HEALTH CARE

Obamacare Repeal Good for Health-Care Real Estate Market: DeRosa

The repeal of the Affordable Care Act has the potential to benefit health-care landlords and the medical system as a whole, according to Tom DeRosa, chief executive of Welltower, the biggest U.S.-listed health-care REIT. DeRosa says the ACA is keeping too many hospitals open when providers could deliver better service in a different setting. DeRosa was interviewed by Ainslie Chandler on May 5. Comments have been edited and condensed for clarity.

Q: Which part of the market do you think offers the biggest opportunities?  
A: The biggest opportunities are still going to come from senior housing when the demographic wave of the 85-year-old-plus really starts to separate from the rest of the population in 2020. We are focused in major metro markets. If you look at where the population is moving in the U.S., it is moving back to the city. Most of the senior housing infrastructure in this country was built for a generation that lives in the suburbs. Their children no longer move to the suburbs and our growing elderly population want to be near their families. If their children and grandchildren want to live in Brooklyn, they are going to want to live in Brooklyn. Years ago, their children and grandchildren would have lived in Westchester County, now they are living in Brooklyn. And there is a lack of supply of high-quality senior housing options in the major metro markets in this country. As well as London.

We think there is a real opportunity in the outpatient medical space because today in the U.S. ... New York Presbyterian or NYU, they own all of their real estate. We believe that in the future they won’t own all their real estate. And that’s how we want to grow, we want to be the trusted partner. That’s the future of our country. There is $1 trillion of real estate sitting in hospitals and medical office buildings. Eighty-two percent of that is owned by hospitals and physician groups, with only 10 percent owned by REITs. If you look at any other real estate sector, you would see the inverse of that. The need for the health care systems to reduce their acute care hospital footprint in favor of outpatient medical is going to require a tremendous amount of capital. There is a huge need to invest in technology for these health systems to remain competitive, so they simply cannot continue to own all of their real estate. We are standing at the very early days of that trend.

Q: Overall, is there an oversupply of senior housing in the U.S.? There has been a lot of construction in recent years.  
A: Just like in other sectors of real estate, the oversupply is in the markets that wouldn’t surprise you, it’s in the markets with very low barriers to entry. We have been very focused on owning senior care assets in the major metropolitan markets. I saw this week there were spikes in job growth in Jacksonville and Atlanta but they are not places that we choose to own much real estate because they are markets that have very low barriers to entry. I don’t think those job statistics are necessarily sustainable in those markets.

Q: Are you a net seller of assets at the moment?  
A: We are an opportunistic investor and in the last quarter, we had an opportunity to sell a portfolio of assets that would not have been strategic for us. Good assets. This is one of the sectors of real estate where there is very little differentiation in capitalization rates, if any, between an “A” quality asset and a “B” quality asset. If we can take advantage of that factor, we will. We will always take whatever steps we can to refine our portfolio, to make sure that we own the right assets for the medium-to-long term. Real estate is always for sale. Issues in the REIT sector occur when you don’t exercise the same discipline in selling assets as you do in buying assets. REITs have a disincentive to sell real estate because it disrupts the resilient growth of funds-from-operations per share. But if you don’t do it when you can, you will always pay the price at some later date.

There have been lessons learned, if you look at the sector today. There are mall companies that clearly should have been net sellers of assets because now there is no market for them.

Q: What impact did the Affordable Care Act have on your portfolio and what impact would its repeal have?  
A: We have aligned our strategy to be a facilitator of this move from fee-for-service health care to a value-based reimbursement model. That means that we would not invest in hospitals. We think the repeal of Obamacare is really going to help drive this transition from fee-for-service to value-based care. We think it will create a more competitive market. Health care is going to become more of a consumer product and there is going to be much more choice in terms of how we manage our health-care needs.

