William Pattison & Clint Culp

Episode 267: Real Estate Debt Markets: Finding Value in Market Dislocations

GUEST Q & A

Stewart: 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 if I can get it out. We are focusing on private real estate debt and we're joined by Will Pattison, who is the head of research and strategy real estate with MetLife's Investment Management Real Estate Group. Will, welcome. Thanks for being on.

William: Thank you for having me, Stewart, and thanks to the listeners for joining.

Stewart: Absolutely. And we've got Clint Culp, who's regional head of real estate debt production for the southern region at MetLife, Investment Management's Dallas office. Clint, welcome. Fellow Texan. Nice to talk with you. You were born here in Austin where I am, and now you're in Dallas. So thrilled to have you on.

Clint Culp: Yes, thank you very much, Stewart. Appreciate it.

Stewart: So let's start it off the way we always do, which is where'd you grow up and what was your first job, not the fancy one, and talk a little bit about how you got into the seat you're in today with MetLife Investment Management. Let's start with you, Will.

William: I grew up in Cedar Rapids, Iowa, and my first job was an afternoon paper route, so that was when I was, I believe, 13 years old. Then I worked at a grocery store, Hy-Vee which is a Midwest chain, for about five years into college. I studied economics and computer science, and coming out of college ended up at an insurance company. Iowa has quite a few insurance companies.

Stewart: Yes, they do.

William: Working in the real estate group. Did not have a lot of direction coming out of college, was applying at multiple places and just happened to get an analyst role there, and that was around 20 years ago.

Stewart: It's funny, H-E-B was really close to where my mom lived in Springfield, Missouri. And Hy-Vee. I'm sorry, Hy-Vee. And when the Hy-Vee shows up, everybody's excited. And it's the same way in Texas with H-E-B. When the H-E-B... If your town has an H-E-B, it's like you've somehow or the other, you've made it. So great background. Thanks for giving us that info. Clint, how about you? I know you grew up in Austin and I also know that you've been friends with your wife since you guys were little kids, so give us some more of the upbringing there.

Clint Culp: No, that's correct. Yeah, I grew up in Austin, Texas. I was heavily influenced by baseball as a kid. Grew up playing baseball. My dad actually played for Red Sox back in the '60s. Thought that was direction I was going to go. Didn't throw nearly as hard as he did, so switched over to real estate pretty quickly. But that did lead into my first job. So during college I coached several different teams, coached a lot of different camps, really had a love for coaching. But after playing baseball for a couple of years in junior college, went to Texas, A&M, went through their real estate program and did a couple other real estate jobs, but ultimately landed at MetLife. I've been there about 15 years and I've been all different parts of our company. Started as an analyst here, so I've worked on loan management, loan production, equity asset management, moved a lot throughout and now lead our debt team.

Stewart: Let's just get into it. So there's been negative press surrounding commercial real estate this year, but it always, in my experience, and I've been at this for a minute, that tends to create opportunities. And so it gets to my first question, which is what factors do you feel like are creating opportunities for investors, particularly insurance investors right now?

William: We never really know until after the fact if the opportunities were great or not until the loan has paid off or done better. Although it does seem like today the opportunities are pretty strong. The main reason or certainly one of the main reasons for that has been a pullback from regional banks and their lending activities and that's created a gap in the capital markets. And then another reason, which is maybe equally important is the high inflation that occurred in 2023 and 2024. I think most of your listeners may know intuitively that real estate and inflation are linked or high inflation does contribute to better real estate returns. What's maybe less intuitive is why that occurs. And the reason really relates to the construction pipeline.

So when inflation is high and labor costs are growing, the cost of cement is growing, the cost of commodities are growing, that's when construction projects stop penciling out or the starts slow down and that causes a gap or a lack of new construction two to three years after the fact. An average commercial real estate project may take two to three years to build when you think about getting the land entitled, getting the construction started. And so those benefits from inflation in 2022 or 2023 really haven't been realized yet, are going to start getting realized probably later in 2025 as that lack of construction creates a supply demand imbalance. So those are the two reasons that I believe there are probably a little better than average opportunities today.

