Jack Gay & Jason Hernandez

Episode 265: The Cyclical Nature of Real Estate Debt

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. Hey, welcome back and thanks for joining us. We've got a great podcast for you today on real estate debt and we're joined by Jack Gay, who's the Global Head of Commercial Real Estate Debt. And Jason Hernandez, Head of Real Estate Debt in the Americas for Nuveen Real Estate. Gentlemen, welcome. Thanks for taking the time. I can't wait for this. It's going to be a great one. Good to have you back, Jack.

Jack: Stewart, great to be here and appreciate you having me back. Looking forward to the conversation.

Stewart: Absolutely. So you were a part of a multi-firm panel on real estate a little while back, and I think that you had a very interesting perspective, and you were also at our annual meeting and I know you really distinguished yourself there, as well. So I'm looking forward to it. But to the extent that everybody didn't remember you from the last time, let's just start like we always do, which is can you tell us a little bit about where you grew up? What was your first job, not the fancy one, and how'd you get into the seat at Nuveen in the first place?

Jack: Yeah, well, I'm pretty sure there's a lot of people that wouldn't remember, but yeah, happy to go through it. I grew up outside of New York City, a small town called Armonk in Westchester County and grew up there. I'd say my first real job might've been working at a tennis club, so doing maintenance and every now and then getting on the tennis court, as well. But tennis is a passion and had a couple of summers at a tennis club in high school. So that was fun.

Got out of undergrad college, went into banking in New York City and moved my way into real estate debt. From there, I've been a long career in real estate debt, always on the lending side, and now manage the debt business for Nuveen Real Estate globally. So sitting down in Charlotte, moved down to Charlotte, North Carolina now.

Stewart: Nice. You were saying just before we hit the record button that you just got a dusting of snow for the first time in something like three years down there. Is that right?

Jack: Yeah, I was very surprised to see that through the darkness this morning when I got up, but it's pretty. Could have used it a little closer to Christmas versus Thanksgiving, but it was nice to see.

Stewart: That's cool. So Jason Hernandez, how are you? And thanks for coming on. Kind of the same set of questions. So where did you grow up? What was your first job, not the fancy one, and how did you get into your seat at Nuveen?

Jason: Sure. Stewart, thanks for having me. I'm a city kid. I was born and raised in Chicago. I was born in Lincoln Park back when it was a working class neighborhood.

Stewart: Oh, I lived at Seminary and Webster.

Jason: Oh, right on.

Stewart: I sure did. Yeah, and it's so true. People told me that it was a working class neighborhood. That it absolutely was not the well-heeled neighborhood that it is today.

Jason: Yeah, it was definitely a little different when I was making my bones as a young kid, but obviously great place to grow up. But I live in New York City now, so I'm just a city kid. You know what you know. I guess my first job was, I was an RA in college, a Resident Assistant, that was my first real job. Didn't get paid though. I got free room and board, which I guess counted.

But my first professional job, I worked for GE Capital, I did their analyst program for two and a half years. It's called the Financial Management Program, and they tried to make you into a CFO. And the last thing I wanted to be was a CFO and I did my last rotation in the real estate group. And as people say, "Careers only look elegant in retrospect." So you fast-forward 27 years later and I've spent the majority of my time investing up and down the capital stock. Started out doing equity investing for the first 15 years and I've been on the credit side for the last 12 or so. And been with Nuveen for 6.5, going on 7 years next May.

Stewart: That's so cool. It is interesting how the rotational program, sometimes it works out great. You find something and you go, "Hey, I like this." And when I was teaching we had a number of students who went through rotational programs that seemed to have been making a bit of a comeback in more of a formal training program in some spots. So it's super cool. So just following along there, and if you would, Jack, just give us a quick overview of Nuveen Real Estate, the global debt platform as it is today, and a little bit of the history, as well.

Jack: Yeah, sure. Well, Nuveen Real Estate has $145 billion or so in assets under management. One of the largest real estate asset managers in the world. We do both debt and equity. About $45 billion of that AUM is in the real estate debt space, so what Jason and I and others look after. And we're an active lender in the US in Europe and in Australia. Actually, that's a growing business force in Australia recently.

