ground and those who own, manage and lease assets for us to make sure that we're making those decisions in an informed manner.

Stewart: I grew up in rural Missouri and even there they say location, location, location. With that in mind, when you are constructing a portfolio, do you focus on specific geographies? I just know for me, I moved from Chicago area down here to central Texas and economically, it's just a very different place here, right? I mean, nothing's cheap here. Everything is just going great, guns, valuations are all over the place. I'm wondering how do those trends manifest themselves in a portfolio that you might construct?

Nailah: Yeah, so most of the lending that we do is in the US, but as I described before, Stewart, when we focus on our competitive advantage, which is really access to largest scale capital, high quality assets, institutional assets, lending to institutional sponsors, we tend to be in more major metro markets throughout the United States. We can lend in Europe and the UK and Canada and Australia, but predominantly our portfolio is concentrated in the US. To your point, you've raised a very good point. Every market is different. Every asset class is different. Even within certain sectors, there are certain asset classes and certain markets where even corner by corner, you may have a very different view in terms of that asset's ability to perform over the long-term. We take a very specific view, individualized view on how we approach underwriting each asset just to make sure that we're not broadly flooding into certain markets or flooding into certain asset classes because they're hot right now. We really want to make sure that we're focused on where we see longterm intrinsic value.

Stewart: I have gotten a great education on real estate debt today, Nailah, and I appreciate that. I've got a couple of fun ones for you.

Nailah: Okay.

Stewart: You were recognized by PEI's Women of Influence Under Real Estate. First of all, congratulations. I've seen some other work that you do outside of the office, and I think it's fair to say that we have some commonality in where our hearts are, right?

Nailah: Thank you.

Stewart: Yeah, it's terrific. When you look out, and I know you have these opportunities because you seek them out when you are talking with young professionals, particularly young women professionals from underrepresented groups, what advice would you give them? I don't think that it's a lack of aptitude. I think it's just a lack of awareness about what the opportunity set actually is in the world of finance. What advice would you give someone today?

Nailah: Well, my advice for young professionals, especially women, aspiring to have long successful careers in finance or on credit, is to be adaptable. Stewart, the most important thing that I have learned is that things change all the time. Markets change, company cultures change, management styles changes, and your ability to adapt to these changes is invaluable. How you learn how to navigate shifts and view these changes in a way that helps you refine your skills, learn and grow, is really, to me, what keeps you ready, what keeps you relevant and what keeps you resilient. Those are three things that I feel like I tell myself often when I see things are moving and when I see things are changing.

I can remember making sure that I took advantage of the impact of COVID and just making sure that I didn't allow myself to get flustered or be reactive to things that I couldn't control, nor could I explain, but my ability to be ready and to stay on top of how I could be influential and impactful as we look to see how we could continue to grow and continue to take advantage of opportunities that come during these changing environments, really will make you better at what you do. It makes it fun, and it really, like I said, it keeps you relevant and resilient in an industry that you can't avoid that things will change. You hit on one other thing that I wish, and I hope that my presence in this industry is just inspiration to other people who may not be as aware and understand that these opportunities are, though it's hard work and it's challenging, it's really fulfilling to be able to learn so much in the world of finance and in the world of credit and in the world of real estate. I hope that I continue to also just inspire people to pursue this as a career.

Stewart: Well, you've inspired me. I'll tell you that. It used to be they said the three R's are reading, writing, and arithmetic, but you've gotten a new three R's, and I want to make sure everybody catches them, ready, relevant and resilient. That is the new three R's right there. You heard it here first, folks. My last fun one is a table for four, lunch or dinner, you're one, you get three. Others up to three. Who would you most like to have lunch or dinner with, alive or dead?

Nailah: This is an interesting one because if I could only pick one, I'd say Michelle Obama, but because I can pick three, I'd say Michelle Obama and her two daughters. I'll tell you why. Michelle Obama, one, just has been an inspiration. As you can see, I think that I have really hit on something to me that I think is meaningful to really have in this industry, which is resilience. I think she has shown so much resilience in who she is as an African-American woman. I think she just brings a unique perspective on leadership, on finding purpose in life. That, to me, should resonate with anyone who has a career in finance.

The reason why I would invite her two daughters is because I am passionate about pouring into the next generation. I love mentoring. I love training young people. I love when I open up an industry newsletter and I see someone who interned for me or worked for me, and now they have a big job on Wall Street or a big job in real estate. I'd be curious to see how that conversation flows with two young women at the table who have a mom like Michelle Obama and who for me would just be an opportunity to have more in-depth conversation about how we all collectively can continue to advocate for diverse voices and just make sure that we're helping to bring success to a broader group of people and opportunity to a broader group of people

Stewart: From your lips to God's ears, Nailah. If Michelle Obama is listening to this podcast, please shoot me a note. I'm happy to connect you with Nailah.

Nailah: If Michelle Obama is listening to this podcast, I need to send you a tip, a nice tip.

Stewart: Listen, coffee's on you. If so, if this happens, coffee's on you, so that's great. Listen, thanks so much for being on. I've gotten a great education today, and I know our audience has too, so thank you.

Nailah: Thank you for having me, Stewart. This was fun.

Stewart: I'm glad you enjoyed it. We've been joined today by Nailah Flake, managing partner, head of Real Estate Debt at Brookfield Asset Management and Brookfield's Credit Group. Thank you for listening. If have ideas for a podcast, please shoot me a note at Stewart@insuranceaum.com. Please rate us, like us and review us on Apple Podcasts, Spotify, or wherever you listen to your favorite shows. My name's Stewart Foley. We'll see you next time on the Insuranceaum.com Podcast.