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LOOKING AHEAD ISSUE

Green Thumb

BentallGreenOak's Jonathan Epstein has a knack for growing businesses through market cycles

Green Thumb: BGO's Jonathan Epstein Has Traversed a Few Crises in His Time

Jonathan Epstein's grandfather kick-started a passion for real estate that's endured through cycles and market crises, and one that shows no signs of abating.

By Cathy Cunningham

"It's better to be lucky than good" has been something of a mantra for Jonathan Epstein, a managing partner at BentallGreenOak (BGO), throughout his career.

And, what a career it has been.

Today, Epstein is responsible for all of BGO's investment activities in the Western U.S., but he has his grandfather to thank for the early fascination he developed for real estate — one that would eventually catapult him through the ranks at firms such as Merrill Lynch and Lehman Brothers and see him build several businesses across the globe, while transacting through multiple crises.

As commercial real estate struggles to take a breath between a choppy end to 2022 and what may come in 2023, Commercial Observer sat down with Santa Monica, Calif.-based Epstein to learn how lessons from crises past have informed the investor he is today — and why it takes more than just luck to be successful during volatile times.

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Commercial Observer: How did you first get interested in commercial real estate?

Jonathan Epstein: I grew up in Worcester, Mass., about 45 minutes outside Boston. My grandfather owned buildings and was in development partnerships when I was a little kid. He also had another business, a paint, wallpaper and carpet store, and he sold to home developers and builders around Boston. He had multiple stores and started his business when he was 18, so I learned his work ethic from an early age. My brother and I would often stay over at our grandparents' and sometimes in the winter a boiler would break in an apartment building, or something would happen, and my grandfather would wake us — we were probably 8 and 6 years old at the time — and we'd get in the car and go help him fix whatever broke down. He was very self-reliant and wouldn't call a plumber to fix what he could fix himself. When I got older, he'd put me on painting crews. His view was you learn from the bottom up.

My grandfather built, with a couple of partners, the Bostonian Hotel, and he had a lot of contracts with the State of Massachusetts for government buildings. He had a terrific eye, and could look at a vacant piece of land and envision a shopping center there or know that a parking garage would be a fit for a surface lot because it happened to be across the street from a courthouse, and, if we put one in, we'd get more attorneys as tenants in his office building. I worked for him every summer as a teenager, and I think just learning about real estate from him and seeing how he talked about it gave me the bug, and intrigued me in a way that eventually led me to my first job.

What was that job?

At Merrill Lynch, in their analyst training program. I went to Boston University, which had a big retail building on campus to buy your books. It was a big building in Kenmore Square that was running out of space, so they were in the process of selling it. I got to know the broker representing the university and I was talking about buying the building, working with Boston University to master-lease it, and I was going to finance it with the Bank of Boston — which doesn't exist anymore. Nobody saw my vision for it, but the broker was friends with the head of Merrill Lynch's Boston office and said to him, "You've got to meet this kid. He's working his ass off trying to put this real estate deal together, and he's a junior in college."

And so, I get a phone call from [the Merrill head's] secretary asking me to meet him at his office at 6:30 a.m. I said, "Sure, I'll be there." I called the broker, and he said, "Just a word of advice: If you want to impress him, he's in the office by 6 a.m., so I suggest you get there at 5:45 a.m." I was waiting for him when he came in at 5:59, and that, I think, set the tone for the conversation. He had me fly down to New York to meet with the head of recruiting, and the rest is history.

What was your role there?

I started in the analyst training program, which typically lasted four months, but I was in it for just shy of three weeks when the [Resolution Trust Corporation] crisis started unfolding in real time. There were two key people at Merrill Lynch at the time, one was Bowers Espy, who was a legend in the mortgage trading business, and the head of M&A, Jeff Peek, who later went on to become CEO of CIT. They formed an investment banking/capital markets hybrid team to advise Bank of America — back then, this small, super regional bank — on buying thrift banks from the United States government, and valuing those thrifts' real estate, performing loans and nonperforming loans. They had built out a six-person team and needed an analyst, and somebody happened to remember that I had worked in real estate and recommended me. The next thing I knew, I was on a team, traveling around the country with Bank of America's M&A team. I would show up — this kid who knew nothing — and meet the head of whatever division at these thrifts who was 30 years older than me.

How was that received?!