But we started, our roots are tied back to the parent company TIAA and lending on behalf of the insurance company back some 90 years ago or so and have lent on behalf of the insurance company capital for many, many decades and have grown that business over the last 8 or so years into more bridge lending and lending on behalf of a number of different clients. So started in the US and then we've grown our European business. Started in 2015 and then shortly after that expanded into Australia.

Stewart: That's super helpful. And so, Jason, just turning to you, and just set the stage for today's discussion, can you please share your perspective on the current CRE debt market landscape and what are the prevailing macroeconomic conditions for lending as you see looking out your window today?

Jason: I think it's interesting. It's very timely because I was on a panel this morning, one of the law firms here in the city had a panel discussing some similar topics. And I think historically when people think about the CRE debt landscape, they think about it very tactically. Think about almost from a product perspective. There's banks, there's life insurance companies, there's the GSEs, Fannie and Freddie, there's CNBS, and there's debt funds or alternative lenders or real estate private credit providers.

But I think if you take a step back, and every one of those people kind of plays in their own lane, and the question was asked, there's some report came out last week, there's 220 debt funds. And the question was are there too many players in the space? And I think if you take a step back and you think about real estate debt simply as a means to facilitate an equity execution, you can break down the landscape into three or four distinct segments based on a risk profile. Because all we're doing is facilitating whether it's acquisitions or recapitalizations, and I think those three or four segments, that's really what's driving the changing landscape in debt today.

So those segments are just by risk profile core, very basic core risk, core plus risk and value add. There's opportunistic as well, but that's not as large and like most people, I can only process three things at a time. So let's just focus on core, core plus and value add. And so, what you're seeing today is across the market, the landscape, Jack touched on this in his opening remarks about Nuveen, we're an insurance company with an 80-year history. What you've seen is life insurance companies have predominantly dominated the core space. And what you've seen is, Jack touched on this, not just us, a lot of life insurance companies have built out core plus and value add investing capability so they can offer the full suite.

Conversely, you've seen large institutions that generally operate debt funds in the value add space, they're running the same play just in reverse. They've either bought insurance companies or they're doing tie up with insurance companies so they can offer both the core and the core plus, as well. And I think everybody's running that same play. And my answer to the question this morning was, it doesn't matter if there's 220 or 300, what matters is there's probably going to be 10 to 20 large players in the space that can invest across the stack. And the reason why that's so important is, like anybody else, the more inputs you have into your process, the better outcomes you should drive.

But also for investors. Investors, LPs want fewer relationships, they want to invest across the profile. And conversely borrowers, if you look at the consumers of that capital, everybody wants to have fewer more significant relationships. And when you think about that trend of life co-core providers going up the risk curve and the value add investor going down the risk curve, one of the biggest drivers in fueling that strategic shift is the insurance segment.

Stewart: I don't want to put words in your mouth, but when you talk about that where my mind goes is relative value. I'm thinking that if you are investing across the stack, the three that you mentioned, core, core plus and value added, that you are able to make a better determination of where the best risk adjusted value is. Is that a fair statement?

Jason: That's a very fair statement. And liquidity comes in and out of those segments, so at different points in time there's better or less relative value across those segments. It's like the old adage, to a guy with a hammer, everything's a nail. I think we're trying to build out, not just be a guy with a hammer and really play across the core, core plus and value add to pick the point in time where you can get the most relative value.

Stewart: So Jason, where are you finding value in today's CRE debt market? And I think maybe as importantly, what areas are you cautious on?

Jason: Maybe I'll talk about sub-sectors first. So what I would say is where we're seeing the most opportunity today in terms of, I'll talk about property types and then we'll talk about risk profile, but it's generally in, not surprising, in the housing and logistics in the alternative space.

When we say alternatives, we mean self-storage, manufactured housing, medical office, these niche sectors. And it's interesting because the second part of your question is where are we cautious? Everybody's very cautious candidly in the office market today. And the reason why people like housing logistics, even put aside, there's just much better tailwinds, there's better tailwinds supporting those property types, but there's also more price transparency. If you look at housing and logistics today, that's probably 90% of what we've done this year is housing and logistics and what you're seeing in that space, you're seeing much more acquisition activity. So there's much more transparency and price discovery in that segment.