On balance, I think the ACA was likely keeping open too many hospitals in this country, keeping the lights on in too many hospitals that need to shut down. We would be able to save so much money if we could stop some hospitals from operating. They are just becoming centers of custodial care and we can’t afford to offer that any more. I am hopeful, I am optimistic about the repeal of the ACA and what it will do for our business and what it will do for health-care delivery overall. If you just take a step back I think that we have to focus on better outcomes at a lower cost.
Investors See Potential in Reinvigorated Health-Care Property Sector as Population Ages

By AINSLIE CHANDLER

WITH THE POTENTIAL repeal of the Affordable Care Act, the U.S. health system may undergo sweeping changes. Despite this uncertainty, some real estate investors say now is the time to invest in the sector. Health-care properties, such as medical offices and senior homes, have outperformed other real estate sectors in recent years, and are poised to benefit from a number of long-term trends. The aging population is creating demand for health services and elderly accommodation, new technology is increasing the need for specialized medical office space and health systems are trying to shift care into out-patient facilities.

Demographics
One of the factors most often cited by investors when discussing whether they expect health-care assets to outperform is that the population is getting older. Quickl. And that means demand for care is expected to rise.

Health-Care Assets Outperforming Property Types
The Green Street Health Care Commercial Property Price Index has outperformed the aggregate/major sector CPPI, the data show. The Green Street indexes measure unleveraged U.S. commercial property values, capturing the prices at which commercial real estate transactions take place.

“In pretty short order we will sell more adult diapers than baby diapers, and that has already been the case in Japan for many, many years,” said Al Rabil, co-founder, managing partner and chief executive of Kayne Anderson Real Estate, citing a speaker at the firm’s recent annual conference. His firm has about 90 percent of its real estate assets in medical office and senior housing assets.

“Eleven thousand Americans a day turn 65 and 6,000 a day are turning 75 for the next 20 years. This is a global trend,” he said.

Health Policy
Favorable health policy has driven the market in recent years, according to Chris Bodnar, CBRE executive vice president and co-leader of CBRE Healthcare Capital Markets Group.

While the outlook is somewhat uncertain, as President Donald Trump pushes to repeal and replace the Affordable Care Act, the ACA has driven a push for efficiency in the medical sector that is unlikely to be reversed, even if the law is repealed, Bodnar said.

“We don’t know what the policy will look like going forward but in our discussions with health systems and providers out there, they are continuing to move forward with strategy put in place several years ago,” Bodnar said in an interview with Bloomberg. “What the Affordable Care Act did for health systems is that it was a wake up call that they need to do more with less.”

The forecast demographic shift in the U.S. is enough to drive the sector, regardless of uncertainty around payment models and potential policy changes, according to Chris Kay, chief operating officer at Hammes, the private health-care investor and developer focused exclusively on outpatient facilities.

“Uncertainty abounds,” Kay said. “[But] at the end of the day, the fundamentals are there. You have demographics that are going to demand health care be provided to a large portion of the population and we can’t do that through traditional means.”

The market trends that are driving demand for medical property assets started before the ACA came into effect and should continue, according to Christopher Merrill,
co-founder, chief executive and president of firm Harrison Street, which invests in assets like private-pay elder care, assisted living and memory care facilicites, as well as self storage and student housing, and has about $12 billion in assets under management. Increased U.S. spending on preventative health care and the need for hospital systems to push services into outpatient facilities in order to save money should continue to drive demand for medical real estate, Merrill said.

Medical Office
Within the health-care real estate market, medical office has proven to be the hottest sub-market.

Capitalization rates on medical office deals are the lowest in the sector and rival those of high-quality office assets, according to Real Capital Analytics figures.

Green Street Advisors’ real estate performance index also shows that medical office assets are outperforming, compared to an index comprised of other property types, including retail, office and industrial.

This strong performance can be attributed, in part, to its low exposure to Medicare and Medicaid reimbursements, according to CBRE’s Bodnar.