Stewart: That's super helpful. You mentioned the pullback or reduction in lending by regional banks. How is that reshaping the commercial real estate debt market, Clint? And do you see anything that is likely to change that? That Condition?

Clint Culp: I'd say first, at MIM, we do a lot of core floating rate deals, which means kind of sub 60% LTV deals where we used to compete with banks a lot more on that, so it gave us more opportunity to win that business. I'd say another part that really affected was construction lending. So not only is construction slowed down by, what Will mentioned, with higher inflation, but it's also with the banks pulling back, there's not as many buckets of capital for developers to go to to borrow that money. I will say it has come back some; some banks were completely doing nothing close into the last year, but are getting back into the market more now. But we've definitely taken advantage of a lot of opportunities where that competition wasn't there.

Stewart: And you mentioned rising construction costs. Can you talk a little bit about how rising construction costs and inflation are influencing real estate market returns and investment strategies in your region? And I look out at the housing market right now and I look at pricing and I look at what it costs to build today. And it seems like there's a lot of stuff that is for sale that you can't build for what they're asking for it. It is that applicable in your world?

Clint Culp: With the rising construction costs, it really makes it hard for developers to make deals pencil. So as an example, as we're looking at loan opportunities, let's say on multifamily of existing products, we can look at how much cost they're going to be and say, "Well, the market rents are this." They probably need to be about 30% higher to justify building something because construction costs are so high. In return, developers don't do those deals then the market gets tighter as supplies absorb through demand. And for our markets, there's definitely some headwinds over the next couple of years. There's a lot of stuff that has been delivered over the past few years, it still needs to stabilize, but you're seeing starts come to an end. So we're thinking in two to three years that kind of supply demand balance will get back to a little bit more equal and you can rent growth at that time.

Stewart: I think I know what it means, but I'm not a real estate person. So I just want to ask, so when you say a deal won't pencil, that means that when you model the cash flows, the deal doesn't work? This is pre-construction, you're modeling a potential project. Is that what you mean by the term pencil out?

Clint Culp: That's exactly right. Yeah. You're going to have to be able to assume you can get specific rent levels to justify spending that money on that construction because the construction cost being so high, that's really not going to work for a lot of deals right now because you're not able to achieve those rents in the market.

Stewart: So Clint, what changes have we seen in the commercial mortgage yields compared to pre-pandemic levels in your market?

Clint Culp: Yeah, sure. I mean, prior constraint spiking a little bit higher back in '22, I would say for your just average down the middle deal, you were seeing rates in the two to 3% range, and that's for core deals. Today with the indexes rising, with spreads rising, you're seeing deals more in the five to 6% for core deals and the higher yielding deals more in the seven to 8%. So quite a bit of premium of what you saw prior to 2022.

Stewart: That's super helpful. So I've heard the term vintage risk. Can you explain vintage risk and how it influences your investment strategy?

William: Commercial mortgages differ from most of the bond market in that the year they were originated is a more meaningful indicator of default. And this is a slightly more complicated topic than it may sound, but a few years ago I partnered with a commercial mortgage ratings team at Moody's Analytics and we co-authored a study partially or almost mostly focused on this topic that I'd be happy to share with anyone that wants to send me an email or ping me on LinkedIn. But to summarize it, we found that higher risk loans that were originated towards the end of a business cycle or when the construction pipeline was at its highest point, had about double the loss rate of loans that were originated during normal periods of time or during average points in the business cycle.

We couldn't actually compare loss rates at the end of the business cycle with at the start of the business cycle because there was so few loans or so few losses in the loans that were originated at the start of the business cycle we had a divide by zero error or denominator error. And this was using the entire CMBS universe, MetLife's 50 plus years of loan origination performance history, and the loss rates were so low in those periods of time coming out of a recession when construction completions were low that we couldn't even make those comparisons.

