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CMBS ISSUE

Star Quality

The market doesn't always know what to make of Starwood Property Trust's unusual playbook. Its executives don't really care.

THIS ISSUE

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- Blackstone's $724 million refinance of Hudson Commons
- Ann Hambly: How to make a better borrowing business
- Why it's always feast or famine in CMBS
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2nd Annual LA Power List

‘Next Question, Please’

Don’t you dare doubt Starwood’s no-nonsense team of Barry Sternlicht, Jeff DiModica, Dennis Schuh and Andrew Sossen

By Cathy Cunningham and Matt Grossman
Photographs by Sonya Revell

It’s never fun for a lender when one of your portfolio’s most prominent recent financings suddenly becomes one of your company’s biggest question marks. But that’s exactly what appeared to take place for Starwood Property Trust this fall.

Back in February, the mortgage REIT, led by Jeff DiModica under the auspices of Barry Sternlicht’s Starwood Capital empire, took on a $379 million exposure to 424 Fifth Avenue. The historic building had long been the flagship store for Lord & Taylor, but the fabled department store had wilted under the rising tide of the so-called retail apocalypse. In a stunning deal that seemed emblematic of changing times, WeWork announced it was taking over the majority of the 10-story building on West 38th Street. With a $229 million piece of the first mortgage and the entirety of the $150 million mezzanine loan on its books, Starwood brought the deal to the finish line.

Fast forward half a year and things looked very different. At the end of September, WeWork had announced the indefinite shelving of its IPO after investors turned up their noses. It looked like the chickens were coming home to roost for a company that has at times lost an average of $219,000 per hour, as the Financial Times reported.

WeWork’s major-league problems would be the stuff of nightmares for lenders who hadn’t already preempted any possible borrower distress and employed a defensive strategy.

But that’s not Jeff DiModica. When it was time for a tough crowd of savvy institutional analysts to grill him, George Foreman-style, about the deal on Starwood’s third-quarter earnings call on Nov. 8, DiModica was in command.

He told the analysts — plus everyone else who dialed in for the call— that although Starwood held the mezzanine debt on the building, its stake enjoyed a $612 million cushion: a junior tranche worth $225 million held by another lender, plus another $387 million in equity. What’s more, though WeWork was faltering, it had still signed over to Starwood a 15-year corporate guarantee.

Six months after the deal closed, that looked like a prescient thing to have asked for.

On the call, explaining those details was apparently enough to satisfy Keefe, Bruyette, & Woods analyst Ryan Tomasello, who moved onto another line of questioning. But DiModica wasn’t ready to let the issue drop.

“Hey Ryan, I wanted to revisit your supposition on the equity’s paying too much for 424 Fifth Avenue,” DiModica said a few minutes later, before delivering a trademark, off-the-cuff seminar in mathy capital-stack analysis. “If the tenant were no longer a going concern, and we had to re-let the office — if we re-let it $30 lower on our blended rents we would still be south of 70 percent loan to value and north of a 7 percent debt yield on that building. We have supreme confidence that our loan is better than money good. By the way, we have a Libor floor that’s 70 basis points in the money on that loan as well.”

Translation: Even if rents dropped $30 per square foot and the value of the building took a massive hit, Starwood would still be in a well-protected position and earn a solid 7 percent return on their loan.

“So, we feel very comfortable,” DiModica concluded. “Next question, please?”

FOUR AT THE FORE: Left to right, Dennis Schuh, Barry Sternlicht, Andrew Sossen and Jeff DiModica have shaped Starwood Property Trust into an unusually dynamic and protean commercial real estate debt provider, putting it at the front of the alternative-lending landscape.

'Running on all cylinders'

DiModica's confidence in the might of Starwood Property Trust's platform is unwavering. But speaking with Barry Sternlicht, who co-founded the company's parent, Starwood Capital Group, in 1991, you can't help but wonder whether the swagger comes all the way from the top.

Sternlicht said that while Starwood Property Trust's diverse collection of business lines has sometimes been difficult for analysts to grapple with, the company is designed his way, all the way.

