REAL ESTATE COMPETITION: OPPORTUNITIES AND CHALLENGES FOR MANAGERS

- Craig A. Spencer, **Arden Group**

Since converting to a fund manager, what has been Arden Group's overall strategy?
We focus on transactions that are exclusively in the US.

As a value-add investor on the equity platform, we use a "cycle-tested" strategy of buying assets that have some level of "stress" in the equation but only in those markets with strong positive demand factors; and we firmly believe that market selection is as important as asset selection. Once we have arrived at a suitable market, we filter the opportunities, until we find an asset where we can execute a value-add business plan. Our business strategy on every asset is a systematic program of: (i) buying at the right basis (ii) correcting operating and physical deficiencies thereby improving the asset to a level where it is competitive; and (iii) selling a stabilized asset at the appropriate equity multiple and IRR. Our typical hold is less than five years and we look to generate 60% or more of our overall returns from current cash flow.

In our debt program, we provide first mortgages, mezzanine debt and preferred equity investments which can yield 9-11% net returns to our investors. As in all decisions, capital preservation and a fiduciary mindset are top priorities. We are not a loan-to-own platform. We are looking to make great investments with strong sponsors, in good markets, with well-structured credit terms. We use our experience as an owner-operator to validate our borrowers' business plans and source the best opportunities.

Do you see further opportunities in the hospitality and office sector in the US despite the significant run up in values over the past cycle?
Yes, we do. Real estate is a local/regional business and as such there are markets that are overheated with too much new supply and conversely there are markets that have limited new supply despite strong demand fundamentals. We continue to see opportunities to deliver strong risk-adjusted returns to our investors. We diligently review investment opportunities and markets to find the properties that meet our investment thesis.

We have seen a number of alternative lenders spring up over the past 2-3 years, and Arden Group has recently joined the fray with the launch of Arden Credit Fund, L.P. What is your rationale and desire to act as a lender?
We have always felt that a lending platform would be complementary to our existing platform. We had our initial closing on our credit platform in Q1 2017 and we have seen significant investor demand and a strong pipeline of opportunities. There are numerous forces at work, which have led to the rise of alternative lending platforms, which we see to be lasting structural changes and not temporary shifts in the lending market. The regulatory environment has changed significantly since the GFC and it has dramatically influenced the composition and trajectory of various capital providers. Certainly, we have kept a close eye on the shrinking CMBS market and commercial banks' pullback on lending. As a value-add investor and transitional asset lender, we know we are in demand from borrowers that need to access efficient capital that they cannot find from traditional sources.

What are the challenges for alternative lenders in 2017 and beyond?
For larger debt transactions (>$75mn), there is significant competition for every quality deal. This has resulted in price compression on rates. One of the primary challenges for lenders is to balance the risk appetite with the projected return on the investment. On the smaller deals, under $10mn, the lender must always evaluate whether the sponsor has the capability and wherewithal to execute the business strategy. So, smaller deals have a unique risk, which can be difficult to underwrite. We believe the mid-sized deals (mezzanine loans of $5-25mm) provide the best risk-adjusted returns.

What is your expectation for valuation correction in the US?
We have lived through four major cycles and from experience know it is difficult at best to accurately predict either cap rate expansion or compression, and interest rate movements. It is even more difficult to predict black swan events that affect the broader capital markets. So we focus on what we can control. We try to insulate ourselves from valuation corrections by buying prudently.

ARDEN GROUP
Arden Group features in our most consistent top performing real estate fund managers table (see page 74).

Arden Group is a full-service real estate company with operating verticals in the office, hotel and high-rise residential sectors. Arden Group was established in 1989 with a focus on value-add commercial real estate opportunities Arden Group has purchased and or developed in excess of $3bn of real estate and its asset management division has managed $5bn of assets. The firm established Arden Fund Management in 2012 and now invests exclusively through its equity and debt funds, Arden Real Estate Partners I, Arden Real Estate Partners II and Arden Credit Fund.

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