Gems to Be Found in the Middle Market

By Christopher O'Dea, September 4, 2015

Despite chatter about frothy pricing in the middle-market segment of commercial real estate, opportunity abounds amid a graying demographic.

There's been chatter that the middle-market segment of commercial real estate has attracted so many well-financed players that the bid for most properties is leaving little room for one key ingredient – a return on investment.

But looking into the details reveals a market segment with plenty of opportunity for investors and managers who understand the composition of the middle market and the dynamics that are shaping it today. This includes a "graying" of the market that's impacting the supply of property available for investment.

Jay Rollins, JCR Capital

"The primary ownership profile of middle-market real estate owners tends to be 50-to-75-year-old males," says Jay Rollins, managing principal and co-founder of JCR Capital in Denver – a firm that specializes in middle-market property investment. "This 'graying' of real estate ownership is giving rise to a whole new set of opportunities and issues." Life events such as death, succession, divorce, and liquidity and partnership issues "are a significant driver of middle-market real estate," he adds.

The market for middle-market property is opaque, with most capital controlled at the local or regional level by private funds and their investor networks. The big managers that invest money from pension funds and other institutions are virtually absent – transactions in the $5M to $50M range are simply too small to affect the returns of major funds.

The middle market makes up the majority of assets, by number, in the U.S., says Rollins. "These deals are too small for the big guys and too big for the country club money, leaving a void few can fill."

Rollins manages funds to fill the middle-market void. Earlier this year, the firm launched JCR Capital Commercial Real Estate Finance Fund III. By August the firm had raised $210M for the fund; JCR expects to exceed the original $250M target and reach a final close of more than $300M. Fund III will invest more defensively than its predecessors, Rollins says. The fund will originate high-yield senior debt, participating debt and structured equity, and structured preferred equity, and will provide programmatic joint-venture facilities.

Some big funds are testing the waters. Ares Commercial Real Estate Corp. (ACRE) specializes in principal lending and mortgage origination for what it calls the "underserved financing needs" of middle-market commercial real estate, operating as a real estate investment trust managed by a subsidiary of $87B-AUM alternatives manager Ares Management L.P.

Based on ACRE's latest earnings statement in July, it's time to dive in. Year-over-year earnings rose 35 percent. Todd Schuster, ACRE's president and CEO, expects "a continuation of the same in 2016 and beyond".

Todd Schuster, Ares Commercial Real Estate Corp

Principal lending offers "opportunities to further expand ROE [return on equity], "Schuster says. An example is a recent $39M senior loan collateralized by a full-service hotel located in suburban New York. "We expect this investment to be highly accretive, with mid-teens returns before expenses," he adds.

ACRE also expects a boost from rising interest rates. Approximately 90 percent of loans held for investment carry floating rates, as do approximately 93 percent of liabilities. "If LIBOR goes up," says Schuster, "we expect our net income to go up as well".

Preparing for rising interest rates has become a staple of the middle market. The owner of a 24-story office building in downtown Los Angeles faced a significant defeasance prepayment penalty if it refinanced a CMBS loan on the building prior to May 2015, but also feared interest rates might rise during the first two quarters of 2015. "We were given the task late last year to secure a loan that could not close for approximately half a year," says Jonathan Hakakha, managing director of Quantum Capital Partners, a real estate capital advisory boutique based in Beverly Hills.

Jonathan Hakakha, Quantum Capital Partners

Quantum arranged a 15-year $34M loan at a 3.5 percent fixed rate with John Hancock Life Insurance Company – including a five-month forward rate lock. "During the five-month rate lock period, the 15-year interpolated Treasury bill rose by 18 basis points," says Hakakha. "The cost of the forward rate lock was a fraction of that amount."

The deal met a unique need from investors. "Usually we're asked to close a loan as quickly as possible," Hakakha explains. With interest rates set to start rising perhaps as early as this month, that urgency may return as owners and investors try to stay ahead of the rising tide.

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