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NEWS & ANALYSIS

TerraCotta's Zhang sizes up deal flow adjustments amid uncertain backdrop

Inflation, potential recession factor into new lending opportunities across LA manager's portfolio.

TerraCotta Group is taking a new look at how its deals are structured to accommodate unfolding economic pressures and continued interest rate hikes.

The El Segundo, California-based commercial real estate credit business has been on watch for inflationary trends since last year, a time when the Federal Reserve viewed the US economic situation as being manageable. It is now retailoring its approach to new credit opportunities across geographies and asset classes following sustained rate hikes, including a 75-basis-point increase in mid-June this year and another that is expected next week.

Tingting Zhang, CEO and founder at TerraCotta, said the firm is seeing more bridge lending activity as a means of stabilizing properties facing lease rollovers and because permanent lenders have shown more concerns around the leasability of certain larger spaces.

Navigating inflation

The current backdrop and natural deal flow is not converse to TerraCotta's thinking at present. Zhang said the firm is able to have a greater sense of predictability with its current levels of in-place cashflow. In tandem, TerraCotta can also take a better measure of debt servicing, broader market forces and how vacant space may be leased up.

Zhang said the strategy and overarching measures dampen risk slightly and happenings in the economy track with TerraCotta's thesis when trying to reposition a given property in the current environment.

At the same time, TerraCotta has seen value-add activities slow down a little bit in the first half of 2022 after the pandemic stalled permitting processes and adversely affected construction costs.

Multifamily lending has been an interesting realm for TerraCotta amid the current period of sustained market volatility. With regional factors already influencing where is best to lend, Zhang said the firm has the added layer of inflation to account for.

"In the inflationary environment, the real estate price usually increases with the initial phase of inflation as the real asset – there is a finite number of them. When there's inflation, the rents go up." Zhang says. "Multifamily is the asset class with the shortest lease term, so in theory, it's supposed to catch up with inflation more efficiently compared to the office asset class, which typically has much longer lease terms."

In the current potentially recessionary cycle, Zhang said the affordability factor is kicking in because tenants are only able to pay so much. When rent plateaus in such a scenario and rates go continually higher, cap rates are expanded in the denominator.

"Real estate value historically takes on a concave shape in response to inflation, this is a historical classic curve," Zhang said. "Multifamily is interesting because rental affordability has taken on a great deal of variation across different markets. In some markets, the room for growth is still there."

She cited Phoenix and Las Vegas as two locales already ahead of the market curve because of the number of tenants attracted and significant rent growth during the pandemic. "When rents are not increasing, the cap rate will expand as a result in an inflationary environment," Zhang said. "We actually see that in some of the Sunbelt markets. Although there's still great demand for multifamily, significant growth in rents has undermined the affordability factor in the inflationary environment. This may not be a good thing."

Zhang said TerraCotta sees the most pronounced multifamily opportunities within the affordable subsector, especially with Class B and Class C multifamily housing assets, because of demand driven by broader economic habits.

Stress-testing

Across all asset classes, TerraCotta is using data from past market cycles to make sure all its loan amounts are covered under any recessionary scenarios. "Our loan size will be no greater than the underlying collateral value in a third-standard deviation recession, so that underwriting parameter hasn't changed, but certainly the impact of the underwriting parameter in an inflationary environment is magnified," Zhang said. "Some markets become very challenging; we see potential fall of 55 percent in asset value, including multifamily assets in some Sunbelt markets."

Zhang said the firm understands a 55 percent LTV will not be competitive and is bowing out of such marketplaces in some ways for the time being. TerraCotta also has to consider cash flow and debt service as a lender in the current environment, wherein debt funds mostly use variable rates. "On one hand, your opportunity cost is minimized and controlled," she said. "On the other hand, how is your borrower going to pay the rising costs of the debt if and when the revenue of the underlying collateral does not rise in proportion?"

To compensate for the fluctuation, Zhang said TerraCotta looks to service the debt by re-margining for the interest reserve requirement on a quarterly basis and checks to ensure the combination of the cash flow from the property and what is in the interest reserve is sufficient to hit 1.25. In scenarios where numbers do not measure up, she said the firm can look at injecting more cash to service the financing.

"That conversation really started nine months ago, and we're certainly speaking with borrowers about inflation, about what kind of leases they're signing, about appropriate annual lease escalation, are they priced around 3 percent straight or are they going to use the consumer price index?" Zhang said.

As inflation rises higher, TerraCotta's topic points evolve to include the trade-off for rehab insurance or allowing the firm to put EDCRE in place where it is more efficient in addressing problems when they arise versus, as an example, paying half a million dollars for rate insurance when it may or may not be used. Zhang said in certain scenarios, rate insurance could be a better option for properties with more vacancies and rolling leases depending on the underlying credit.

TerraCotta is also drilling down on what the optimal capital stack looks like for borrowers because with inflation, the equation is different from securing equity. "Lenders are not meant to be your equity partners," she said. With cash flow volatility, Zhang said debt must be greater than it would be in a normal environment, and while sponsors are conscious of the risk element, they may not be as systemized in thinking through issues such as risk-equity ratio, special credit cases or changes in competitiveness.

On the map

Location is taking the front seat when it comes to new deal sourcing especially.

"We're not saying for sure there's a recession, but we're managing as if we're getting into a recession," Zhang said. "In these scenarios, there's always a flight to quality. Good locations don't just perform a little bit better, they perform far better."

TerraCotta's asset class priorities include grocery-anchored retail, select multifamily opportunities and life science as well as industrial, the lattermost of which still has room for rent growth in certain sectors, according to Zhang. Market forces brought about by the pandemic and related headwinds have curtailed TerraCotta's presence in the office sector notably, including Portland, which Zhang noted lost substantial momentum because of covid-19 and volatile economic conditions.

Zhang said TerraCotta's financing opportunities are also picking up steam as the CRE CLO markets encounter headwinds after accumulating so much prominence among debt funds in recent quarters. In the mid-market where TerraCotta lives, Zhang said she believes pricing will expand because of the disappearance or an end of dominance for the CRE CLO market atop the interest rate expansion.

"By the same token, I think a lot of repo lines are getting more expensive as well, because of the double expansion – of the margin of the interest rate, as well as of the risk margin widening," Zhang said.