Lowenstein Sandler's Real Estate Podcast: Terra Firma

Episode 6:
A Lawyer's Approach to Real Estate Investment

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Stacey Tyler: Welcome to Terra Firma: Conversations on Commercial Real estate. I'm Stacey Tyler.

Stephen Tanico: And I'm Stephen Tanico. Stacey and I are real estate attorneys at Lowenstein Sandler. On today's episode, we'll be talking about the state of financing. Joining us in this discussion is Jon Wishnia, chair of the mortgage and structured finance practice at Lowenstein Sandler, an absolute wizard with numbers, some say so good that he should probably not be a lawyer. Thanks for joining us today, Jon.

Jon Wishnia: I appreciate, Stephen, the opportunity to be here. And I think me not being here as a lawyer is a way to get me out of the firm.

Stephen Tanico: Awesome. Jon, generally within your practice, what are you seeing these days with deal flow, particularly with financing?

Jon Wishnia: Yeah, I'll talk high level a little bit first about the practice and then how that ties into the financing world. Because where we were a year or two years ago, certainly pre covid, is very different from where we are today.

The practice as a whole represents clients across the demographic of receivables trading, and so that can be buying, selling, financing, any kind of cash flowing assets. Loans in particular, but that could be mortgage loans, business loans, student loans. Doesn't really matter. And then working with those companies to build, grow and or dispose of those companies or get financing at the company level.

A lot of what we do is general advice giving as opposed to specific legal advice, which I always find frankly to be far more interesting because you get to play the role of helping to run the business as opposed to just providing an arguably commoditized service at times. What that means in the financing space is we work with clients regularly on repurchase facilities, warehouse facilities. Participation structures that allow clients to access leverage to help grow their investment portfolio and help them hopefully make a lot of money.

Stacey Tyler: Ideally.

Jon Wishnia: Yes, ideally. Correct. And even in really tough economic environments, we've got clients that even recently have started new businesses and gone into very esoteric investment spaces, and financing is absolutely a key to be able to do that. Because their investors are still seeking specific returns, and it is an incredibly important tool to have access to leverage, whether it's two to one, three to one, four to one times, or even more in some cases. To be able to get the returns you need to be able to justify running the business.

Stacey Tyler: And are you seeing a lot of real estate mortgage loan flow right now? We personally have been expecting to see a lot more refinancing activity than we have been this year, but it's been so odd with rates being what they are.

Jon Wishnia: Well, that's exactly right. In our world in particular, we've seen an incredible slowdown. As soon as rates started to go up, a substantial portion of what our clients do does revolve around the refinance of loans. Obviously, there's always new origination. And as long as there's a country as large and as vibrant as ours, there will always be people buying and selling homes. And so there will be a portion that is new origination, but a substantial portion is refinance.

Some of that is refinance brand new where you're bringing in new customers. Some of that is protective refinance. If the average loan will refinance every five to seven years, clients who are mortgage servicers or originators that are also servicers or that partner with servicers want to be out in front of the possibility that somebody else is going to refinance that loan and take it away from them.

On the origination side, you're looking for the fees you get as an originator. As a servicer, you're getting paid a small strip of the interest every single month. So the longer you can extend the life of an individual loan, the more you get paid for servicing that loan.

Stephen Tanico: From the borrower side, interest rate seems to be the big buzzword. Is there more? In your world is there more to it than that or is it really as simple as interest rates go up, deal flow slows down?

Jon Wishnia: I'm a lawyer, so the answer is it depends. So when you look at a super duper high level when you're looking at a pool of mortgage loans, you're going to be analyzing lots of assumptions. But the two core assumptions if you take a pool of loans are going to be prepayment risk and default risk. So when you look at something like interest rates. Interest rates are high liquid related, not surprisingly, to prepayment risk. If you've got a higher rate and rates come down, there's going to be substantial prepayment activity. If rates go up, prepayment activity drops substantially.

That said, independent of prepayment or default, when you see substantial rises in valuation, it becomes that much harder for so many people to even access the financing they need to buy those because they simply are priced out of properties. And so if prices came down, you probably see an increase in activity because there is more availability for folks who can't afford a 7% rate and a mortgage of X, Y, or Z. Whereas if it was X divided by two and 7%, they could do it. Or if it's X divided by two and 5%, they absolutely could do it. So fewer people and a rate structure that doesn't incentivize anybody to refinance unless they absolutely need to, and therefore you're really focused more on new origination, which is a much smaller pool of the overall pie.