"There are companies that are monoline that are easier for the street to understand, and some of them trade OK," Sternlicht said loftily. "But this is how I want to run my money, and that's the way we built the company."

And how Sternlicht built the company is Starwood Property Trust's chief selling point, in DiModica's eyes.

"I think what differentiates us is that we do have seven different businesses," DiModica said, quipping that the best headline to describe the firm might be 'Running on All Cylinders.'

Commercial lending is the oldest and biggest of the REIT's seven business line. It launched in 2009, the same year Starwood Property Trust shares began trading on the New York Stock Exchange and counted a $7.9 billion portfolio as of the end of 2019's third quarter.

But that's far from the be-all, end-all of what Starwood is up to. The company entered three other real estate fields in 2013, when it started both selling mortgages for securitization and also buying CMBS B-pieces. That was also the year it acquired LNR Property, the world's biggest CMBS special servicer, which it continues to operate.

Over the three years that followed, Starwood Property Trust jumped into the securitized residential lending business, and also started buying real estate — a lot of it. Today, it controls a portfolio valued at $2.9 billion. And last year, it made its most outside-the-box move yet, paying $2.56 billion to buy General Electric's project-finance business.

Still, originating commercial real estate debt remains by far Starwood's biggest segment by volume. Year to date, it has put out $4.5 billion in real estate debt between its CMBS and commercial lending segments.

And though fixed-income investing sometimes has a milquetoast mien compared with the equity game, Starwood isn't messing around. Its owned real estate segment actually targets more modest returns than its lending business, an indication of the complexity and ambition of the company's debt portfolio.

"The best opportunities for us, since our inception, have been on the largest, most highly complex, more structured deals," DiModica said.

Dennis Schuh, the company's chief originations officer, elaborated on that theme.

"We pride ourselves on the more complex deals, because our equity DNA allows us to underwrite those," Schuh said. "It allows us to have less competition for those types of deals. If there's a loan that 50 lenders are trying to do, it's probably not a good use of our time. We certainly love to win plain-vanilla stuff, but we differentiate ourselves on complexity, absolutely."

IT HAPPENED ON FIFTH AVENUE: Exposure to WeWork's tumult at one of the company's landmark buildings, the old Lord & Taylor flagship at 424 Fifth Avenue, could have been disastrous. But Starwood Property Trust's careful structuring of its mezzanine loan in the deal averted trouble that might have doomed a less sophisticated lender.

Schuh enough

The reason Starwood Property Trust's team is so productive is that the team knows how to structure its deals, said Matt Pestronk, the president and co-founder of Post Brothers, a multifamily owner and developer based in Philadelphia. Pestronk's company grabbed a $183 million debt package from Starwood in 2016 to refinance a 1,000-unit complex in that city.

"What Jeff is really good at figuring out is how to make a good deal for the borrower and a good deal for him," Pestronk said. "His fundamental approach to business is that if the borrower thinks he's getting a good deal from you, he's not going to continue to do business with you. They grow their business by having repeat borrowers. They are smart and first class to deal with."

Further, the team doesn't issue offers and term sheets without full consideration. "They're measured and deliberate, but certainly not slow," Pestronk continued. "You can just count on them to deliver every time."

One of Schuh's special gifts is the ability to see deals the way they look from the other side of the table, according to Scott Alper who, in his position as chief investment officer at The Witkoff Group, has overseen major borrowing from Starwood on several occasions.

"He understands the big picture, and how a borrower looks at a deal," Alper said. "They're super-smart guys who are practical and user-friendly. And given that Starwood's also in the equity business, they get our perspective."

That came in handy when Witkoff turned to Starwood in 2017 for a $173.3 million loan on 215 Chrystie Street, where it had just built a hotel that also included about a dozen condominiums. Structuring the deal was a challenge, Alper said, because Witkoff wanted to start paying the loan down quickly as the condos sold. But DiModica and Schuh found a solution that worked, he added.

"They took the whole loan, and it had to be a pretty complex structure. Dennis was very creative," Alper said.

In the end, Starwood was able to close on the loan before construction even wrapped up — which Alper said was a testament to DiModica and Schuh's ability to understand a multifaceted asset.