Conversely, going back to your second question around where are we cautious, in the office space you don't have that. You have the macro headwinds of COVID and the whole return to work and just the large capital intensive nature of office, but you also don't have price transparency. So it's really hard to lend on office if you don't have price transparency and it makes it even harder to buy it candidly. So we've seen very little if any activity in that space.

But going back to your comment earlier on relative value, if you think about the world of core, core plus and value add, where we're seeing the most opportunities today is on the barbells of that strategy. It's the core side and the value add side. And that's really driven by, if you think about that core plus space, that middle segment, the fat part of the curve, for lack of a better word, that space was dominated by banks, open-end debt funds and mortgage rates.

And you guys know as well as or better than I do, the banks have pulled back tremendously from the primary. They're still active in the secondary market with warehouse and repo financing, but they've pulled back from the primary direct lending market, I'll call it. And, obviously, the mortgage rates and the open-end debt funds are dealing with liquidity and valuation concerns.

So going back to the consumer, the equity owner, if you have a core plus business plan, you have one of two choices. There's no core plus capital available. So you either have to take a fixed rate deal or you have to take a loan from a value-add credit provider. So we look at that and we say, going back to your relative value comment, in the value-add space today, our view is, and we're seeing it, is you can get value-add returns for core plus risk, which just feels like a great ARB for us today.

And then, conversely, on the core side, given where the tenure is or spreads are, it's a really attractive time to also deploy capital in the fixed rate space, generally on the 5-year term. I would say you're not seeing, given where rates are, and we can debate whether rates are high or not, people feel like they're high. And so you're seeing borrowers take shorter duration, so you're seeing 5-year versus 7 or 10 on the fixed rate side, but still incredibly attractive to deploy capital in that core space and that value-add space.

Stewart: Yeah, it's interesting. I'm an aged member of the community and I remember when rates were dramatically higher, but it does feel like rates, although I feel like it's normalizing a little bit. And I appreciate your willingness to talk about office. It seems to me, and this is just I'm somebody who, A, doesn't have a capital position and secondly I'm not a real estate expert at all, but it seems like there's no transactions happening because there hasn't really been a seller where you can get real price discovery. Everybody knows that values are down, but we just don't have enough prints to make a definitive statement. Is that a fair representation of where things stand in office today?

Jason: I do think it's fair. It's interesting. We had a meeting this morning with one of the big advisory firms and they were walking us through, "Hey, what are you seeing today?" And I think in the office space, I think you're a 100% right. You are seeing buildings transact. The challenge is they're not really true arms-length transactions. What I mean by that is you'll see in the next couple of weeks there'll be two large institutions are going to acquire a portfolio of office. They're going to put their two portfolios together, but the lender's selling the assets, but the lender's providing seller financing.

So I think it's really difficult, going back to your earlier comments around price discovery, the only way that we're seeing office transact today is if the existing lender stays in and provides seller financing. And again, that's not to say there aren't attractive opportunities in the office space today. I want to be very clear, we talked about core, core plus and value add, and so everything I'm saying is colored by Jack and my view of how we think about credit investing.

There are opportunities in the office space today. I think our view is that's an equity risk and that's not a credit risk. For all the points you talked about, price transparency in the headwinds. So when we say we're not doing office, we don't view office as a good credit risk. As an equity risk, I think you could debate there could be great opportunities on the horizon. It's just doesn't fall within our realm.

Stewart: That makes a lot of sense. So Jack, back to you. Let's just talk a little bit about accessibility. And you talked a little bit about it earlier. There's definitely an advantage, there is a scale advantage in capital markets today I think for sure. And so when you think about an insurance company tapping into various opportunities that Jason has talked about, how should I be looking at that as far as getting access as an insurer, particularly if I'm not a bulge bracket insurer?

Jack: Yeah. You hit on it, Stewart. If you have scale, you can access it directly. And certainly there are bulge bracket insurers that have that scale and can build out teams, but this is a private asset class. Pricing is a little bit less clear than say the public markets, which makes it attractive investment piece. But to really build out and get access to that, you've got to do it in scale or else it's just too costly to put all the systems in place and hire all the people and get the expertise that you have to make good loans.

