



Q&A: Unlocking Opportunities in an Evolving Commercial Real Estate Market

In this Q&A, Adam Beeler, Head of Institutional Sales, and Sumit Sasidharan, Head of Commercial Real Estate, explain how Angel Oak is leveraging its diverse platform to engage across the entire real estate capital stack, from liquid assets and lending to opportunistic property purchases, adapting to various market cycles. In this wide-ranging discussion, they provide an overview of the current state of commercial real estate (CRE) and how Angel Oak is identifying distinct pockets of opportunity.

Q: What drew you to Angel Oak?

A: I was looking for a platform to do relative value across the real estate spectrum rather than pick one track and stick to it, like lending or opportunity or just securities. I was drawn to the breadth of the Angel Oak platform and its ability to service different parts of the CRE sector—the capital stack—from top to bottom in the different pockets of capital it manages: liquids and semiliquids in mutual funds and ETFs, lending in the private side, and the opportunistic purchase of real estate assets. I appreciate Angel Oak’s ability to be a relative value player in all parts of the capital stack in real estate and therefore be relevant through all parts of the cycle.

Q: What are your views on the current state of CRE, and more specifically, where you are focused?

A: CRE has become the focus in the financial industry today because the math is so overwhelmingly powerful and simple. If you look at where interest rates were and where they are today and the relative risk premium you had to suffer to buy real estate, I do not think it translates well in this interest rate regime. What I believe brings value to the Angel Oak platform is having different pockets of capital find value within that period of contention and dislocation, when asset values are going to reset. The impact is going to be felt in liquid securities first and in private capital after—and having that divide and being able to cover it gives us the ability to source opportunities on both sides. As the market comes to grips with this value reset, there will eventually be a capitulation or an understanding that the values of yesterday are not the values of tomorrow. It will be a painful transition, and it may take time, and there will be unequal outcomes, but I think the ability to play in different parts of the capital stack will be very helpful to Angel Oak in sourcing opportunities.

Q: What areas of the CRE market still give you pause? Conversely, where do you find the most opportunity?

A: That is a great question because it makes you sit back and go through the investment philosophy. What we are trying to build as an asset manager is not someone who takes a pause but instead finds the right pocket of capital to take advantage of the opportunity at hand; we want to be opportunistic, not fearful. I think what is happening in office property is hard to rationalize as an investment because the value is not readily apparent. You are contending with demand, and some of that is a fundamental shift in the way we have approached work as a culture, around the globe and in the U.S.

We don’t know what the outcome will be, but it looks different from the prior regime, and that value reset is expressing itself in the market with the steepest discounts.

The way office leases and the profit is structured in them, the discounts have to be steep enough to make that value apparent, and I don’t think the value is readily apparent; rather, it’s just an extremely cheap price point. Now those could be great combinations for the right pocket of capital to take that risk, but because the value reset is macro, I think there are easier opportunities to digest in the realm of multifamily, which is fundamentally still solid. As a lender and investor in housing, we see it as an extension of what we already do at Angel Oak, and the conviction there flows through into multifamily—that while asset values will reset, the core fundamentals of cash flow generation in multifamily assets will continue.

Q: Tell us a bit more about the multifamily reset. What are your thoughts on the opportunity side, geographically?

A: In terms of localities, we like the Southeast, from Texas to Florida. We are headquartered in Atlanta and have deep roots here, with access to partners and assets across this region. In multifamily, we have conviction that the asset value reset will coincide with cash flow generation, which will only happen because people rent assets. We want to be where people want to live, because we provide housing, and the Southeast is where many people are moving, whether it be for politics, taxes, lifestyle, etc. Other regions that look very interesting to us are New York and San Francisco, as they’re both great attractors of talent. We want to be expansive in our approach so that we do not put all our eggs in one basket. Opportunities will be varied, and we will be better able to source good risk if we’re more expansive in our views and geography.