Other health assets like skilled nursing facilities have a high reliance on Medicare and Medicaid reimbursements, making them less attractive to big investors, Bodnar said.

“You are not going to see an institutional core fund representing pension money really trying to get into the skilled nursing sector, given the risk in that asset class, based on the unknowns going forward. Medical office is the one that is getting the most demand going forward.” (For more on medical office see p.4.)

Senior Housing
Aged housing is another sector currently favored by health-care landlords, albeit in select markets.

“We’re extremely bullish on the sector as a whole, both in the near term and longer term because the demographics in this country are daunting,” Kayne Anderson’s Rabil said, pointing specifically to markets like Florida. “I cannot see in my lifetime there ever being equilibrium of supply and demand.” (For more on senior housing see p.7.)

Health-care REITS Outperforming Peers in 2017

REIT Performance
Demand for health-care assets has surged in recent years, driving capitalization rates down to rival traditional office assets, according to data from Real Capital Analytics.

Health-care focused REITs have also outperformed so far in 2017, compared to their peers. The growth comes after a weaker few years for the sector, according to Bloomberg Intelligence senior REIT analyst Jeffrey Langbaum.

The weakness was fueled by the sector’s strong correlation to the 10-year treasury yield and its exposure to interest rates, in an environment when many expected rates to rise rapidly, Langbaum said. Both of these are now causing investors less concern, he said.

While the health-care REIT sector is outperforming, not all vehicles are created equal. Within the health-care REITs space, smaller, more narrowly-focused REITs are outperforming their bigger peers.

The biggest REITs, including Welltower and Ventas, have experienced weaker earnings as they have sold assets to take advantage of strong property prices and paid down debt in lieu of buying additional real estate, despite strong liquidity and access to capital.

Meanwhile, smaller REITs including Senior Housing Property Trust and Sabra Health Care REIT, which find it easier to access more moderately-priced smaller assets and achieve growth, have rallied.
Healthy Market for Medical Office Investors

By AINSLIE CHANDLER

Health-related office properties are in demand, as new supply remains constrained, occupancy rates climb and uncertain health policy creates concerns about other medical property asset classes.

Office Assets Favored by Buyers
Medical office buildings were the health-care assets most favored by investors surveyed by global commercial real estate services firm CBRE, with 97 percent of respondents to the Healthcare Real Estate Investor & Developer Survey saying they met their investment criteria, compared to the next favored, ambulatory surgery centers, which 80 percent of those surveyed said they were interested in.

“Medical buildings are probably in the most demand right now, because they are one of the asset classes that has the least exposure to Medicare and Medicaid reimbursements,” Chris Bodnar, executive vice president of CBRE Healthcare Capital Markets Group. “That is the unknown right now, [in terms of] policy with the current administration, how are they going to treat certain asset classes that are extremely dependent on Medicare and Medicaid.”

Assets like skilled nursing properties, which are highly dependent on government reimbursements, are not as attractive to investors, Bodnar said.

Cap Rates Declining Amid Investor Demand
Medical office capitalization rates have continued to tighten, as new supply of assets has been constrained and investor demand continues to rise, Mary Beth Kuzmanovich, national director, healthcare at Colliers, said in an interview.

The stability of medical office properties was seen during the 2008 financial crisis, when values and returns dropped less than in other asset classes, including retail, office and industrial properties, Kuzmanovich said. Capitalization rates have been falling consistently since 2010, when they rose to as much as 8.0 percent, falling to an average of 6.7 percent in 2016.

Vacancy Hits Record Lows, Rents Rise
The national average asking rents for medical office properties rose to $23.96 per square foot in 2016, as vacancy rates dropped to just above 7 percent, according to Colliers International’s report. Key markets had tighter vacancy rates and higher rents, with Seattle at a 4.9 percent vacancy and a $27.66 per square foot average asking rent. Southern California markets of Los Angeles and San Diego also had lower-than-average vacancy rates and higher-than-average rents.