Stephen Tanico: Now it's interesting. Because if you go back historically, interest rates are high now but have been significantly higher in the past. And yet the pendulum swing between where the market was two years ago and now, there's this whiplash where pricing hasn't quite adjusted to interest rates, I think. Can you speak on that a little bit?

Jon Wishnia: So in addition to chairing the practice here in the mortgage and structured finance space, I do my own personal real estate investing. And I'll say I do it because I really enjoy doing it. I think that when you're in a position to diversify your own personal investment portfolio, real estate should be a part of that, but only to the extent you understand what you're getting into and you want to do it, ie. you shouldn't invest in things you're not interested in. That just doesn't make sense.

But without a doubt, looking back even over five or six years, you saw an incredibly frothy market. Single family rentals or small apartment complexes, you saw prices rise substantially, predicated upon 2%, 3%, 4% of the commercial space interest rates. Rates have doubled in some cases, maybe even more depending on the kind of asset you're looking at. And sellers of those assets haven't adjusted.

In areas in which I have been investing in or looking to invest. I regularly get updates from the real estate agents that are out in the commercial space selling things. And I've seen in the last six months far more "Please make a bid" type emails. The problem with those kinds of emails, even on properties that look like they're B class or even A class depending on where it is in an area you're willing to consider, is the pricing is still so incredibly high that you'd have to bid something that is far below the list price. There has not been an adjustment from sellers to acknowledge that the cap rate, the effective rate of return, is not any more aligned with the interest rate environment. Which means when interest rates go up, cap rates have to go up. Because if your cap rate is not higher than what I can use when I'm investing with the federal government, which is effectively a risk-free rate, then there's no point in investing in an asset like real estate. And they haven't moved.

Instead what we've seen a bunch happen, myself and some others here at the firm and otherwise that have been trying to invest together, is you see descriptions of portfolios where the real estate agents will talk about the "market rent" you could be getting, and then try to predicate cap rates based upon rents that don't exist today and vacancies that don't exist today rather than here's where we actually are. And in a really hot market with really low interest rates, they were getting away with that. They're not, and so inventory is just sitting.

Stephen Tanico: It's wild. Because you had this bidding war on the pricing plus lower interest rates, which is this double whammy that doesn't exist today and it just really has not adjusted at all back. And I almost feel like the guy next door got this price. Why can't I get this pricing? Do you foresee... Obviously you don't have a crystal ball. Do you think the market will move or what might give that will adjust this?

Jon Wishnia: Well, I don't see rates going down anytime soon. They may go up even further. And I think even for home mortgage rates, we're going to get above 8% soon which is insane in light of the last X number of years. It is far less insane when you look long-term obviously, but nobody wants to go back to 1970. That's a scary thought, but it just makes home ownership so incredibly unaffordable for so many people.

So a couple of things. First, I'll say stick to fundamentals before we even get into any specifics. The folks that bought and got great rates, they probably overpaid for the properties they got. Because at least what I've been seeing in my experience in certain markets was you'd get big institutional investors swooping in and bidding across the country on properties sight unseen. That was driving up the property prices substantially.

And if you are doing what I'll consider to be intelligent investing. I'm sure people would disagree with me, but I've been called worse than intelligent before in my life. You've got to stick to your fundamentals. You've got to know what kind of return you are seeking. What kind of properties you're willing to invest in. And so even if person X got a 3% rate, if they paid way too much, then they paid way too much. Which means if you look at a 5, 7, 10-year horizon when a lot of folks want to turn properties, they're not going to be able to turn that property. Because that property, while they have a 3% rate, is now worth far less than what they originally paid for it.

If you've got a much longer-term horizon. I tend to invest longer term. My view in building a portfolio is you're building it for a legacy, you're not building it necessarily to turn it in five or seven years, then you're somewhat less price sensitive in that respect. However, your fundamentals should still be your fundamentals, and you should still know how you are running your numbers to figure it out. And at the end of the day, I personally don't care about the person that got 3%. That's in the past. That's equivalent of a sub cost. You can't talk about what happened. All you can talk about was today and therefore what numbers do and don't work.

And you can always lament. "Oh, if only I'd invested in this city in 1990, or in this city in 2000, or in this city in 2010." Those opportunities will always be there. And if you spend time worrying about that, then you're spending time on things you can't control and things that will only give you lots of angina, and that just seems like a terrible idea.

Stephen Tanico: And Jon, right, because you have these old school guys who will just back of napkin mortgage payment over rent roll, and then you have new school guys who have pages and pages of Excel. Where do you fall based on the fact that you exist at this intersection between both finance and law?

