

How Core-Plus Play Turned Into a Home Run

The sale of a nondescript office building in Oregon two weeks ago wrapped up a textbook case of how good timing and smart moves can turn a core-plus play into an opportunistic windfall.

By itself, the \$39.8 million trade of the 212,000-square-foot building wasn't particularly noteworthy. But it marked the final disposition from a 3.5 million-square-foot portfolio of buildings, net-leased to **Wells Fargo**, that produced outsize returns for its owners.

National Financial Realty of Los Angeles, via separate partnerships with **Oaktree Capital** and **Vereit**, acquired 41 properties in 2010 and 2013 for a total of \$267.9 million, at roughly an 8% capitalization rate. Since then, in 34 transactions, the properties sold for \$366.4 million, at a cap rate of about 7%.

"We took core or core-plus risk at best and ended up with opportunity-like returns," said **Vincent Pellerito**, president and chief executive of National Financial. "It turned out better than we expected."

The upshot: The partners more than doubled their aggregate \$85.5 million equity investment, reaping \$98.5 million of profits.

While the investment risk was deemed to be no higher than core-plus, the National Financial partnerships were expecting an internal rate of return in the mid-to-high teens over a five-year hold, including the benefit of leverage and value-enhancement strategies. But in the end, they far exceeded that goal, pocketing a hefty 26% annual return.

To be sure, that outcome was partly due to the steady rise of property prices in recent years. But it was also the result of breaking up the portfolio to execute a wholesale-to-retail strategy — and making some innovative moves to enhance the values of individual properties.

The story starts with the Oregon building.

National Financial, founded by Pellerito in 2006, specializes in properties leased to top banks. In 2010, it partnered with Phoenix-based Vereit (then known as Cole Properties) to buy the office property, in the Portland suburb of Hillsboro, for \$27 million.

The following year, another 40 Wells-leased buildings held by **Gramercy Capital** fell into foreclosure. New York-based Gramercy had inherited them in 2008 via its \$3.3 billion acquisition of **Nicholas Scorch's American Financial Realty**. When Gramercy was unable to refinance debt tied to that transaction, **KBS Realty** of Newport Beach, Calif., foreclosed on a \$500 million mezzanine loan.

Pellerito approached KBS with an off-market offer to buy the Wells buildings. Eventually, a deal was struck, and in 2013 National Financial teamed up with Los Angeles-based Oaktree to pay \$240.9 million for the 3.3 million sf of properties, spread across the country with a concentration in the Southeast. It remains Pellerito's biggest transaction to date.

The Oaktree team also was able to restructure the existing debt. **PB Capital**, which held a \$225 million mortgage on the portfolio, agreed to write it down to \$183.5 million given the post-crash drop in value.

The partnership was quickly approached with an unsolicited offer to flip the portfolio. It hired **CBRE** to test the market, but ultimately decided against a quick sale. "The favorable loan terms allowed [us] to generate consistent cashflow while selling each individual asset into the market," Pellerito says.

There was a complication: The buildings were among 140, totaling 7.8 million sf, that are covered by a 20-year master lease Wells signed in 2004 with American Financial Realty. Although it provides stable revenue, the triple-net lease carries a single national rent — just over \$6/sf — that is well below market in some locations. And it isn't ironclad. Wells can cancel, although it would have to pay off all remaining rent.

The lease also gives the bank options every few years to vacate a set amount of space. That presented a challenge: Potential buyers and lenders would shy away from individual properties because of the risk they could be the losers if Wells chose to reduce space.

National Financial and Oaktree decided to provide buyers of the largest properties — roughly 200,000 sf and up — with a guarantee to cover rent shortfalls in the event Wells moved out.

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“The backstop effectively made lenders and investors whole if there was a termination event,” Pellerito said. “The ‘insurance policy’ was a game-changer.”

The duo set up a reserve account to cover potential payouts, the cost of which was factored into the overall return.

In addition, the partnership leased up portions of the properties that weren’t covered by the Wells contract, boosting the overall occupancy rate to 97% from 90%. It also spent several million dollars on upgrades and renovations.

The first sale from the portfolio was also the largest. Five buildings in the Southeast, totaling 1.6 million sf, were bought by a family trust tied to Brazilian billionaire **Samuel Klein**. The deal, closed in phases between December 2014 and January 2015, was valued at \$146.7 million. Oaktree and National Financial had paid an allocated \$124.5 million for those properties.

Later in 2015, the partnership carved off 16 acres from a Raleigh property that served as a mortgage-operations center for Wells. It sold the land to Atlanta apartment developer **Pollack Shores Real Estate** for \$6.7 million. That turned out to be pure profit, as the office building later sold for more than the whole property’s initial basis.

The biggest gain came on a play at Philadelphia’s 401 Market Street, a 482,000-sf property a block from Independence Hall. The 11-story building was 100% leased to Wells, but the

bank wasn’t using floors nine and 10, and it was subleasing two ground-floor retail spaces. The **American Bible Society** was interested in both portions, so Oaktree and National Financial reached agreement with Wells to carve those spaces out of the master lease, then bought out the retail tenants. The society moved its offices to the building from Manhattan, where it had been headquartered since its founding in 1816, and converted the street-level space into its “Faith & Liberty Discovery Center.”

With the society paying market-level rents, the building’s value rose, and in late 2015, **Miller Investment** of West Conshohocken bought it for \$78.5 million. It had been valued at \$39.3 million when it was acquired by Oaktree and National Financial.

Pellerito acknowledged market timing and rising values contributed to the portfolio’s particularly successful disposition. But he said it’s also a validation of the wholesale-to-retail strategy and the firm’s efforts. “It wasn’t just that we lucked out,” he said, pointing to the moves the partnerships made to add value. “When you look at the risk profile we took and the return profile it resulted in, that’s the story.” ❖