Those markets are being driven by the cities’ growing populations, which boosts demand for medical services, Kuzmanovich said.
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AFTER A STRONG period of construction, developers are responding to an oversupply of senior housing, new figures show.

The amount of senior housing under construction, as a percentage of the overall inventory, dipped to 5.8 percent in the first quarter of 2017, its lowest level in two years, according to figures from the National Investment Center for Seniors Housing & Care.

Developers have overbuilt in recent years, in anticipation of higher demand for senior housing as the U.S. population ages, with areas like Texas, Florida and Atlanta suffering the biggest oversupply, according to Bloomberg Intelligence’s senior REIT industry analyst Jeffrey Langbaum.

“Developers and lenders are now more cautious, with concerns of oversupply more prevalent, according to a report from Langbaum and Bloomberg Intelligence associate Colin Winrow. “This is resulting in construction delays, lengthening the typical two-year process and preventing some projects from getting off the ground. As existing units under construction are completed, the decline in new starts will likely result in a reduction of new supply 12-18 months later.”

However, the completion of projects that are already underway could spell falling rents for landlords, as supply continues to exceed demand, according to analysis by Bloomberg Intelligence.

“As the large number of previously started projects finish, they’re competing for residents with existing properties, hurting occupancy,” Langbaum and Winrow said.

The first quarter of 2017 was the fifth consecutive quarter where new supply exceeded demand, according to BI’s analysis.

Average occupancy, in top 31 markets tracked by the NIC, fell 30 basis points to 89.3 percent, its lowest level since the third quarter of 2013, and rent growth slowed for the second consecutive quarter to 3.3 percent, according to BI.

An uptick in the percentage of the population aged over 65 is expected to drive up demand for progressively higher levels of supported housing in coming years, according to data provider NIC.

The percentage of the U.S. population aged over 65 is expected to increase 17 percent to 55 million by 2020, and to almost double to 89 million by 2050, according to the U.S. Census Bureau.

The overall population is expected to increase by 4.7 percent to 339 million by 2020 and 33.2 percent to 431 million by 2050.

“Senior-housing and nursing-home demand should rise with gains in the over-65 population in the next 10 years, first for independent-living properties and then for higher-need assisted living and skilled-nursing facilities,” according to Langbaum and Winrow.
Small Is Beautiful for U.K. REITs Navigating Brexit Uncertainty

By SUSAN MUNDEN, Bloomberg Intelligence Analyst

IN THE WAKE of the U.K.’s vote to leave the European Union, the outlook for London offices remains a challenge. Possible losses of about 50,000 workers, phased over several years, could be absorbed with modest rent and value declines. Initial fears that space equivalent to 10 London Shards would be vacated following a 100,000 Brexit-related job relocations, have been pared to half that figure. The London office market would struggle to digest this without weakening in one year but could withstand the outflow.

Office workers are typically allocated 100-120 square feet of space per person, so that 50,000 jobs would amount to 5 million to 6 million square feet of the vacated office space. The London City District’s 10-year average annual demand is 5.2 million sq. ft. with the remainder of Central London doubling that figure.

Real estate investment trusts exposed to smaller buildings are less constrained by Brexit concerns than large development landlords, who have meaningful single-asset risks. Navigating the potential political fallout without squandering the current defiant, robust and globally synchronized economic performance, is testing REIT strategies.

Some U.K. REITs are so well positioned for the downside that they face re-engagement risks if a crash doesn’t materialize. It may be challenging to replenish portfolios, kick-start large projects and re-leverage balance sheets if property prices don’t fall.

Capital commitments are low and the combined war chest of the six largest London-focused REITs is as much as 35 percent of London’s average annual deals. Deploying this cash into assets could be difficult without a crash.