Jon Wishnia: So I've got an 8000 line algorithm for my fantasy football team. I do not have an 8000-line algorithm for real estate investing, I can promise you that. It doesn't mean I'm not using calculators because I certainly am. But honestly, I will start with something simple like the 1% rule, kind of like the back of the napkin type things. Or I'll go to BiggerPockets type calculators.

Stacey Tyler: Wait. What's the 1%?

Jon Wishnia: The basic idea is you're looking at either rent rolls relative to purchase price, which is where you're looking for 1%. Or you're looking at your gross income minus your expenses for the 50% rule, excluding things like any financing charges. But there are two or three or four basic metrics. Even a cap rate calculation. You can pull a cap rate calculator off of anywhere on the web, and it's only going to require 4, 5, 6, 7 inputs. Now, you're guessing on those because you're going to have to enter your operating expenses, you're going to have to enter your vacancy rate. What are any capital expenditures you're going to have to do? What's your management expenses? Once you've done it for a little while, you have some sense of that, but you're never going to be exactly right. And so those are more back of the napkin. Still 5, 6, 7 entries to get a sense of what makes sense or what doesn't.

There is still risk in this. The reason you're doing it is you're getting paid more than the risk-free rate. And so nothing's going to be perfect, but what you want to make sure you're doing is being somewhere close again to, "Hey, my benchmark is I will not allow my gross rent to be less than 1% of my purchase price." For example. There are plenty of people that have horribly violated that, and I can promise you a lot of those people are going to lose a lot of money in a market like that. I'm not saying that's the rule. It isn't the rule. There are no rules. But it's a good way to get a rough estimate of things that you're looking at.

Stephen Tanico: Now, I think to tie back to what you were talking about earlier for our listeners, that's where with the market now and these brokers saying that the market rent could be this. I could... You could input any market rent you want into one of these calculators, but it doesn't help you relative to what the actual market rent, what the actual vacancy is when doing this type of calculation.

Jon Wishnia: Correct. So two things on that. Speaking of listeners, if I don't take hello to my mother, I promise you she will say something. So, hi mom. That's number one. You think I'm kidding. She'll comment to you guys as well, I promise you.

Number two, you need to be very careful when you're looking at marketing material. Because marketing material is designed to sell, and you actually need to... While my calculators may only have 5, 6, 7, 10 entries, you're going to get an offering memo that has 25 glossy pages of beautiful pictures of things that aren't even real, and then buried in the back is the actual rent roll. And is that a column that's actual rent? Is that a column that's market rent? You've actually got to spend the time understanding what's being presented to you to then use those numbers to input that. Because yes, that's... Without a doubt. They'll frankly say the as rented on a market basis cap rate of 12%. But you run the cap rate and it's really 4%. You're going, "Well, why is that?" Well, it's 50% vacant, and the rents are three-quarters, 75%, of what they're claiming market rent should be. What is the current landlord doing? What's the current owner of the property doing? Why aren't they raising rents?

Stephen Tanico: Wild concept, right? Brokers trying to sell things.

Jon Wishnia: No comment on brokers on advice of counsel.

Stacey Tyler: So what asset classes are you looking at these days? We saw so much multifamily activity, industrial. What do you see as hot right now?

Jon Wishnia: As hot? Nothing at all whatsoever. Everything is overpriced and not appropriately valued.

What are things that I'm interested in? It depends on the price point you're looking at. From my perspective, I'd love to be in smaller apartment complexes. The bigger than [inaudible 00:14:26] limits. So you're talking about true multifamily five plus units. In the 5 to 25, 5-to-50-unit range, depending on where you're located. And the reason for that is you look at a lot of big institutional investors, those kinds of properties are too small for them. And if you look at a lot of mom-and-pop investors who are doing single family rental, they don't have the means to be able to invest in them. So, in theory, there's an opportunity there.

The problem again is what's hot. Valuations have been completely out of whack, and that's why I'm getting desperate emails from... As I pick up my phone that nobody listening to this podcast can see. But I get desperate emails from brokers in areas where I'm looking saying, "Please, this is listed for $6 million. Please bid."` And if I were... Not that I'm going to invest in something that expensive then anyway. But if I ran numbers. Let's say it might be a $2.5 million purchase price, and there's no way to even consider something like that. It just doesn't make sense in any way whatsoever.

Stephen Tanico: I'm assuming you have this steady job as a lawyer, you're not managing. So many jobs to do. You're not managing these properties yourself. What do you look for in a management company? That might be something that our listeners should be aware of.

