Tough Times For Commercial Real Estate Are Making Debt Deals Attractive

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Cory Johnson, chief executive officer at Pender Capital, which runs the Pender Capital Real Estate Credit Fund, a closed-end debt interval fund. Read the Q&A below as Cory says that there's "an abundance of very interesting opportunities" as the commercial real estate market goes through big changes as regional banks pull back from the sector and reduce liquidity for borrowers. The result is "a kind of a heyday, the most attractive risk-adjusted yields we have seen since the Financial Crisis [of 2009], borrowers buying at discounted valuations, looking for debt providers." He says the continued challenges for commercial real estate should keep providing good, safe opportunities for investing in senior-secured debt amid continuing headline woes.

Cory Johnson

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: We're talking about the real estate side of private credit with Cory Johnson, chief executive officer at Pender Capital, welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization representing all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today, we're looking in the direction of the private credit landscape in one of the most interesting and talked about sectors in the investment world, commercial real estate, and we're doing it with Cory Johnson. He's the chief executive officer at Pender Capital, which runs the Pender Capital Real Estate Credit Fund, a closed-end debt interval fund that trades under ticker symbol PNDRX. You can learn more about the firm and the fund at PenderCapital.com. And if you want to size up closed-end funds, interval funds, and business-development companies in general, check out AICAlliance.org, the website for the Active Investment Company Alliance. Cory Johnson, welcome to The NAVigator.

CORY JOHNSON: Thank you for having me, Chuck. Happy to be here.

CHUCK JAFFE: Like I said, commercial real estate, one of the most talked about. I think actually I read something recently, and I know I heard from Dave Sekera at Morningstar, the chief US markets strategist, that commercial real estate is currently the most reviled and hated sector out there. When we talk about that market, A, different investing in debt and private credit than it is investing in properties, B, one man's downtrodden interesting sector is another guy's bargain. So give us an update on commercial real estate, and specifically your take on it when it revolves around the private credit market.

CORY JOHNSON: Without a doubt I think commercial real estate has been in the news for better or for worse for the last couple quarters at least, huge wall of maturity's hitting, seems like every day there's a new doom and gloom article that's hitting the papers. So really what we see as the opportunity set, and like you said, there is some opportunities depending on what side of the table you lie on, we are on the debt sector. We are a senior secured bridge lender seeing an abundance of very interesting opportunities for basically getting new exposure within a marketplace of sponsors on one side that are buying, buying at distressed, call it new valuations, come into groups in the private credit space, because frankly the regional bank pullback is a limited amount of liquidity that is out in the marketplace and the private credit shops are able to pick some of this up. So really for us it's kind of a heyday as we're looking at the most attractive risk-adjusted yields that we've seen since the Financial Crisis, borrowers are buying at discounted valuations, looking for debt providers, and fortunately for us that's lower loan to values on new pricing, some higher yields as what's gone on in the interest rate world in the last couple of years. It's a very interesting time, and

I think we kind of walk people through the challenges, because I think there's a lot of exceptions out there of what is happening in the real estate markets, specifically the CRE space of the doom and gloom, it's all falling apart, but that really does bring a different amount of opportunity sets to groups that are positioned on the other side of it.

CHUCK JAFFE: Something I don't want to get lost in that answer was senior secured debt. So when somebody hears about commercial real estate, and they're hearing what's going on and worries about defaults and what this could mean for the banking sector and all the rest, if you're buying senior secured debt, and forgive me if I'm wrong, but that puts you at the best spot. In other words, you're at the top of the heap by focusing on senior debt, you're the first one to be paid back, so that should minimize your default risk at a time when everybody's talking about default risk in that sector being high, right?

CORY JOHNSON: You are 100% correct, so we are the first to get paid, we are the last to take a loss, and when we've got loan to values that are sub-60%, ultimately what it means is you've got really a 40+% equity cushion from the sponsor side before your first dollar of debt is at risk. So definitely puts us in a much more protected position on a move-forward, and really limits the level of default risk you have. Because you do hear there's a lot of mezzanine, a lot of preferred equity plays out in the space, and that's just ultimately rising you up within the capital stack, putting you closer to where that par valuation is, so we are the last ones in that line, it puts us in a nice control position should any addition pain points hit the CRE marketplace.

CHUCK JAFFE: If there are additional pain points, if you're senior and you're secured, you of course could wind up getting the property. Right now as commercial real estate tries to sort itself out, that might not be a good thing, but how do you think commercial real estate does sort it out? As much as there's people talking doom and gloom and horrible scenarios, every community, every city, every whatever has gone through its own renaissances, you would assume that at some point this gets figured out, doesn't it?