Cash-rich REITs, prepared for a Brexit crash in U.K. office and retail property prices, have rewarded stoic investors who have stomached post-EU vote share-price declines exceeding 10 percent with special or higher dividends. Some of those arise following major disposals while others reflect strong cash generation after buoyant rents and leasing activity in 2015 and 2016. While low gearing is prudent, large disposals of mature assets could result in a cash drag on earnings if options for re-deployment are scarce.

When share prices trade at discounts of more than 20 percent to their market value, either markets crash, shares rally or deal-activity accelerates. M&A activity has kicked off in the U.K. listed-property sector with two deals totaling 2.4 billion pounds ($3.1 billion). Both involve the takeover by the major shareholder at premiums of 20 percent, or more, to the previous close. Property values in the U.K. have remained firm following the referendum on robust transaction volume, supporting valuations. Nevertheless, Brexit worries still weigh.
Fears of a bubble in U.S. commercial and residential markets, the challenges facing shopping malls, the impact of the health-care reform, and the effect of foreign investors on the New York market were front of mind for the leaders of some of the world’s biggest real estate companies when they recently spoke with journalists, investors and analysts. Comments have been edited and condensed for clarity.

**Brookfield Asset Management chief executive Bruce Flatt, speaking on Bloomberg Television May 2.**

“Generally, in the United States and in the developed economies, we are a net seller in a lot of those places. Where we have been putting money to work is in the emerging markets, markets outside the United States, Europe and Australia. We’ve done a number of things in Brazil, Colombia, India and China.”

**Sam Zell, Equity Group Investments chief executive officer, on Bloomberg Television May 10.**

“‘Bubble’ would not be an appropriate description for either commercial or residential property. I think the U.S. commercial market is a little frothy. I think we are about to have very significant additional supply and supply is the elixir that takes care of bubbles.”

**Simon Property Group’s chairman and chief executive Barry Sternlicht, speaking on Bloomberg Television May 3.**

“At the end of the day, if there is less retail space in the United States – and I expect there to be – we will be the net beneficiary of that because of the vastness of our portfolio and scale helps and a big balance sheet helps. So we’ve got $7 billion of capital ready to go to work in whatever form we can do to increase our profitability. And so we’ll weather the storm like we have in the past, we’ve done some of our best work when it’s the most foggy.”

**Hammes Partners Principal Todd Kibler, discussing the future of the health-care market, in a May 5 Bloomberg interview.**

“The idea is to push operations into real estate [in] the community, so that you have patient convenience and you are serving the community in a lower cost setting. That’s the whole idea of the Affordable Care Act, how do you drive costs down.”

**Vornado’s Steven Roth discussing the New York property market on the company’s May 3 earnings call.**

“There is a total bifurcation and as you would expect in the market. The speculators – and the momentum buyers that we discussed in the past quarters – have all but disappeared, which I think is appropriate because they’re not doing well and empty assets … have to be financed with equity. So I think the great assets are pretty much right around the high watermark and the unrented assets are distress.”

**Simon Property Group’s chairman and chief executive David Simon speaking on the company’s April 27 first quarter earnings call.**

“At the end of the day, if there is less retail space in the United States – and I expect there to be – we will be the net beneficiary of that because of the vastness of our portfolio and scale helps and a big balance sheet helps. So we’ve got $7 billion of capital ready to go to work in whatever form we can do to increase our profitability. And so we’ll weather the storm like we have in the past, we’ve done some of our best work when it’s the most foggy.”

**The State of Play in U.S. Real Estate**

By AINSLIE CHANDLER
Malls are fighting for shoppers with one thing their web rivals can’t offer: parking lots.

With customer traffic sagging, U.S. retail landlords are using their sprawling concrete lots to host events such as carnivals, concerts and food-truck festivals. They’re aiming to lure visitors with experiences that can’t be replicated online — and then get them inside the properties to spend some money.

“Events draw people to come to the shopping center,” said Craig Herkimer, whose company, KevaWorks Inc., is working with big landlords including GGP Inc. and Simon Property Group Inc. to produce outdoor events. “They generate revenue for the owner and offer a chance for cross-promotion, so they can try and drive more customers into the stores.”