So absent of building it out yourself, you can hire a manager like Nuveen, or certainly many others, that have that scale and can go access it. And there's really two primary ways for an insurance company to work with a manager. One would be in a separately managed account and that would be where you'd go to a manager and say, "Hey, we have X amount of money to invest." And build out a strategy that fits your risk return and duration parameters and work with the manager to get something that's a little bit bespoke to you. That needs some level of scale, just because you want to build out an account that has enough diversification within it to have it make sense, but certainly not as much as it would take in terms of investment dollars to justify building out a platform.

And then the other way is through funds. And so the funds tend to be more in that value add or opportunistic space that Jason touched on, but there's certainly a number of managers that are out there that have funds. And then you get into what's your risk return profile and whether you desired a closed-ended fund structure or an open-ended fund structure. But all those certain structuring techniques and fund alternatives are out there with certainly a number of good managers.
Stewart: And when you think about the many sources of capital in real estate, are there general or specific statements you can make about what role the insurance company plays in the market?

Jack: Yeah. Traditionally, and Jason mentioned this, traditionally the insurance company has been that long-term core provider. Insurance companies generally like duration and they call protected investments so they can match asset and liabilities, which tend to have long durations to them. And one thing about insurance companies is their balance sheets have historically been very healthy and they do this unlevered core lending. And so they're consistently in the market.

And if you look at other providers that in terms of the amount of capital they provide into the market, the insurance companies are almost always there. Just steady year-end, good year, bad year, the insurance companies are very steady. So that's a reliable, steady force of capital to the industry, which is certainly helpful. And, again, would also say that they dominate that long duration piece. CNBS has historically been there as well, but duration has moved in for CNBS in particular to more that 5-year spot. And the bond buyers have learned to live with the five-year duration and the borrower's desire it for the reasons that Jason touched on.

But more recently we have seen some insurance companies go out the risk return spectrum, and whether they do that by building out their own teams and getting up into that value add space, trying to get higher returns. Or whether they go and say, "Hey, for this piece of my allocation, I might do core myself, but I might do the value add or the opportunistic piece and I might work with a manager to help build out that piece." So you can use a combination of merchants there.

Stewart: It leads me where I was headed next, which is if I'm a CIO, or a head of real estate someplace, and I'm looking to expand my real estate debt allocation, what would be some best practices that I should be thinking about and are there any common pitfalls to avoid? And then let's ask the same question, how does that answer differ if I'm, I don't know how many folks would be new to the asset class completely, but are you seeing anyone that is seeing this as an entry point?

Jack: Well, I'd say look, one of the number one rules would be disciplined about your entry into the market. It's a cyclical business. Real estate's a cyclical business, and so real estate lending follows those cycles obviously with a little bit more protection than say on the equity side. But vintage matters, and we talk about this a lot. Right now is a really attractive vintage. We're at the bottom of a real estate cycle and expect to come out of that over the next certainly several years, look to be setting up as reasonably attractive vintages.

But as a long-term investor, you don't want to just dump all your money in and play it opportunistically where you dump in now and say, "I'm going to liquidate my portfolio or pull out in two or three years." So be disciplined about it and be long-term focused on that.

I'd say another thing is when you're looking for people to partner with as you go along this journey, whether it be advisors helping you get in and to do it directly or giving someone a separate account allocation or a fund allocation, is go with somebody who's traditionally a lender and has been in the lending business a long, long time. Jason referred to it a little bit on some of this capital that's flying into the office market, the distressed office market if you will. And a lot of times that's an equity player, but they have an equity risk and return mindset to it.

And we found because look, Jason and I sit in Nuveen Real Estate, there's an awful lot of equity people that we debate deals with back and forth at investment committee and other places. Equity people think about risk differently than debt people and we think about structuring loans differently. So you need people that are debt people. It's great to have your equity colleagues weigh in on values and what they're seeing in the market, but you need debt people doing it. So those would be two primary things. Be disciplined and take your time and partner with somebody who's really a long-term debt provider.