Stewart: I've learned over time that MetLife Investment Management is an extensive user of data. Can you talk a little bit about how you use your extensive data set for risk management and investment decisions?

William: MIM has the longest known commercial mortgage performance history data set anywhere. It was the primary source of many of the founding commercial real estate and commercial mortgage research reports in the 1980s and 1990s. And we're continuously maintaining and updating that data set and have found it useful in informing investment strategies. I personally owe a part of the success of my career to whoever the employee was at this firm in the 1950s that decided we should start tracking all this performance history and formalizing it and standardizing it, and we've been doing so ever since.

To your question though, Stewart, one example of how it's helped inform us is I think we have a better understanding of how and when various commercial mortgage risk measures matter more or less. So measures like the loan to value ratio mattered more during the 1991 and 2008 recessions where it was really not a very important factor during the 2001 .com recession. The debt service coverage ratio, which is another real estate measure, mattered more during that .com recession. And even though we don't know exactly what the next recession will look like, this history and having pretty detailed, robust analysis on why those factors mattered more helps us with our forecasting as to what we should be relying on today.

Stewart: It's super interesting to me that, I mean, I cannot imagine what the financial markets were like in the 1950s and having that much data has got to be a competitive advantage. I mean, it's irreplaceable. You can't run out and grab it. I think it's a really interesting point.

Let's talk a little bit about, and we were talking with someone not long ago about office, and the answer was essentially there haven't been any real market price trades. There's been some distress, but there's not really a lot of price discovery at this point. With the rise of remote work, which seems to be here to stay. I was just in New York and Tuesday, Wednesday, Thursday seemed like normal New York days and then Friday was a lot less. How do you factor that into the office sector and how does that affect your investment approach in your region, Clint?

Clint Culp: I'd say a key factor for us really on the debt side is how we manage those loans. MIM has been doing loans on office for a long time, certainly since I've been here over the past 15 years, and there's a couple different factors going into that. We've been successful on a lot of our office loans because one, I think we probably picked the right deals. I think our regional focus helps us pick the right office deals that have still been successful during this timeframe. Two, our borrowers are usually very well capitalized, experienced owners and operators.

And three, we do a good job of loan management. These types of things when there's going to be an issue, getting out in front of them, communicating often with the borrowers can get you to a good resolution. As an example, here in Texas, over the last couple of years we had about $800 million in office loans coming up for loan maturity. We worked through a lot of those deals where we either paid off, we were paid down via loan modification or maybe even provided acquisition financing, but have been able to reduce that exposure by about $600 million without taking losses.

Stewart: That's an interesting story. I'd love to know more about that. So let's talk about metrics for just a second. What metrics are you monitoring to guide your investment decision in these various markets?

William: I think one measure that has been especially important over the last couple of years has been migration patterns. Just taking a step back, real estate is different from other sectors because it's driven largely by population and employment. It's not driven by the corporate tax rate or driven by GDP growth in a correlated way other sectors are. And so being able to track where jobs are growing, where people are moving has always been important. But since the pandemic started in 2020, there were a lot of people who moved from central business districts or downtown areas, either into the suburbs or in some cases even to other states. And even where we stand today four years later, projecting where that's going to go is an incredibly important part of if we're going to be successful with our investments or not. So that's been where a lot of my team's focus has been over the last two years and even just in recent months. It's still a very relevant issue.

Stewart: I mean, I'm a relatively new resident to Dripping Springs just west of Austin, and you can feel the traffic, the traffic's gotten noticeably more congested since I've been here in March. I mean, I think these migration patterns are super important. And certainly here in Texas, I mean it seems like these businesses are just doing just fine here. I mean, it's good to see.