Mall owners across the country are grappling with record store closures and declining rents. Retail property values are down 3 percent in past six months, as all other types of commercial real estate showed gains, according to the Moody’s/Real Capital Analytics indexes. A Bloomberg gauge of publicly traded mall landlords has tumbled 15 percent in the past year through April 20, the worst performance among U.S. real estate investment trusts.

Amazon.com Inc. and other internet retailers continue to grow, while department stores including Sears Holdings Corp. and Macy’s Inc. have been closing hundreds of locations. Payless Inc., the discount shoe seller, is among the latest to announce a massive shuttering — of 400 stores — as part of a bankruptcy plan.

“We expect to see a trend of more closings,” said Carol Kemple, an analyst at Hilliard Lyons. “Most retailers, if they’re still standing in September, will probably try to make it through the holiday season.”

Creating Experiences
Retail landlords have already made a push toward experience-driven offerings by adding restaurants, movie theaters and activity centers for children. Many malls are also adding rotating stores around for only a short time — known as pop-up shops — that are meant to attract young customers who see shopping as an event.

Now, events are reaching beyond the malls themselves. Herkimer’s task is to bring crowds to parking lots with events that generate as much as $60,000 a week for mall owners from the largest outdoor events.

Civic Center parking lot in Cathedral City, California.

The idea is gaining traction. Next month, Simon Property is having the first carnival in its Round Rock Premium Outlets parking lot, about 20 miles (32 kilometers) north of Austin, Texas. Similar events are being held for the first time at locations such as Central Mall in Port Arthur, Texas, managed by Jones Lang LaSalle Inc., and a Cheyenne, Wyoming, mall owned by CBL & Associates Properties Inc. In July, Simon Property’s Orland Square Mall, southwest of Chicago, will be holding its first parking-lot food-truck festival, with plans for live music performances, Herkimer said.

Movie Nights
Lisa Harper, senior director of specialty leasing for Chattanooga, Tennessee-based CBL, said the company has expanded its carnival business at many of its 87 properties over the last couple years. She and Herkimer have discussed the possibility of pumpkin patches in the fall months and adding movie nights to some properties. CBL’s Triangle Town Center, in Raleigh, North Carolina, is about to start its second mini concert and food-truck series, called Creekside Wind Down, Harper said.

Retailers rent the outdoor space in a structure that resembles their indoor leases, Harper said. While each deal varies, the agreements involve a base rent fee for use of the space and a percentage payment after the event reaches a certain threshold. Department stores, which sometimes own or control their parking lots, are seeing more value in renting the space after many years of restricting their use, she said.

“Events brings that additional traffic and also encourage people to stick around longer,” Harper said.

There’s no guarantee, of course, that people will go inside, said Tracey Hatley, director of specialty leasing for JLL Retail. But the events offer opportunities for cross-promotion. Customers receive fliers advertising stores or restaurants inside the mall or coupon books to help draw them in.

‘Driving Traffic’
That works well for properties like the Santa Rosa Mall in Mary Esther, Florida, Hatley said.

“They are a property that’s struggling with occupancy, struggling with driving traffic to the center, so they love doing parking-lot events,” she said. “You can see it from the road and it gets people on the property.”

Simon Property representatives didn’t respond to requests for comment.

The U.S. is currently home to about 1,100 shopping malls, according to Laurel Durkay, vice president and
associate portfolio manager of real estate securities at Cohen & Steers Inc. That number could be cut in half over the next decade, though it may not take that long to determine who the winners and losers are, she said.

“You’re going to see a resetting of the bar for demand,” Durkay said. “Ultimately, high-quality players will emerge stronger than before, but it’ll be a rocky road.”