There were a few other investment banks that were doing the same, but everyone was learning as they went, so I wasn't alone in trying to figure out how to value a disparate set of assets: performing and nonperforming commercial real estate loans, home equity loans, auto loans, credit card loans, literally anything that anybody financed. We'd fly back to New York, spend 48 hours crunching data trying to come up with a valuation, fly back to meet with Bank of America's head of M&A and the board, give a presentation, and then they'd make their offer to the government. They actually wound up buying 11 thrifts in around 12 weeks. At the end of four months, Bank of America turned to Merrill Lynch and said, "Look, we love buying the deposit franchises, but quite frankly, we don't really know what these real estate assets are worth, so why don't you guys buy the assets?" And that was like music to Merrill Lynch's ears. They went up to the board and got a huge allocation of capital for it.

It was really the beginning of everything we know today, because there was no third-party servicing business for loans or assets then, and there was no way to finance it. I like to say that investment banks were in the "moving business" then, not the "storage business." Morgan Stanley and Goldman Sachs were at the beginning stages of raising what eventually became private equity funds. Merrill was doing it off balance sheet, selling assets, monetizing assets, monetizing loans through senior/sub securitizations — which seemed like rocket science back then. We created the first whole loan repo arrangements and the first asset financing arrangements because Merrill Lynch at the time had something called the Ready Asset Trust, or RAT. It was the largest money market fund in the world back then.

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There were a lot of representation and warranty issues, and we were putting loans we were buying for 60 cents on the dollar back [to the loan's originators] at 100 cents on the dollar, so Merrill was making an enormous amount of money and kept giving us resources. I was this junior person, not even a year in, and they'd say, "Do you need help? We can get you junior people to work for you!" I just looked at it as: it was better to be lucky than good. I was in the right place at the right time, but it really kick-started my career. In '91 Lehman Brothers hired me away. I worked for Mark Walsh, who was my boss for many years. At Lehman, from '91 to '94, we bought 37 percent of all the assets sold by the United States government through the RTC, the FDIC, other entities, banks, and insurance companies that were having problems.

You were at Lehman for 15 years. How did the rest of your time there play out?

The Lehman playbook from '91 to '94 was buying distressed assets and realizing how bad the plumbing was. We saw literally everything from fraud to bankruptcies to stuff you wouldn't believe. And then we realized there was value in some of these real estate assets. So we became opportunistic investors trying to turn them around. Then other people wanted to buy them from us, so we became opportunistic lenders, providing mezzanine capital. That was really how Lehman's lending business developed. Then we realized we could just be regular senior lenders and develop a whole nonrecourse banking relationship. We then were really at the beginning of what became the credit markets in real estate — again, better to be lucky than good. Lehman really liked that model, because it fed all the different parts of the business, so they sent us to Europe, where we did the exact same thing from '94 to '96. At the end of '96, we got a call from our bankers in Asia saying that most of the economies were about to crack there as well. And I was the first person on a plane.

Everything hit at the same time and the Asian contagion blew everything apart, and we were on the ground in Thailand when the Thai baht cracked. So eventually, I co-headed the business in Europe, ran the principal businesses in New York and then ultimately co-headed Asia. We built all these businesses from scratch, starting with the principal business, equity investing, then building out different lending vehicles.

You left Lehman in 2006, two years before it imploded. What prompted that decision?

In 2005, everything was looking up in the market. My wife's from L.A., we had two children born in Tokyo, and we'd made a decision to move home. The problem was, all the seats I wanted had people not much older than me in them, and they weren't going anywhere. So, the move actually started with Barry Sternlicht. Lehman had financed Barry's purchase of ITT Sheraton, and I got to know Barry. He was going back to Starwood Capital from Starwood Hotels and told my boss, Mark Walsh, that he was looking for a president. Mark said to me, "Look, I'd hate to lose you, but this might be interesting." And so I talked with Barry. At the same time, others found out I was looking. Michael Hackman was a partner of Lehman, and a good friend I'd known for 16 years at that point, so we also talked. Michael ultimately did the smartest thing he could do: He marketed [the role] to my wife. He said, "Come on! You want to be in L.A. You don't want to be in Connecticut!"

So, Michael and I [at Hackman Capital Partners] took a small business and grew it out to this huge operation. And now, obviously, he's the largest owner of independent studios in the world. He and I started

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doing all of that studio research in 2007 and 2008 with Culver Studios because Lehman Brothers owned it. Michael ended up buying it in 2014 at the exact same price we were going to buy it at in 2008.

I'm seeing a trend of building businesses here.

Yes, I've always liked the idea of being an entrepreneur and building something — having to worry about the copier lease and how much Snapple was in the refrigerator for people [laughs]. It was fun for me, and we built a very large business. We were in 13 states with 14 million square feet of space. It was a great learning environment, but then Sonny Kalsi [now co-CEO of BGO] called me — the morning after he left Morgan Stanley — and said, "Hey, it would be really cool to put our rolodexes together and see if we can build something."