The election's always tough. It's always a tough conversation, but we just had an election and we know the direction that the country is telling us they want to go. And how does that affect the commercial real estate market in your mind? There's been many, many things bandied about. Everybody's got their crystal ball out and dusted off. How do you think the election impacts this market?

William: I think because we have single party control, although not by a significant majority, that historically has led to more government action that stimulates the economy or usually does well in general. For real estate, there are quite a few tax laws and other legislative priorities that we're tracking. I'll give a quick shout out to the Real Estate Roundtable. That's a group that we participate with and they make a lot of their information available for free on their webpage for anyone wanting to go into the details there.

But summarizing the dozen or so pieces of legislation and many other factors down to the ones that I think are the most relevant, I would say where terrorism insurance goes and there's a government backstop for terrorism insurance three or four years from now will be relevant for investors who are buying iconic buildings or lending out iconic buildings in the largest markets. And then secondarily is immigration. Immigration has been high over the past couple of years, which has benefited some segments of real estate. And if that starts reversing or slowing down, that would be a negative for some segments of the sector.

Stewart: And I guess just my wrap question here is how is MIM positioned to take advantage of any forced selling or market dislocations that may come about? I don't think it's a certainty that they come about, but I'm keen to know how you think about it and what your plan is.

Clint Culp: I'd say for the debt side, I mean MIM is very active in the lending market. And even to your point, there will be some forced sales, but for those groups that don't have to sell more than likely, especially if it's a multifamily property, it's probably over-levered. These are going to be loans that mature next year that were done three years ago at cap rates in the low threes to 3 1/2% range. With the value reset, there'll be opportunities to come back in and provide financing on those deals where their owners still have some equity to protect, but maybe the leverage has to be a little bit higher to take out the existing loan. So I think we're going to see those opportunities.

And then again, something we did mention earlier was in the hotel space where we've been very active is one of the questions you asked earlier about the vintage. We started doing a lot of hotel loans in 2021 when we were at a trough as far as hotel performance. And we've been active there and those deals are very attractive yields looking back and now have only gotten safer through NOI and value growth. So I think really just being active in the market, having the regional presence that we have, we'll be able to get our fair share of deals done.

Stewart: It's interesting how it wasn't that long ago that we were in the midst of COVID and nobody knew what was going to happen with travel and hotels and all of that stuff. It's nice to be here where we are and I appreciate the terrific education and appreciate both of you being on serving as professors for a day here in the real estate debt market. If you could give our audience a couple of key takeaways that summarize what you talked about today, what should the audience take away today?

Clint Culp: I'd say for me, I mean it's really, it's a lot of our focus on some supply and demand for the deals that we're going to pick. It's looking at a longer runway than just the next one or two years. It's making sure the markets we focus in have a lot of demand drivers, which in Texas fortunately we do, and what supply is going to look like in three or four years, not just one or two years. And then on the fundamental side, we had talked about the office sector for a little bit, but people are starting to go back to the office. You are seeing some tenant demand. It's mostly in the smaller square footage space, but I think in the long run we think that our class A trophy office deals are well amenitized, will be okay in the long run.

Stewart: Thanks, Clint. How about you, Will?

William: I'm going to somewhat echo what Clint said, but maybe just add that in my 20 years working in real estate, there's been two periods of time when assets are trading below replacement cost or below that cost of construction. One was right after the global financial crisis, so probably 2009 through 2011. And the second one has been since late 2023. The peak level where that disconnect was the strongest probably occurred over the summer of 2024. The pricing is starting to move up again, and that level or that premium between the property price and the replacement cost is narrowing, but we're still in this rare period of time where buying existing assets can generally be had below what it would cost to build the asset.

Stewart: That's super helpful. I've got a couple of fun ones for you out the door, if you're interested. You both talked a little bit at the top of the show about how you got where you are today in your careers, and I wondered if you would offer some advice to folks who are younger or earlier or more junior in their careers if they're interested in real estate. And let's just say that you got your degree in May of this past year or a couple of Mays ago. What advice would you give someone who was interested in this segment of the investment markets?