Year-to-date store closings are already outpacing those of 2008, during the last U.S. recession, according to Credit Suisse Group AG analyst Christian Buss. About 2,880 have been announced so far this year, compared with 1,153 for the same period in 2016, he said in a report.

**Groceries, Doctors**

Some malls are doing fine even without renting out their outdoor space, especially higher quality properties with upscale stores. They have been drawing visitors with grocery stores, medical offices and high-end restaurants — all businesses that face less risk from e-commerce competition than traditional tenants. Some retail REITs are adding office space or apartments to their portfolios to diversify.

Sandeep Mathrani, chief executive officer of GGP, said at a conference this month that the perfect mall now would include one department store, a supermarket, an Apple store, a Tesla store and businesses that started out online, like Warby Parker, the purveyor of prescription eyeglasses and sunglasses. Clothing stores now represent about 50 percent of the average shopping center, down from about 70 percent, he said.

“Landlords are trying to give people reasons to come to the mall, whether it’s a Tesla charging station or getting local car clubs to host events in their parking lots,” said Alexander Goldfarb, an analyst at Sandler O’Neill & Partners LP. “It’s not a fun time to be either a retailer or landlord, but it doesn’t mean every single mall or shopping center is going to close. Far from it.”

And for some retailer landlords with better-performing properties, the industry’s turmoil could mean more opportunity.

**‘Enormous Opportunity’**

“This very painful process will surely take more than five years,” Steven Roth, Vornado Realty Trust’s chief executive officer, said in a letter to shareholders this month. “It will also create enormous opportunity for those with the capital and management platforms to feed on the carnage.”

Urban Edge Properties, a Vornado spinoff, is one landlord adding to its holdings. The company is under contract to buy seven retail properties, with 1.5 million square feet (140,000 square meters) of gross leasable space, mostly in the New York City area.

Until malls can figure out how to bring in steady crowds, expect to see corn dogs and carousels in their parking lots, Herkimer said.

“If retail turned around and vacancy rates dropped again, and all the sudden these malls and shopping centers are full of tenants, I think there’d be a circle in the other direction,” he said. “They’d say, ‘We need the parking space for customers.’”
Why Varde is Betting on the Rebirth of the Non-Prime Mortgage Market

Better credit ratings among non-prime mortgage borrowers, combined with increased rigor in loan underwriting, mean this part of the debt market is ripe for investing, according to Brian Schmidt, partner and head of Varde Mortgage Business. Schmidt spoke with Bloomberg’s Ainslie Chandler on April 25. Comments have been edited and condensed for clarity.

Q: Can you start by telling me about Varde’s real estate debt business?
A: Varde has been involved in real estate debt for over 20 years. We also refer to it as our mortgage business, and break it into commercial and residential mortgages. It started ramping up post-2008 and since then we have invested about $6 billion in real estate debt. We’ve invested across the spectrum in securities, whole loans, re-performing whole loans, also sometimes called scratch-and-dent whole loans, down to non-performing whole loans.

Q: Can you explain your scratch-and-dent strategy and how that came about? What does that fund invest in?
A: That’s commercial mortgages. What we saw is that post-crisis, a lot of banks started out selling non-performing loans. We realized that banks are not able to take the full capital loss in the sale of their non-performing loans. For example, if non-performing loans were selling at 50 cents on the dollar, they didn’t have the capital reserves to take the full 50 percent loss. At the same time, they needed to produce liquidity on their balance sheet. So they started turning their re-performing loans, their scratch-and-dent loans, where the borrower has some kind of credit blemish. They are trading at something less than par. Banks are able to digest the loss selling those loans, because they were selling at higher values than the non-performing loans. At the same time, we found them as very attractive risk-adjusted return because they were performing credit at a slight discount to where the non-performing credit was pricing, from a return perspective. We started investing in that more in 2013 and 2014. A lot of those deals are done through portfolios of loans, acquired through regional or national banks.