And if their deal judgment ever slips, they'll have Sternlicht to answer to. He mentioned a prominent hotel he heard about in Washington, D.C., with an asking price of $1.5 million to $2 million per key. "If my team … ever brings me that loan, they'll be dead within three seconds of its arrival," Sternlicht said and laughed. "That hotel couldn't be worth more than $800,000 per key. If there's a lunatic who wants to buy it, unless he's going to collateralize the guarantees alone, we're not going to make the loan."

Just guessing that the owner of said hotel currently being shopped around is otherwise occupied by a career in government . . .

Downside protection

But despite being so well equipped for the business, one of Starwood's particular strengths is its ability to generate income through its other business lines if Schuh and his team don't like the way the tides are turning. Whereas most of the legion of alternative lenders that have sprung up this business cycle have made an all-in play for real estate debt, Starwood can change course at the drop of a hat.

"We have always said that we won't overstay our welcome in the debt market," DiModica said. "When it's not a good time to be a lender, we will pivot."

"If we wake up the next day and say, 'God, the relative value in infrastructure lending versus commercial real estate is fantastic,' we're going to allocate more money to infrastructure lending," Andrew Sossen, the company's chief operating officer, said.

Nor is that only an emergency plan reserved for a real crisis. Even the mildly frothy waters of the CRE debt markets circa late 2014 were enough to prompt the REIT to hit the pause

button, biding its time with an acquisitive equity strategy.

"The banks were getting aggressive, moving up in LTV," DiModica said. "We could buy properties that were strong, cash-flowing, core-plus properties with a 6 or 7 percent cap [rate], finance them in the low 2 or 3 [percent range], and end up with a cash-on-cash return of somewhere near 10 percent."

If, on the other hand, a grimmer scenario arrived that erased opportunities on both the equity and debt sides of the bargaining table, Starwood's LNR division could become a clutch hedging mechanism.

Special servicers such as LNR step in when a CMBS loan is in or at risk of default to administer a resolution for the troubled building that secures it, earning hefty fees for their trouble. In today's relatively placid credit market, less than $10 billion worth of CMBS loans are specially serviced, about half of which date to before the 2008 financial crisis. But at the depths of the Great Recession, special servicers controlled about $90 billion worth of commercial real estate debt.

In a worst-case scenario for real estate markets, DiModica said that LNR's role in that countercyclical trade would provide a counterweight.

"As we get later in the cycle, it's more and more important that we have other options," DiModica said. "I wouldn't just want to be a lender; I wouldn't want lending to be the only thing I was able to do because there will be times when there is too much competition and it doesn't make sense."

Again, this is all part of Sternlicht's master plan.

"One of the questions I got ... when we were raising this money was, 'How do we know you're not going to be like every other mortgage REIT in history and blow up?' " the 59-year-old recalled. "And I said, 'Because we don't really have to do this; it's not our sole source of income, and if there's nothing to do [there] then we won't do it.' "

That kind of resourceful thinking trickled down from Sternlicht's childhood in Connecticut, he explained.

"My dad used to say, 'Worry about the downside and the upside will take care of itself,' " Sternlicht said. "And we [as a team] have been through all the calamities, every one of them; the RTC, the '97 crisis, the global financial meltdown. We've seen the real estate cycles be pretty vicious."

Another benefit of worrying about the downside is that it pleases credit-rating agencies, whose good graces Starwood has actively sought.

"Our ultimate goal is to get to investment grade," DiModica said. "We started on the path five years ago to do that. We've created $3.4 billion of unencumbered assets. That allows us to issue our high-yield bonds [that] trade well inside those of our peers."

"We've always thought having an investment-grade rating will ultimately be the way that we win. It's our holy grail," he added.

To date, though, Starwood's balance sheet hasn't quite made the grade, as far as Moody's Investors Service is concerned. The agency gives Starwood a Ba3 rating, a category just slightly below the worst investment-grade standard. Although Moody's analysts have written admiringly about Starwood's industry prowess, they say that a stubbornly high proportion of secured debt was standing in its way, despite the company's "strong franchise in commercial real estate lending and ... its capable credit, liquidity and capital risk management."