William: One that I would give, although this may be too specific for the role I have, but it's to learn Python, learn how to code, and that can be done in the case of what I work with with Bureau of Labor Statistics Data or Census Data and ChatGPT, or it could be done across a number of other avenues. But pick a difficult data set to work with, maybe the American Community Survey, and ask yourself a question that you would like to understand about it and spend a lot of time with ChatGPT, write a script and put it together. That will be a valuable skillset across a number of different fields in my opinion. And just understanding how to work ChatGPT or large language models that way I think is also a skillset that will be increasingly valued in the future.

Stewart: Very helpful. Thanks, Will. How about you, Clint?

Clint Culp: Well, I love that we have Will and me on here because we have very different answers, so it's perfect. I would say from my role, I think what's helped a lot through my career is really to be curious about what you're doing and not just be as much of a processor. It's actually thinking through the information that you're gathering. It's also being very flexible in the position that you have. Taking on new challenges, not getting in the comfort zone, being fine, starting to do something new. Like I said, through my career, I've worked on a lot of different sides of the business and I think it's really helped me grow a lot and just be willing to dive in and do whatever's needed of you and also really work on building relationships. I think at the end of the day, a lot of our successes in this business is done by the people we get to know well, and not just from a social level, but actually you end up building very meaningful, deep relationships and it's just easier to get deals done when you know people at that level.

Stewart: That's fantastic. Now, the last fun one has to do with a hypothetical lunch or dinner. You get to invite one guest each, and then you have to agree on a guest if you so choose alive or dead. So who would you most like to have lunch or dinner with, alive or dead? We started with Will last time. We'll start with you, Clint. Who would that be?

Clint Culp: Okay. Well, I'll go two different ways. One is a personal relationship. It'd be my mom's dad. He passed away when I was young. I have very, very brief memories of him, but from what my parents and siblings have told me, my older siblings is, we couldn't be more alike and probably would've had some pretty good banter back and forth. So wish I could have know him better.

Stewart: That's nice.

Clint Culp: And then as far as, I'll just go the celebrity route. It's going to have to probably be Elvis. Giant Elvis fan.

Stewart: Oh, there you go. Have you seen the documentary on Netflix, I think it is, on his 1968 comeback special? It's really good. Yeah.

Clint Culp: I have. I've seen most of the things. My wife and I, we've been together since we were kids and we actually got married in Las Vegas. It was planned. We had over a hundred people come. But anyway, that's part of our love for Elvis.

Stewart: Wow, there you go. All right. All right, Will, how about you? Who you bringing? You've got Clint's maternal grandfather and Elvis.

William: There are some colorful stories in my family tree and I think a family member up the chain would be worth getting lunch with, although picking someone that the audience may recognize. George Orwell is someone who I studied in an English class in college and really was briefly obsessed with for a couple of years. He had such an interesting life. He wrote Animal Farm in 1984, but I think more importantly wrote essays about the issues of the day in the 1930s and '40s. Really had it right as it related to what the response should be to Stalinism, to Nazism and was unique in that regard. I'd be curious what he thinks about modern day conflicts like Iraq or what's going on in Ukraine and Israel. Not to take the topic as far as possible from institutional real estate, but I think that would be an interesting person to be able to speak with.

Stewart: That's super helpful. That's great, man. What great answers. I really have enjoyed having you both on today. You've gotten a great education on private real estate debt and the real estate market in general. Thanks so much to both of you.

William: Thank you, Stewart.

Clint Culp: Thank you. Thank you for the listeners for tuning in.

Stewart: Absolutely. We've been joined today by Will Pattison, Head of Research and Strategy Real Estate with MetLife Investment Management's real estate group, and Clint Culp, regional Head of Real Estate Debt Production for the Southern region for MetLife Investment Management. Thanks for listening. If you 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. Will see you next time on the InsuranceAUM.com podcast.

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