Privcap RE/ Presents

A Conversation With
Michael Nash
Blackstone Real Estate Debt Strategies

With insights from:

Kirkland & Ellis LLP
Featured Charity:
Melanoma Research Foundation

About Privcap Media

Privcap is a digital media company that produces events and digital thought-leadership content for the global private capital and private real estate markets. Privcap Media offers communications services to market participants.

Privcap is known for its authoritative online video programs and digital reports. Since its launch in September 2011, Privcap has produced dozens of focused reports and at least 800 video programs—mostly in-depth interviews and panel discussions with private investment experts. In the private equity and private real estate markets, Privcap's audience has grown to about 8,000 unique visitors each month—a mix of institutional limited partners, general partners, high-net-worth investors, and service providers. Each week, Privcap and its sister site PrivcapRE release and promote new content.

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If you are a GP or LP and would like to request an invitation or a future Privcap Presents gathering, please email events@privcap.com

If you are a service provider interested in being a sponsor of a future event and report, please contact Gill Torren at gtorren@privcap.com

About PrivcapRE Presents

PrivcapRE Presents is a series of invitation-only networking events designed to bring together GPs, LPs, and other guests. The events are organized by Privcap Media and hosted in partnership with leading professional service providers.

Each PrivcapRE Presents event begins with an intimate onstage interview with a notable leader from the private real estate industry. A transcript of that interview is used as the basis for a digital report (like the one you're reading now) that is made available to Privcap's global audience. Also included in PrivcapRE Presents reports are perspectives from the event partners, including a nonprofit selected by the featured interviewee.

Improving the View From the Mezzanine

At the debut PrivcapRE Presents event on February 24, 2015, PrivcapRE editor Zoe Hughes interviewed Michael Nash, CIO of Blackstone Real Estate Debt Strategies, on key markets, cap rates, and LP returns

Michael Nash, Blackstone

PrivcapRE: Michael, you're on every committee at Blackstone that matters in the real estate space, and you run the debt business. Can you give us an overview of the Blackstone debt portfolio as it stands today?

Michael Nash, Blackstone: I'll step a little further back to contextualize the business. It's been around since 2008. We have three distinct platforms. We have a billion-dollar hedge fund business that trades CMBS securities. We have a mezzanine fund that we raise with institutional LP capital. It's a roughly $4B fund, and we're actively deploying that and have since April of 2013. And we have a public company that we manage, BXMT. Our portfolio today is a series of value-add, floating-rate loans, both in the United States and Europe. Our specialty is to provide capital to situations that are not stable, that are transitioning high-quality real estate. The business plan of the owner, typically, is to buy, fix, and sell it. They're not long-term owners necessarily. They want a floating-rate capital solution, so if they improve the property and reposition it, they have the option to refinance at a cheaper cost of capital and own it a little bit longer or sell the property.

How is the private fund BREDS II (Blackstone Real Estate Debt Strategies II) invested today, and what sort of returns are you seeing? And how much dry powder does BREDS II have available?

We don't publicize dry powder fund by fund. I would say we're substantially invested. We've committed or closed about 35 discrete transactions out of that fund. Our average deal size is typically on the higher end of things. It's a mezzanine fund, so sometimes we will do the entire whole loan transaction and then go to the syndication or A-note market, as we call it, and sell a piece of senior risk to that market and create mezzanine return for the fund and our investors. We've done that in about the last 20 or 25 deals we've done out of BREDS II. We get a better outcome—the difference between owning that mezz at 8 percent, 9 percent, or 10 percent versus the 11 percent, 12 percent, or 13 percent that we've created by doing that.

We're seeing a lot of equity capital entering the market. As a mezz lender with a view across markets and property types, are you concerned about the ramifications of putting all that equity to work?

We're not concerned yet. I would say the following: It's not as easy providing debt capital or buying real estate... today versus two, three, four years ago, especially in the United States. It's easier in Europe. Having said that, values still have a relationship to replacement cost. The people we lend to are actually able to borrow more, and many times we're willing to lend more, and they don't want to take the additional leverage. The lessons of '07, '08, and '09 are still fresh in everyone's mind, so I'm very optimistic that that discipline will stay in the marketplace.

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Attendees networking at the debut PrivcapRE Presents event, featuring Blackstone's Michael Nash

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>
> –Michael Nash, Blackstone

Speaking of replacement cost, what's the supply situation around the country, and how do you tackle development opportunities?