Q: Can you walk us through a specific example of something we are underwriting that you find extremely attractive?

A: Absolutely. I think it is such a terrific value proposition because the math is very easy to explain. In 2021, you may have bought a multifamily asset at a 3.75% capitalization (cap) rate because rates were near zero and you were getting a massive premium over the neutral rate to invest in real estate. If you could buy an asset for 3.75%, you could borrow at levels that were very accretive, where loan coupons were below 2% at their bottom. So, you made a positive return on cash, and the expectation was that you would sell it to someone at either a tighter cap rate or with more cash flow, and thus harvest principal growth as well.

In a very short amount of time, the Federal Reserve has proven that real estate is not really a spread product, which is why Angel Oak addresses liquid securities that can be spread products. Real estate at its heart is a very long-duration bond that seeks to provide income and appreciation over a sufficiently long period of time. When there are whole periods of two to three years where there are inflection points, this rate increase lays bare the lack of value.

To recap, let us say you bought an asset at 3.75% and borrowed at 2%, and the neutral rate on the short end of the curve went to 5% or 5.25%. Immediately you are feeding the leverage, not feeding the asset, and you are certainly not reaping equity returns. In a new environment (obviously rates are not going to stay at 5.25% forever, but they can't be zero in a healthy economy), if you forecast that the Fed cuts rates and gets to a neutral rate somewhere around 3% to 3.5%, it's still a 100% to 200% increase in the interest rates that they can bear. Now if you extrapolate that to the cap rate, which was 3.75% when rates were zero, it is anyone's guess as to what you can rationalize when interest rates are 5% to 7%. Put very simply, if you were to value assets today like you valued them when you purchased them in 2021, it would imply that your existing equity is now zero on a fresh mark to market. That seems like a very punitive stance to take, but that is what the math would tell you, and that is why people are focusing on commercial real estate, because the math just seems too obvious now. Obviously, all real estate is local and reacts differently to buyer demand and the value someone sees on a forward outlook, but the context is still one of great value destruction for all legacy purchases.

Q: As the term for the original loan comes up, the lender must make a difficult decision: extend the loan at the new rate, sell the loan to a firm like Angel Oak, or ask the borrower to bring in equity to bridge the gap, which could cause them to walk away. As financial institutions, these community and regional banks are not in the business of owning real estate. There are going to be some uncomfortable conversations with the sponsors of these projects, some of which are done, some owned on balance sheet, others almost done in a lease-up phase. What do you think the community and regional banks are going to do, and how are those conversations with sponsors going to play out?

A: We're The market is contending with that difference between bid-ask, where the reality of the math flows into a loan on a community or regional bank's balance sheet that looks like it is a 100% or 120% LTV. In a very transparent fashion, the impact on them is one of risk capital and regulators reviewing their portfolio. There are a lot of potential pressures in terms of liquidity and how they operate and the things they can do. Obviously, a large underwater book of real estate loans means that the ability to finance new loans is nil to limited. That puts pressure on the market in general in terms of how much liquidity there is for middle-market real estate, because community and regional banks are systemically more important than large banks to that middle-market real estate space. The granular part of real estate is going to go through this value destruction and coming to terms with a new value regime and multiple components of the capital stack—that is, the lender, borrower, and operators all need to figure out where that value is. Borrowers may support assets, but they cannot support them indefinitely if it's just a negative.

Q: Are you seeing community and regional banks begin to sell these loans at discounts?

A: I think they are coming to a place where they are realizing that is the answer. Part of acceptance in the process that any large organization will run is making sure the price they're going to get is something that they can live with and something they can communicate to their investors and their regulators—there's a little bit of managing the story as well as managing the outcome. As they build conviction and put out small loan portfolios for sale and see that those prices may not match their expectations and decide they need to buoy those prices by providing leverage, that is going to make it complicated. Doing that does not really take risk off your book, because you have to provide an unnatural amount of leverage on legacy loans to make them appear profitable for the new regime. The further we go with the higher-rate regime, the more this cost proposition comes into focus. I think it will force people to make a decision either on the borrower side—about how long they want to carry it, and if they can support negative returns for themselves and their investors—or on the bank side, about how long they can withstand pressure from regulators on loans that clearly look like they're overvalued.