CORY JOHNSON: Yes, every city has gone through their own ups and downs, and even within a larger city you're seeing segments of the markets with the same asset classes that are having different recoveries and different timelines related to those recoveries. When the Fed came out in December and was indicating some rate cuts, I think a wave of optimism hit the real estate industry and you had some equity sponsors who were ultimately understanding they were out of the money all of a sudden said, "Hey, well, wait a minute. If we have a couple of additional rate cuts we may not be fully back in the money but we're maybe going to recoup a little bit." Obviously we saw the Fed, the was pricing into the marketplace was roughly about eight anticipated rate cuts, they are now recently down to four, so you've had this wave of optimism. I think rate cuts will obviously help with some of the landing, if you do get more than four it will definitely soften the blow, but there's going to be re-trading, we needed some sort of correction within the industry as a whole. But you look at certain marketplaces, I mean, asset types are really one of the main talking points in the CRE space these days, obviously office has got a fair share of the bad publicity and rightfully so, but take a market like Los Angeles, downtown LA is massively depressed office environment, you go six miles away to Century City and they're having some of the best matrixes that you could really ask for in a CRE office market today. So very much a localized problem, localized recoveries throughout, but across the board there is going to be levels of distress and there's going to be options to groups that are going to take advantage of this from the sponsor side of the table that have some dry powder, they're finally able to price themselves back into the money. You've seen the bid-ask on property values kind of come in significantly there, and so those guys, there's going to be some very, very well-priced trades that do take place. The flip side of that is debt still remains a very challenging sector. When you have data out there across the board that is talking about the lack of liquidity within the marketplace, the lenders are going after the most qualified sponsors that they can get; bigger balance sheets, better track records, that's who really is going to be able in my opinion to take the best advantage of what's currently in the marketplace today. Because when you go too far down, I think more call it the mom and pop type trades that are taking place, there's just not as much liquidity for those groups around. So I think this is really going to be an interesting recovery as we get into it and as we start moving forward, but we really do need some level of the regional banks to come back to the table, but I do think that's going to be probably out towards the end of 2024 into early 2025 as the banks are really trying to understand what their balance sheets entail, what they're allowed to do, and what really their focus is going to be on a move-forward basis.

CHUCK JAFFE: Let's bring this back to the fund, again it's Pender Capital Real Estate Credit Fund, in an earlier answer you were talking about preferred equity and mezzanine financing, there are a number of private credit funds out there but there are not many that do what you do. So how does your fund work into someone's allocation? I mean, obviously not all private credits are created equal, but how would you hope someone would use a fund like yours in their investment portfolio?

CORY JOHNSON: A fund like us, and really being focused on senior secured positions and really having no fund-level leverage, really limited to no leverage at our vehicle, we're really more I think a complement to a traditional investing portfolio, someone looking for some higher yield, fixed income but does have a nice security instrument attached to it. We're not one of those groups. I mean, I think there's a lot of distressed debt shops out there, some higher octane mezz that certain groups utilize a few turns of leverage to really manufacture the returns, that's not really what our bread and butter is. Our bread and butter is really more the slow and steady, have something that's lower volatility but you can kind of count on even in a time of duress, still posting positive returns in the higher single digits. And to us that's where we really like to play with our clients, they're not looking for us to swing for those fences, they just want those bunt singles to slowly get around the bases and that's what their clients are looking for. I think we complement the higher octane funds very well, but we also complement the traditional equity bond portfolios very well. As more and more groups are looking to alternatives to fill certain buckets, we're not really competing with anything on that front, we're just a complement piece.

CHUCK JAFFE: Cory, interesting take on everything. I hope we get a chance to chat with you again on The NAVigator.

CORY JOHNSON: Thank you, Chuck. Appreciate you having me.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe, I'd love it if you'd check out my hour-long weekday show on your favorite podcast app or by going to MoneyLifeShow.com. If you want to learn more about interval funds, closed-end funds, and business-development companies be sure to check out AICAlliance.org, that's the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Cory Johnson, he's chief executive officer at Pender Capital, which runs the Pender Capital Real Estate Credit Fund, a closed-end debt interval fund trading under ticker symbol PNDRX. Get more information on the firm and the fund at PenderCapital.com. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing or following along on your favorite podcast app. We'll be back next week, and until then, happy investing everybody.

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