KEYNOTE INTERVIEW

The evolving face of CRE credit investing

The commercial real estate credit market has begun to embrace data and look to quantitative methodologies, yet the industry as a whole still has a long way to go, says Dr Tingting Zhang, founder and CEO of TerraCotta Group

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Q You founded TerraCotta Group in 2004. What did you set out to achieve and how is it going today?

TerraCotta was founded 17 years ago, and at the time I wanted to bring a quantitative and scientific perspective to CRE credit underwriting. Back then, investment decisions in this space relied on a great deal of human intuition. The investment approach of relying on 'comps' fundamentally lacks the analytical rigour to adequately explain and predict change.

Over the last nearly two decades, TerraCotta has created a comprehensive and coherent set of quantitative methodologies that have expanded and improved with the exponential growth of data in real estate, in both magnitude and variety. We continue to build an enormous data warehouse with trillions of data points, and a sophisticated data ontology that allows us to leverage this data.

Today, we are able to conduct predictive analytics to assess, forecast and stress test property value and cashflow throughout the various market cycles at a fraction of the traditional underwriting time, but with more breadth and depth. Thanks to the large volume of data we collect and our proprietary quantitative methodology, the firm has built a strong performance track record – with no single credit loss since our inception.

The market has been very interesting in the last year during the covid-19 pandemic, and into the recovery period in 2021. Usually in transitioning market cycles, the market becomes more exciting for us, and right now we see dual-track opportunities.

On the one hand, we've started to see distressed opportunities bubbling up and are looking into how we might take advantage of them. On the other hand, we continue to earn a pricing premium by providing certain credit products not otherwise available because of the capital markets' bias against certain asset classes.

Retail loans are a good example. Our credit investment in retail property-secured loans is premised upon our investment thesis that e-commerce is not likely to bring about the demise of retail properties – it simply separates the winners from the losers. Physical retail properties that survive will either be those that continue to serve the daily needs of the local communities in ways that e-commerce cannot, or those that adapt to serve the needs of the New Economy.

For example, larger online sellers such as Amazon and Sephora are aggressively expanding their physical locations to create an omni-channel distribution. These tenants will be increasingly focused on the location of their properties and their access to the local communities. Based on these trends, we continue to hold strong convictions in grocery-anchored neighbourhood centres with a location score (a proprietary TerraCotta scoring methodology) in the top quartile of the submarket. This investment thesis was proven out during the global financial crisis and has held true throughout the pandemic.

TerraCotta's large quantitative toolbox enables us to pick winners that will thrive despite expanding e-commerce, as physical retail locations continue to be an indispensable distribution channel in the ecosystem of the New Economy.

Q How have attitudes towards data-driven methodologies in the private credit investment space changed in recent years?

There has been a sea change in the overall market perception towards the application of data and quantitative methodologies in private markets investing. In the last five years, we have seen many new data collection firms and property technology firms forming to help companies take advantage of the recent proliferation of data.

But while there has been progress on data collection and operational technology, to my knowledge, TerraCotta remains a lone pioneer in the research and substantive application of quantitative methodologies in real-world CRE

"There has been growing utilisation of CRE CLOs as a financing tool among real estate private credit funds"

Q When it comes to diversity and inclusion in private credit, where do you see the challenges and opportunities as a manager looking to exert influence over your portfolio?

TerraCotta is at the intersection of CRE and private credit, and neither industry has diversity as a hallmark. I think I have come across perhaps one real estate firm owned by a woman in my career, and only a handful of firms owned by ethnic minorities. It is certainly a complex challenge.

Within TerraCotta, we try to level the playing field by building a merit-based culture, and as a result many women have become senior decision-makers on the investment team. We feel that the very fact that we are a diverse firm and that we have consistently outperformed the industry, in itself sends a message.

Of course, private credit firms are very different from private equity firms in their influence and leverage over their portfolio companies. Among institutional investors, there is a push towards diversity at both the firm level and at the portfolio level. In the investment management field, investors' focus is still primarily on the bottom line, and rightfully so. As a firm that is uniquely diverse, we certainly want our LP allocations to come on merit. I do not think we will help the trend towards diversity if it does not come alongside exceptional investment performance.

credit investment. Given the complexity of their application in private markets investment, there remains a lot of common misconceptions. For example, I am often asked questions such as, "what if the data is incorrect because it is privately sourced?" I have also been told algorithms do not work in the real world, and that a data-driven approach is a black box that cannot be trusted.

Yet in the past two decades, TerraCotta's quantitative methodology has been battle tested through a severe recession and a global pandemic. TerraCotta's property valuations have proven to be far closer to final sale prices in a severe recession when compared to third-party appraisals. We are continuously refining and improving our methodology by 'empirical testing' through real transactions.

Our view has also evolved in the last 17 years. We have always viewed data as a powerful tool to assist in decision making – but today, it has become entirely indispensable to the fabric of who we are as a firm. We use data and quantitative methods in every aspect of our investment and operations, and it has been the primary driver of our success.

Q We have seen something of a resurgence of the collateralised loan obligation lately, blurring the lines between public and private credit. How is that impacting private credit as an asset class?

The CRE CLO v2 really came back around 2017 at scale. Since then, there has been growing utilisation of CRE CLOs as a financing tool among real estate private credit funds. As a result, we saw private credit transactions become more susceptible to capital market sentiment swings.

That is a pretty meaningful trend, because traditionally, private credit has been a private markets strategy.

"Diversity simply cannot be achieved without a culture that emphasises merit, tolerance and change"

It has been all about generating alpha by spotting and exploiting market inefficiencies rather than conforming to market consensus. The resurgence of CRE CLOs has ushered in a generic loan production business model among some private credit firms that compete on thin margins for assets that are widely sought after by public market investors.

This trend is bound to challenge the conventional thinking of many investment firms in CRE credit. Firms will have to decide where they belong.

TerraCotta's private equity-style investment strategy has always centred on mid-market inefficiencies, an aptitude for separating real risks from perceived risks, and our relentless focus on delivering a differentiated and tailored borrower experience. All of these traits enable us to separate ourselves from the pack in a very meaningful way – particularly during major black swan events, such as the GFC and the current pandemic.

We do not see ourselves departing from this differentiated approach; however, we do recognise the cost efficiencies that CRE CLOs bring to borrowers and investors alike, and we have been thinking deeply over the past few years around where they might fit in our portfolio and how to manage the capital market risks. CRE CLOs would never comprise our entire loan portfolio, but if they help part of the portfolio grow with stability, we would be open to it.

Q What steps can firms like TerraCotta take to help the private credit industry welcome a more diverse range of professionals into leadership and senior roles?

If you look at TerraCotta's investment team, it is almost 50 percent women, which is quite different from a typical investment team in direct lending. Thanks in part to our senior-level diversity, we attract a diverse range of job applicants. A certain culture attracts certain talents. Hopefully we can provide more opportunities to diversify the profession based on merit.

In the private credit real estate world there are certain invisible barriers. By building a merit-based culture, where women have a voice and feel their opinions are valued, we aim to address some of those barriers. I would like to think we encourage everyone to speak up regardless of their background and seniority, and both men and women in our firm embrace that, which creates a virtuous circle.

A lot of firms genuinely want diversity, but, for whatever reason, people with diverse backgrounds still do not feel they fit in and do not feel they can speak up and contribute. I cannot think of a more costly mistake than an investment firm missing out on the value of intellectual diversity. Diversity simply cannot be achieved without a culture that emphasises merit, tolerance and change. ■