Stewart: That's super helpful. I really appreciate that. And very practical advice. How do you see the real estate debt, the role of real estate debt evolving over the next 5 or 10 years within an insurance portfolio? I realize I'm asking you to dust off your crystal ball a little bit, but I've seen yours and it's pretty good.

Jack: I appreciate that. We've seen a big growth in what I would say private capital and private debt markets over the last decade or so, and a lot of that's been on the corporate side. And commercial mortgages, certainly that market has grown, but it's grown really with traditional regulated lenders that provide the bulk of the capital there. So it's been insurance companies and banks and the government, the GSEs, that have been the largest consistent forms of capital. You could probably throw CNBS in there as well, but they've been a little bit less consistent than some of the other sources.

And look, we've seen this growth on the corporate side of private capital and it's happened on the mortgage side, but we think there's tailwinds there for that private capital to continue to grow. Investors are looking for a little bit of a leg up in terms of spread. And when you invest in private asset classes at a minimum, there's a bit of an illiquidity spread that you can get when you're playing in those markets. And if you have long-term capital, like insurance companies do, at least for a portion of your balance sheet, you can take the illiquidity risk if you will, and earn that premium, and private capital is a great place to do it. And commercial mortgages I think will be a beneficiary of that trend that we've seen in the last 10 years in the corporate space. I think that that trend will continue to exhibit itself in the mortgage space, as well.

Stewart: That's super helpful. So Jason, moving into 2025, what do you think are the big uncertainties in the minds of most institutional investors and how do you think that that translates into assessing the risk in the marketplace?

Jason: Yeah, it's interesting. Timing is fortuitous. As I mentioned earlier, I was on a panel this morning with a bunch of people at a law firm here in New York City, and I would say the questions really, there was three key themes that people are concerned about. Obviously, it's inflation, risk of inflation with the new administration. It's also candidly the view on rates and where rates are going. And then, not surprisingly, the last one is political.

We started this podcast talking about that. Martial Law was declared today in South Korea, and I've been watching, I have another monitor over here, and the president declared Martial Law and then the parliament voted to remove it and the military was waiting for the president to remove it. He just removed it as of 10 minutes ago. That's real risk. There's political, I think people think about political risk in the US, and I think it's less about whether you're red or blue or purple. I think it's more about instability around the globe because that impacts capital flows. That's one big risk.

The other big, we talked a lot around rates, and I think you touched on this earlier, we talked about when I first started doing this, it was LIBOR before it was SOFR and LIBOR was 6% or 7% when I first started.

Stewart: Absolutely. Yeah.

Jason: Underwriting loans. And so you play this game long enough, you have a little perspective. And if you think about investors, I think most investors, they always ask me, "Hey, what's your view on rates?" If I knew that, hopefully I'd have my own podcast if I knew where rates were going to be. But unfortunately I don't.

Stewart: Hey, if I knew real estate, you could have this one.

Jason: Well played. Fair trade, fair trade. But look, I think it's more about stability, right? And it's less about is the tenure 3.5% or 4.5%. When you think about the tenure risk fee rates, it impacts your cap rate and your cost of capital.

Stewart: Without a doubt.

Jason: As we started talking earlier, we talked about office, but even any asset class, it's really hard to buy and sell an asset when you don't know what your cost of capital is. And so what I would say is I think investors are looking for some stability in rates. But the one positive I would tell you talking about inflation and just credit spreads in general, is we've seen relative stability in credit spreads.

I'll give you an example. We talked about the core space in the fixed rate lending. 2 or 3 years ago, it was hand-to-hand combat. You fought over basis points, 3 to 5 basis points to win a deal. When there's 20, 30, 40 basis points swings in the treasury over a couple of day timeframe, people focus less on the 2 or 3 basis points in the credit spread and much more around, "Hey, can I execute today?"

So what I would say is it's really about, and again, big thing is we can't control any of these. So I can tell you my view on it, but I can't control political risk. I can't control where rates are going. But I do think there is, we've seen stability in the credit spread piece of it, and I think that's giving investors comfort to invest not just in the credit space, but also as an equity owner to go out and acquire properties. If I can figure out, pick a number, 60% to 70% of my capital stack and what that's going to cost in the credit space, I'm that much closer to certainty around price transparency.