Q: How big is the multifamily market in the United States?

A: Multifamily in a conventional sense has stopped being just five-unit, 10-unit, 100-unit buildings. There are different modes in terms of whom they are catering to—corporate tenants, furnished stay, co-living, single family rentals, owning single homes and renting them like multifamily units, etc. Obviously, what is of importance to Angel Oak is that the market is vast; we don't need to be in the billions. The size of the market speaks to the amount of participation and the availability of opportunity. As this macro issue plays out, it impacts everybody, good and bad assets. It really is a generational shift in value. Real estate is cyclical, and a great part of capturing value—income and growth, which is what we want to do at Angel Oak—is the entry point into real estate. We think that in the next 24 months, real estate is going to provide a great entry point in terms of pricing, to be able to drive both income on a regular basis and growth.

Q: Sourcing is a large part of Angel Oak's business model. Can you talk more about the firm's sourcing capabilities?

A: Another reason for my attraction to the Angel Oak platform was that while it normally looks like a reboot of the CRE platform, it is really building out a different discipline within an exercise and a practice set that already existed. Angel Oak has done 50,000 to 60,000 loans. It is hard to overstate the advantages of possessing the mechanics, the processes, the legal support, and the asset management support that funnels these loans onto a part of the platform that will make use of effectively hundreds of commercial real estate loans. The benefit of that practice is something we will reap readily in terms of systems, personnel, and expense management.

But in terms of the opportunity in multifamily and with community and regional banks, we hope to leverage expertise in lending to these banks and, being debt holders to them, to gain a firm grasp of how they manage their portfolios and how we can provide them with helpful real estate solutions.

We want to be accretive in liquidity in terms of the debt we write to the capital structure and the balance sheet by taking real estate risk off their hands and managing it more appropriately at these distressed valuations. We also want to ensure these banks see us as a beneficial partner that can help them solve real estate problems rather than just take advantage of distress in the market.

Q: How do you see the opportunity in servicing retained by community and regional banks? Do you feel that these banks still want to be involved in the servicing side, or do they just want to get it off the balance sheet?

A: I think that is going to be a mixed outcome based on how these organizations are set up to deal with their current portfolio. To the extent that they have capabilities that are unique to the portfolio that Angel Oak cannot replicate in terms of economies of scale or process or credit oversight, then it will be beneficial to have these partnerships. Truly what we want to do when we have these transactions is not just do trades but also form partnerships on the private side, in terms of investments we make and assets we take and help others through.

Servicing requires people, and there are many servicers out there who have great processes in place. For the most part, we would like to control that servicing ourselves and be in touch with borrowers where we lend to them or if there is distress in notes we buy. We want to be nimble and think about how we can appropriately capture risk.

Q: There is very much a credit side and an equity side of this business, two very different approaches. One is dividend distribution and yield; the other is capturing potential upside. Can you talk more about these two very different strategies?

A: Part of Angel Oak's philosophy is to be relevant in all parts of the capital stack—liquid securities, lending, and equity. We see an opportunity to form two different kinds of vehicles. One vehicle is focused more on income and core growth, which we would call a credit fund; the other vehicle is focused on an opportunistic outlook on the market, which is going to take advantage of this asset value reset (that is, equity). We want to own real estate assets at great basis today on the asset value reset as well as generate income and potentially large and outsized principal growth as the assets appreciate over a period in which interest rates improve. It could be a great opportunity for anyone who is looking to the future and wants to supplement income. The other component is to take advantage of what the market offers in terms of this vast asset value reset through the lens of this macro issue that interest rates and the Fed's movements to combat inflation are impacting all asset types and all financial markets.



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