AMERICAS NEWS: The power of an operator

With its new debt strategy, Related Companies will be one of the few real estate operators that also is a significant lender. PERE Magazine, March 2013 issue

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As one of the largest US real estate developers, Related Companies stood out amid a sea of competitors when raising its first opportunistic fund in 2011. Now, the New York-based firm is betting that its operator status will provide a similar advantage as it expands into the high-yield debt arena.

“If you’re going to be in the fund business, differentiation with your specific skillset is critical,” said Jeff Blau, Related’s chief executive, in an interview with *PERE.* For Related, that differentiation comes from its hands-on real estate knowledge, whether investing in equity or in debt.

When Related first launched its fund management business in 2009, there already were plenty of real estate managers in the market. “If we were to have a go at it, we wanted to have a different approach,” Blau said. That approach focused on the firm’s background as an operator.

With 2,500 employees, Related handles everything in-house, from property management to construction and design to sales, marketing and leasing. “We bring that entire skillset to our fund business,” Blau said. “We are able to pursue a different type of deal because we are able to fully analyze the risk of construction, renovation and turnaround in-house.”

It was while pursuing deals on behalf of its first vehicle, the Related Real Estate Recovery Fund, that Related began to consider debt as a greater focus for the firm. “What became very apparent was that we were passing on a whole host of deals that were in a different place in the capital stack,” Blau explained. “We really liked the risk-return profile, but we did not have the proper capital in our equity fund necessarily to do all those transactions.”

With that, Related saw an opportunity for a new debt strategy, which would pursue high-yield investments that would be lower on the risk-return spectrum than those made on behalf of Related Real Estate Recovery Fund, which has a return profile that is more similar to an equity opportunity fund.

While Blau declined to provide specifics on potential vehicles for the new strategy, *PERE* understands that Related is expected to begin raising capital this year for high-yield debt transactions through a commingled fund and a number of separate accounts. The new fund would have a similar investment capacity, both in terms of transaction size and total capital, to the Recovery Fund, which raised $825 million in 2011.

Managing principal Justin Metz, which heads Related's fund management business, will oversee the new vehicle, while the firm's existing investment team would execute deals on behalf of the new strategy, sources said.

Although Related formed a $250 million construction loan fund – now fully invested – with the United Brotherhood of Carpenters in 2010, the firm's new strategy will be its first commingled debt venture. The new vehicle will cut across the capital stack, targeting not only whole loans and subordinate positions in transitional assets that traditional lenders would find difficult to underwrite but bridge and mezzanine debt as well.

Operator-sponsored debt vehicles are a rarity in the industry. Of the 108 debt funds that The Townsend Group currently is tracking in the market, just one or two are sponsored by developers. Related has invested about $600 million of capital in debt since 2010 through a combination of its equity and construction loan funds, as well as transactions that were done through its balance sheet.

Going forward, debt investments will fall into two major buckets. Any so-called loan-to-own situation, where Related would buy the debt to get to the asset, would be considered an equity investment for the Recovery Fund, explained Blau. Meanwhile, with investments for the new debt strategy, the firm would not have the intent of taking over the underlying property, but instead focus on generating cash flow and ultimately getting the debt repaid.

Still, Related views its ability to take over assets as a competitive advantage as a lender. For example, in an August investment on behalf of the Recovery Fund, the firm purchased a 50 percent stake in a subset of a large loan portfolio that was acquired by a bank for approximately $1 billion. Related and the bank, which kept the other 50 percent interest, informed the borrowers that they were their new lenders and to pay back their loans. According to Blau, the response was "shocking" – the loans were paid back at a premium to Related's basis within 45 days.

"I think that speaks volumes as to the power of an operator in this space," Blau said. "When a borrower thinks that a lender is never going to take an asset back, the lender doesn't get paid. When a borrower realizes that their lender could wind up owning the asset, it's a different conversation."