Q: Is there a particular market segment where you are seeing more scratch-and-dent loans?
A: Not by asset. It’s a very diverse asset portfolio and it’s also diverse geographically. There is a common theme, we call it “small-to-mid balance” loans, less than $50 million in size, is where we see the majority of that opportunity.

Q: Is the opportunity for this strategy growing or have the banks worked through their portfolios in the wake of the financial crisis?
A: There’s always a supply of scratch-and-dent loans, it’s just a matter of when the banks will sell those. We’re seeing a good amount of supply this year. If you look at overall commercial mortgage maturities, there’s about $1 trillion maturing between 2016 and 2018, with the peak in 2017. As we start to get to some of these maturities, that is also a timeframe when banks are trying to sell some of these scratch-and-dent loans that are coming up on maturity, because they might require some kind of modification or discounted pay off and they don’t want to deal with working with the borrower.

Q: Where are you seeing the most growth in your business? Performing loans or non-performing loans? Commercial or residential?
A: We are still seeing a lot of opportunity in this small-to-mid-balance new origination. What they are capturing is loans that are maturing this year. With more than $400 billion of loans maturing in 2017, in the commercial mortgage sector, a lot of these were originated 10 years ago, back in 2007, and they are not going to fit squarely into a bank balance sheet right now and the CMBS market.
has pulled back to a third of what it was in 2007, so they won’t refinance that way. What we have seen is private lenders entering the space and we’re one of those. That’s where we are seeing the biggest opportunity. Private lenders’ market share in the commercial mortgage space has doubled in the past three to four years.

**Q: Does a rising interest rate environment change the way you do business?**

**A:** The majority of the product we are looking at is floating rate mortgages. So I think the sector is well protected with that. The balance we are always looking at is that in rising interest rates, the corresponding rise in borrowers’ net income. As long as those are lining up, property prices should hold in. We’re also investing in the debt side right now because we do think it’s better protected than the equity side here in the U.S.

**Q: On the residential side, what sort of loans are you investing in?**

**A:** What we think is most interesting right now is the rebirth of the non-prime mortgage market. We’re looking at what used to be called sub-prime but if you look at post-crisis sub-prime. But if you look at post-crisis sub-prime, average FICO scores for that kind of borrower has increased significantly. So the market broadly defines that as “non-prime” now because it’s below prime but given the higher FICO scores, it may not be considered sub-prime, like you would see in credit card or auto debt.

**Q: And you are comfortable with the level of risk in that market? Is there much competition for those assets?**

**A:** The banks have definitely backed away from that space. If you go back to 2006-07 timeframe, annual originations were broadly north of $500 billion per year. Post crisis, they dropped to about $3 billion per year. 2016 was the first year we saw non-prime or sub-prime securitizations getting done in the marketplace and we saw the most growth that we have seen since the crisis. We saw that as a pivotal year and thus far in 2017, we have seen the first quarter up significantly in originations in that market.

  The reason that we like it is when you look at return premiums, these loans are about 500 basis points above the 10-year treasury right now. If you go back to when the market was producing about $500 billion of this per year, returns were about 100 basis points over the 10-year treasury. We see this larger return premium for the product. And when you start to combine that with what credit looks like now, we’re seeing much tighter credit underwriting standards in this space than we have ever seen. If you look at loan-to-value metrics, what kind of debt is that borrower taking on, it’s about 70–75 percent average loan-to-value on this non-prime product. Pre-crisis, it was north of 80 percent. And the second lien market was prevalent then.

  Now we have virtually no second lien market for these non-prime borrowers. More full documentation underwriting, versus stated income underwriting pre-crisis. Then we are also seeing more rigor around the underwriting process. A loan today will often go through three full underwrites, once at the originator, once at the aggregator and once by an independent third party to get a bank to provide any warehouse financing on that portfolio. Pre-crisis, we didn’t see any of that rigor. Now appears to be a great time, over a long history in this sector, to be investing.