DON'T BARRY THE LEDE: Barry Sternlicht, the real estate whiz behind Starwood Capital, plunged into the debt world with the founding of its mortgage REIT in 2009. Starwood Property Trust's seven business lines also include special servicing and infrastructure lending.

DiModica is on it.

"One of the few things that will determine [an investment-grade rating] is having less leverage than our peer group," he said. "We've continually run a lower-leverage business. We're 2.07 times on-balance-sheet leverage, and our peers are higher than that. Our last unsecured bond deal priced at Libor plus 128 [basis points] at the beginning of 2018. So, the bond markets have tended to like us."

Careful attention to capital costs and structure also looks good to borrowers, according to Philip McKnight, who as a managing director at Eastdil Secured represented WeWork in the deal at 424 Fifth Avenue.

"You could argue that it gives them certainty of execution," McKnight said of the mortgage REIT's watchful balance-sheet management. "It gives them pricing power in certain instances. They have relationships with the banks that are as good as anyone's, and that allows them to partner up with [the banks] on certain transactions."

Starwood executives are also proud that they've managed to escape too much dependence on warehouse lending, an approach they say lets the company control more of its own destiny.

"We've taken a conservative approach to our balance sheet in terms of not being overly reliant on bank repo markets to fund our business," Sossen said. "By financing ourselves off balance sheet through the A-note market and by financing ourselves at the corporate level through unsecured debt — all these, I think, are more conservative ways to run our business."

"Our peer group is plus-or-minus 70 percent warehouse-line financing," DiModica said. "Today, we have only 36 percent of our CRE lending on warehouse lines. So, if the market goes sideways — yes, potentially we could have earned a little bit more by keeping them all on warehouse lines, but we're going to be in a much better credit position in a downturn.

Who's done the work

Conversation with DiModica inevitably turn to his ascetic focus on capital costs. But what also comes through in conversation with Starwood executives is the company's creativity — its willingness to be something other than just any one thing, and its model-tested confidence that its leaders' instincts are pulling in the right direction.

That much was clear to Sossen from his first conversations with Sternlicht about joining the team in 2009. Sossen, a lawyer by training, was serving as the general counsel at KKR Financial Holdings at the time.

"Starwood is a meritocracy," Sossen said. "You're only limited by your intellect, and your willingness to work really hard. I remember when I was interviewing with Barry, that was the main topic of our interview: What options will I have here, notwithstanding the fact that I'm a lawyer?"

Sossen recalled that Sternlicht pointed to his own entrepreneurial and highly non-linear career in describing Starwood as a workplace.

"At the time, I was 31 or 32 years old," Sossen said. "Barry said, 'Andrew, I bought Starwood Hotels when I was just a year or two older than you. You're not going to be limited here.' "

The company does seem to offer its leadership a certain measure of personal freedom. In the last couple years, DiModica has decamped from the New York area with his family for Miami, an important city in the Starwood constellation, shuttling between the two East Coast metropolises. He also, by the balance of evidence, chose to forego anything as constrictive as dress socks the day our photographer caught him, Sternlicht, Schuh and Sossen together in Miami, a preference that DiModica shares with Schuh and one half of this article's reporting team.

"That's a big difference: I'm not wearing socks today," Schuh said in a phone call late in the summer, comparing his current job to his tenure at J.P. Morgan Chase. "Or, you know, not wearing a suit every day."

Disapprove of their fashion choices or investment decisions, however, and you won't find much sympathy from the top.

"You may not like what we do, [but] we're going to tell you what we do, and you can make your informed decision," Sternlicht said, reflecting on his vision for Starwood Property Trust.

Yes, the company may have a chip on its shoulder. But the quartet at the top of its real estate lending business are betting that if the company aces the acid test of the next downturn, that will be one valuable chip.

"We've always said to the rating agencies, 'If you're unwilling to get us [to investment grade now], maybe seeing how we perform through a down cycle will be what gets us there,' " DiModica said. "That downturn will show who's done the work along the way. I think it will be really interesting when it happens."