The financial crisis was raging at that point and I was comfortable with raising private equity funds, and had a lot of institutions that were coming to me saying, "Hey, we can give you capital to do that." Michael wasn't sure he wanted to go down that path — we'd always done things on an individual deal basis — and so we had the "life, liberty, pursuit of happiness" discussion, and I said I was going to do something with Sonny.

You joined BGO in 2011. What were some of the key market opportunities then?

There were both distressed and growth opportunities, kind of like you're seeing now. There were dislocations that were forcing people to sell, because they had loan maturities and needed capital. We also were monitoring the rise of the technology sector, between Boston, New York, Los Angeles and San Francisco. Boston invented the hardware, people moved to San Francisco to create the internet businesses, the content was being created in Los Angeles, and the ads were being sold in New York. Coming out of the GFC the job growth was explosive in the tech sector. And — just like now — technology people were all about interesting architecture. They wanted outdoor space, they wanted to bring their dog, they wanted bike parking and showers because they bike into work, and they wanted to know if the building had environmental standards. We were really focused on those gateway cities and the growth of those markets, driven by those local economies.

How does that period compare to what you're seeing and what BGO is doing today?

Today, we're seeing distress where there is a need for what's called higher-octane rescue capital — and there are different risk buckets. We're doing some — what I'd call — gap rescue capital. For example, a developer is building a new multifamily project, they started two and a half years ago and borrowed 60 percent [of cost]. It's now 90 percent leased and the original plan was to go get a brand-new 75 percent CMBS loan and pull out a bunch of equity financing for 10 years, but the CMBS market is not there right now. Further, banks' underwriting has gotten very conservative and they can't refinance the construction loan either, even though it was a lowleverage loan and the value of the asset has now risen, because rents have risen and it's well occupied. The developer can only get 40 or 45 percent loan-to-value so, instead of taking out 15 or 20 points, they actually have to write a check for 10 or 15 points instead. So we're looking at preferred equity positions where we're not ever going to own the asset but you're solving a capital structure problem.

Then, we're working on a deal right now where someone is in significant distress on four office buildings and so they're selling a life sciences asset that's done very well for them because they need cash. So we're making a purchase there. Land prices are also crashing, and we've been able to pick up land at a cheaper basis. We're the largest cold storage investor in the world by multiples, and all of that is driven by ESG standards, net-zero initiatives, automation and robotics. The bulk of the stock in the U.S. is obsolete and 45 years old, so you can't retrofit those buildings. So there's a development piece that fits in there that is very niche for us, but a very sizable opportunity.

Tell us more about BGO's cold storage business.

It's the only true business we have at BGO. We invest in multifamily, industrial and everything else but we actually created a business unit [for cold storage], which I am the head of now, globally. We have teams in Europe and Asia in the U.S., and over the last seven years we've done north of 45 assets and we're at about 21 million square feet, which would make us the third- or fourth-largest cold storage firm in the world if we were an operator, but we're real estate. We have a lot of vehicles that invest in a big development pipeline with development teams internally, operations automation people, and engineers, and we've invested several billions of dollars over the last 36 months. It's really skyrocketed because of the supply chains around food. And, with Russia invading Ukraine, it's only added even more tailwinds. We're being contacted constantly by governments about building new cold storage facilities with them. While major food corporations are large global tenants, we're really leading in what I call ESG design. We're 40 percent more energy efficient in our building designs so a lot of tenants are coming to us now, which has been great. It's an area that's so highly specialized we felt we needed to build a business around it, and now we've built a complete vertical around it with teams around the world.

What else are you seeing today that's new?

One big issue — which no one anticipated — is the sharp rise in interest rates, which has now triggered all these interest rate caps. Every floating-rate loan we ever got we swapped it or capped it, because I ran a capital markets operation, so I hedge everything and I don't take risks with interest rates rising. But all of a sudden, we're starting to hear about hundreds of loans where people didn't buy the interest rate cap. We're getting calls from people, saying, "I've got a $100 million loan, and I could have bought the cap three years ago for $200,000 and now I need to write a check for $10 million."

Any overarching themes throughout the crises you've worked through?

I always say, "You make money in real estate through information arbitrage." When everybody has the same amount of information, you don't make money. We were in that place before COVID when things were very efficient, and last year there was efficiency because everyone was buying the same thing, multifamily and industrial, and for good reason. Everybody had the same information, and it worked. Today, there's distress and some senior people, like me, have the experience and better information flow, so there's a lot of risk-based capital that would like to be involved. But, I don't think you're going to see banks dumping portfolios of loans this time around. Selectively selling here and there? Sure, but not fire sales.