Construction has never been something that the firm has been interested in, because why buy real estate at replacement cost if you can buy it at a discount to replacement cost? But we've done things in pre-sold condos down in Miami, and it's a completely different paradigm. So the lender today in that market—post-crisis, where banks are highly reluctant to go back in—you get equity from your owner. You get deposits on the pre-sales from the end buyers. Those deposits can actually be used to construct the building. And then our debt capital is the final piece in that puzzle. What winds up happening is, you have a loan-to-cost straddling about 50 percent. You have an enormous equity cushion, and you have effectively pre-sold real estate.

What are you seeing in other markets in the U.S.?

We're still believers in big-city office. We think demand will be vibrant in places like New York and Boston, L.A. and San Francisco. So it's all a matter of price, if you're buying. And from a lending side, again, we've got a 25 percent to 30 percent cushion to start our analysis. And we can get more comfortable in this environment. San Francisco has a lot of activity, both in the city and outside the city; [it's an] incredible market. It's going to be less volatile in this cycle than it was in the early 2000s, although it's a volatile economy in general. We look at all these markets for what they are. We're looking

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Zoe Hughes interviews Blackstone's Michael Nash during the debut PrivcapRE Presents event

at Houston for contrarian ideas to lend into, because oil is impacting demand in those markets, so we'll have to underwrite that a little bit differently.

The BREDS II fund is invested about 80 percent in the U.S., but investors gave you the flexibility to invest more in Europe after you closed the fund. Can you walk us through the kind of opportunities and returns you are finding in there?

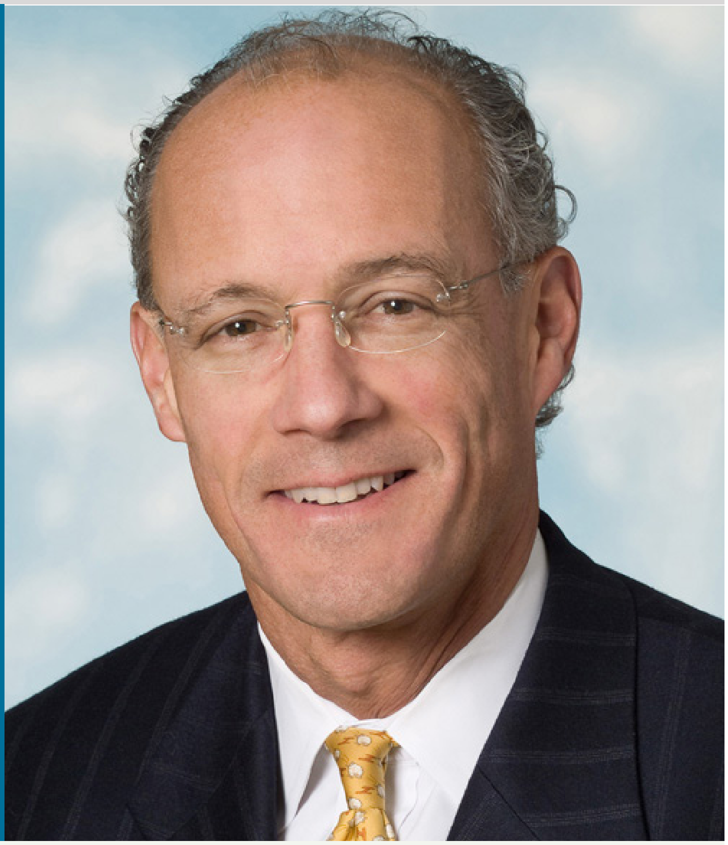
A lot of activity in Europe is more distressed, more non-performing loans or cyclical loans. You could call them subperforming. But they're in a category that doesn't really fit the mandate of our business. We're a pure lender. We're in it for the return, not to take possession of the real estate by virtue of the loan itself. A lot of the activity in places like Spain and Portugal is motivated by banks selling big pools of loans. So we've settled on a loan origination business, doing deals in those markets similar to what we do in the United States. We've done a few things in Spain—again, to U.S.-style borrowers, but the debt yields that we lend at in Europe, just to compare and contrast, are at 10 percent, 11 percent, or 12 percent. In the United States, it's 7 percent or lower. So I'm not here to say it's safer, but I would say it's more cash flowing. We don't make excessive returns in Europe. We just have a high debt yield, lower leverage, and the same return we'd see in the U.S.