Jon Wishnia: That's really hard. And the reason that's really hard is I believe strongly in knowing the people that are involved. So I've got... For properties that I own, I've got two sets of property managers and I know both of them very well. That is not, to be very clear, a scalable model. If you're going to be investing in areas that aren't local, then it's going to be incredibly difficult to be able to know people and then figure that out.

So if you're looking generally, you 100% need to get references. You've got to try to do your own digging on the internet to find out what are the other kind of places that they're renting and managing. To me, that's important. Because I want a manager whose core competencies are around managing the portfolios that I want to invest in. I don't want them investing in better or worse quality or larger or smaller because they need to actually know the properties really well. Now that said, you're going to pay for that and you've got to make sure you're properly accounting for that in the cost of what you're doing.

Stephen Tanico: Right. There's an interesting thing because typically real estate investing was in your own backyard, and now with Google Earth and all this, you can really go out there. And yet there's these other parts of the whole deal that need that personal touch it seems like, that kind of get lost in the sauce.

Jon Wishnia: Oh, without a doubt. That's absolutely the case. And there are a number of companies out there that try to sell that, the management. "We'll find places for you." And yeah, there's no way to know what's going on there.

The other danger of not investing in your own backyard is... I would highly suggest, I can't say you need to, but I'd highly suggest you actually really understand the neighborhoods you're investing in. There are some cities in this country where if you go four blocks away, the makeup of the neighborhood is so incredibly different. And if you're getting marketing materials and you don't have feet on the ground and you haven't been there, you are not going to have an understanding or appreciation even by doing your Google Earth searches necessarily for how incredibly different those areas are. And that doesn't mean it's better or worse. It's just different. And if it doesn't fit your profile, you got to wonder why.

Similarly, if everything you're seeing is overpriced and then something three blocks away is horribly underpriced, you should be asking why that is. Is it because the building has fallen down? Is it because the nature of the neighborhood has changed dramatically? Those are not things you're punching into a calculator. That's an intuitive feel. It has to be there for you to really be comfortable moving forward.

Or you could just risk all your money. Then it's more like gambling than it is investing.

Stephen Tanico: While that no deal is too good to be true, right?

Jon Wishnia: Yeah. Exactly. Always the case.

Stacey Tyler: Well, that brings us just about to the end of our time. Any other final words of wisdom you would have to any real estate investor sitting out there, money burning a hole in their pocket, waiting for the right time?

Jon Wishnia: Your money is burning a hole in your pocket. I'm happy to take.

I'll stress what I've said before, which is you need to decide what your comfort level is with the nature of the return, the area in which you're seeking return, and the nature of the asset you're investing in. I invest in asset classes other than real estate. Obviously, I'm in the stock market. I've got some venture capital type investments as well. I'm very analytical when it comes to all of those things. Do I get paralysis by analysis? At times, yes. I absolutely do. 100%. I fully acknowledge that. But you've got to be comfortable with what you're doing.

I'd seen a recent TikTok. My kids will be happy to hear that.

Stephen Tanico: Really want to shout out to your kids.

Jon Wishnia: Yeah, exactly. Shout out to my kids. No, I normally mock them when I'm speaking publicly.

Stacey Tyler: They're not going to listen to this.

Jon Wishnia: Mia and Zach, if you're listening, consider yourself mocked. No.

Recent TikTok about a comedian talking about how his accountant does everything for him, and he doesn't know how much money it is or where it is. Yeah, Stacey, as your eyes are bulging here. That's an incredibly bad way to run one's own finances. And you don't need to be to that extreme because many of us, myself included, don't have some accountant managing our money for ourselves. We do it ourselves. But that's no different when it comes to being wise about investing. There are many different avenues of alternative investing. But you should understand what you're getting into because every one of them will have their own set of pretty substantial risks, and you should never be investing those dollars you don't absolutely have to lose. Whether it's direct, whether it's leverage/on margin. It's just that's a recipe for a lot of trouble.

Will some people make a gazillion dollars in Bitcoin? Yes, but you're not going to be that person, so don't pretend that the next Dogecoin is going to be the next Bitcoin.

Stacey Tyler: Wow. Such advice.

Jon Wishnia: Something like that.

Stacey Tyler: Well, thank you so much for joining us today, Jon. This has been a really fun conversation. Thanks for helping us get a little bit smarter about real estate investing.

Stephen Tanico: Thank you, listeners, for tuning in today. Be sure to like, subscribe and follow Terra Firma wherever you're listening to this episode. Stacey and I would love to hear from you, so feel free to reach out to us at terrafirma@lowenstein.com. Until next time.

Stacey Tyler: Ciao!

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