Stewart: That's super helpful. I really appreciate it. I appreciate you both. You've got a great education today. And I wondered if you just have a couple minutes to spend with me on a couple of fun questions. I don't know, the last one's fun, but this one's important. At least to me. So I look at you guys and you're both very knowledgeable, very senior executives in the real estate debt space. If I'm a person who's coming out of college, or earlier in my career, and I have an interest in this genre, what advice would you give someone who was interested in learning about the commercial real estate asset class? Be it debt or equity or whatever it may be?

Jack: Yeah, look, I'll jump in first and it's opportune to me. I've got a college junior and he's taken a summer internship at a mortgage banking firm in the real estate space. So I'm trying to give him a little bit of advice, but I would say, look, be eager. Try new things. Show up and be present. Certainly be in the office, ask a lot of questions, admit it when you don't know the answer because you're not expected to know the answer, and be eager to help out where you can. But try new things early in your career. And I think both Jason and I have done that in our careers where you might not know exactly what you want to do, but you try new things and you find something that you like and you become passionate about it and you can focus and concentrate on that avenue once you get there.

Stewart: I have a college sophomore who I've managed to get to agree to take an accounting class, which I count as a win. A big win.

Jack: It's a huge win. Huge win.

Stewart: It's a huge win. How about you, Jason? Anything to add on the advice side?

Jason: Look, what I would say is it's not linear. And somebody told me this one time when they weren't giving me the job I wanted. They said, "Careers only look elegant in retrospect." And I was twisted at the time, but they were a 100% right. I agree with everything Jack said. The only other thing I'll add to that is, especially Jack touched on this, real estate is cyclical. And so we've talked about housing, logistics and office, and I think there's this tendency to always go for the next new thing. And having done this for a while, I think so much more of your, for lack of a better word, satisfaction or happiness is driven by who you work with and for than what you're actually doing. Right?

Stewart: It's so true.

Jason: For me, Jack talked about, I loved his comment around, hey, equity and credit are different. They're just different disciplines. And I transitioned from equity to debt and we had this conversation during my interview, and luckily Jack didn't count against me, but I was like, "Hey, when I transferred from equity to debt, I should have been fired in the first year because I was terrible at it." It was just a very different discipline. And so I think fortunately for me, I was able to try different things and I picked to work for a boss versus the equity versus debt, or the property type product type, and I think it made all the difference. So I would just say it matters so much more who you're working with and for than what you're doing.

Stewart: I think that's great advice, very insightful. I have a great job and then I get to talk to smart guys like you, and it works out for everybody. So my last fun one on the way out the door is a lunch or dinner for you, you each get to pick one guest and then you've got to agree on one. So they can be alive or dead, and it doesn't matter, they don't have to have anything to do with real estate necessarily.

So Jack, you're a return guest and I'll come to you first. Who would you most like to have lunch or dinner with, alive or dead?

Jack: Look, it's an easy one for me. It'd be my father. He passed away when I was 23. Way too early. I think we've reflected a little bit on careers here in the last half hour or so. And when I think about, I was a young banker working in New York, living in Hoboken, New Jersey, not in real estate yet, and so much has happened in my life. It would be the longest dinner in terms of we would just keep going for hours, but it would be precious to be able to share my life experiences and ask all these questions that I just never got around to and never appreciated that I had run out of time to ask him about his life.

Stewart: Yeah, I can't imagine how proud he'd be. That's a very touching answer. How about you, Jason?

Jason: I'm actually going to fold mine because that's an incredible answer, and mine isn't as good. So we'll make this really easy. We'll make this really easy. I think we could agree on that one.

Stewart: That's perfect.

Jason: It's a great answer.

Stewart: That's great. That'd be a great dinner. So listen, thanks so much for being on. I really appreciate you both and got a great education on real estate debt today, and our audience. At the end of the day, what we're trying to do is provide best practices from people who know these markets best, and so thrilled to have you both on. We've been joined today by Jack Gay, Global Head of Commercial Real Estate Debt, and Jason Hernandez, Head of Real Estate Debt in the Americas for Nuveen Real Estate. Gentlemen, thanks for being on.

Jason: Thanks for having us.

Jack: Appreciate it.

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