There's sometimes a disconnect between interest rate increases and cap rates. Are we taking a bet on central bank policy rather than market fundamentals?

I would phrase it differently. I'd say people have gotten really complacent that rates are low and will stay low for a long time. And they've adjusted their perspective on cap rates as sort of a perpetual thing. You did ask what level of increase would concern us. I mean, the 10-year going to 4 percent, that's not going to do anything. This real estate industry has operated when the 10-year is 4 percent, 5 percent, or 6 percent. The big debate is about whether the market is prepared for whatever happens. Does it happen gradually? Are people really, really surprised? What concerns investors is when they don't have any predictive ability as to what the landscape will be. If the 10-year went to 4 percent, it's going to be more good news than bad news, and the real estate industry will generally be totally fine. ■

Expert Q&A

With Stephen Tomlinson
Partner
Kirkland & Ellis LLP



How has the globalization of commercial real estate capital flows impacted transactions?

There has been substantial activity by non-U.S. investors in 24/7 cities such as New York, London, and San Francisco, and it has created a positive momentum on valuations. U.S.-based investors who are trying to generate a greater-than-core return are finding it very difficult to compete [with such investors] for existing stock. [Although it's an] attractive time to sell into those markets…it's difficult to deploy high-returning capital in 24/7 cities. Not impossible, just difficult.

Are increased foreign capital flows in U.S. real estate here to stay?

Yes and no. If we have settled into a new paradigm of oil-market pricing, non-U.S. investors who are heavily driven by oil revenue may have less-rapid inflows to their organizations…and one might expect their investment pace to slow. At the same time, you are seeing significant [new] flows of capital coming out of Asia, particularly China. These are substantial sources of capital, [so overall] few expect a diminution in foreign capital volume, and we could see an increase. It could just be coming from different places.

How is foreign investor appetite different?

We are seeing increased appetite for direct investments by larger non-U.S. investors. There is less appetite for making large investments into funds and more appetite for bespoke transactions where investors have a greater degree of control. One area we are seeing significant emphasis on for large non-U.S. investors is co-investment, which can oftentimes be much larger than the commitment to the main fund.

What does the growth in co-investment rights mean for GPs?

What's difficult for the sponsor is knowing whether the investor is able to execute. Investors ask for many kinds of rights, but will they, and can they, use them in a way that's commercially practicable, especially in terms of dealmaking? Investors need a GP that has the time to dedicate to sourcing and executing co-investment deals and a team dedicated to managing that co-investment piece. At the same time, you have to have an LP nimble enough to be able to act on deals in a relatively short time frame. Deals don't tend to hang around. ■

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KIRKLAND & ELLIS

MELANOMA RESEARCH FOUNDATION

We at Privcap Media use the Presents series to help call attention to causes that are close to the hearts of our speakers. Michael, the cause that's really close to your heart is the Melanoma Research Foundation. Why is that so personal for you?

Michael Nash: Ten years ago, I was personally diagnosed. I'll show you the top of my head. It used to be covered with hair and a higher volume of skin. My brother, who's older, had Stage II-III melanoma four years prior. They never really pinned it down, and we had someone on my dad's side pass away from the disease. So in our case, it's genetic.

What does your work with the Melanoma Research Foundation entail?

Nash: Ever since I was afflicted with [melanoma], I've spent a lot of time on the cause. I actually reach out to people—maybe some in the audience—to raise money for it. It's a worthwhile cause. It's a pretty significant cancer. It affects a lot of people, and unfortunately it does kill quite a few, if you don't treat it.

One statistic that we found quite shocking when doing research for this is that in 2015, melanoma will affect 74,000 people in the U.S., and it will kill 10,000 people.

Nash: I'm one of the lucky ones. My treatment was very simple. It was just a surgical removal. I water my head every morning, and the hair does not grow. But it's one of those cancers, if it gets in your lymph system, it's really, really tragic and lethal. And absent that, it's completely treatable. Doctors can visualize the cancers and use all the latest techniques.

What are you actually hoping to do for the Foundation this year and looking forward?

Nash: We have a big fundraiser in the city in October of every year, among their many fundraising initiatives. It's all about research and new treatments. Again, my case was fairly simple. It was just surgery, but for those who have infiltration of the lymph system, there's a drug cocktail that they continue to work on and evolve, because some of those cases are actually quite dire. So it's all about research, and it's competing with other cancer organizations for funding. And so we do whatever we can. ■