MATT ADDESA

Extending the Concept of Private Credit into Real Assets

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. Today's topic is real assets, private debt, and we're joined today by Matt Addesa, Private Market Specialist at DWS. Matt, thanks for taking the time. Thanks for being on.

Matt: Yeah. Hey, thanks for having me, Stew. Excited to do my first podcast ever. This is a great honor. Appreciate the invite.

Stewart: We're happy to have you. And you're among friends here, obviously. We've been the first podcast for a lot of folks in the business, and so we're a 100% success rate, so this will be no different. So we'll start this one off the way we start them all. What's your hometown? Your first job of any kind? Not the fancy one. And what makes insurance asset management so cool?

Matt: So I'm from Andover, Massachusetts. I've been here for many years, since I was a freshman in high school is when we moved here back in the early 90s. I've aged myself a little bit. And that's when I also had my first job where I became a, what I like to call a pizza delivery technician. So Domino's Pizza.

Stewart: I love that.

Matt: For a couple of years in between prep school and college. Summers was slinging pizzas, both making and delivering. So, that's how I started my illustrious career here.

Stewart: I like it.

Matt: Yeah. What makes insurance asset management so cool? I actually think maybe you asked that a little bit tongue in cheek, but I've spent my career more on the relationship management distribution side of things. And I just find that the problems that are being solved, the questions that are being asked, there's real richness in the discussion and the dialogue. And most of the people that I find in this space are just very thoughtful. It's all different types of people, but most people that are not just looking for the quick answer, that are really looking for layered, thoughtful, durable investment ideas and approaches to solve the problems that they're looking to solve. So I've really found the people are probably the coolest part.

Stewart: Yeah, I agree. I do really believe that insurance asset management is by far the most sophisticated institutional asset management sleeve. There's not a close second, and someone summed it up for me the other day, a friend named Jonathan who said, "It's the externalities." And that's what it is. In one word, it's externalities. It's the ratings, the regulation, the loss experience, the capital position, all of that, tax position. And the risk posture, each one of these firms has their own unique appetite for risk, and it's really about having those conversations to really get to know the client and know how you can help them out. And so with DWS, where it takes this conversation is where in your mind does real asset private debt fit into the larger private debt/credit space?

Matt: Yeah, that's great. I think I'm going to lift your friend's term there. Externalities does really sum it up perfectly and then I think maybe a little bit goes to the question you asked here, and people say the word private credit a lot or the term private credit a lot these days, and it's not unique in terms of the growing interests in private credit to the insurance space. Obviously credit generally plays a very large role in most balance sheets. Lots of folks that have been thinking about insurance company balance sheets for many years are very smart, sophisticated credit investors as you mentioned.

But I think when you expand on that concept of private credit, I think there's a lot of different ways. You and I were speaking, you mentioned all the asset classes that you guys cover and think about on a regular basis. And I think private credit is one of those where, depending on who you talk to, it can mean a lot of things to a lot of different people. We come at and have come at our approach to the private debt space more from the standpoint of investors in both the real estate and infrastructure equity markets. We have been, at DWS for a long time, investors in those spaces, more predominantly in the US as our real estate business and more predominantly in Europe as our infrastructure business as one might expect given the way that private investment and infrastructure is developed.

And so our debt capabilities have really become an extension of that. We've been for a long time trying to figure out; how do we get these opportunities in the hands of the right people who are thinking about the up in the capital stack opportunities that exist? And are they the people that are thinking about, if we're thinking about real estate debt for example, are they people that are thinking about real estate at X, Y, Z allocation division, whether it be the investment division, insurance company or more broadly? Or is it somebody that's thinking about exposure to real estate through structured securities, which obviously played a huge role pre-GFC and then saw some changes post-GFC?

And so what we're finding is some of that is evolving. You have the people that very clearly think about anything in the credit side of the equation from a real asset perspective as an extension of the work they do. They're still thinking about the same fundamentals on an ongoing basis. An asset that I plan to own, I still want to understand how high high-quality an asset that is, even if I'm going to lend against it. Maybe that little wrinkle becomes doing the work on the sponsors and who's actually doing the borrowing if you're not owning it, obviously that adds a little bit of a wrinkle. But what I think we're finding is they're used to credit real estate debt, infrastructure debt. It used to be this tweener asset class and depending on who you spoke to, it was maybe fixed income, maybe sat with the investment teams that are focused on the actual equity asset opportunities as well.

I think increasingly we're seeing that there's a lot more focus, given what we're seeing in the markets right now. I know we're going to probably touch on that a little bit, but that the folks that actually understand the assets themselves are where we're having the preponderance of our conversations about where the opportunities exist. And it really is, because some of these opportunities are getting flipped on their heads, you think about investing in an industrial building, those cap rates were so tight for so long. They've widened out a little bit, but you're still in a spot where if you're going to go buy a new or build a new industrial building, you're still probably targeting mid to high single digits from a return perspective to be the equity owner. Where you might be able to invest up the stack in some mezzanine debt or some pref equity on some of those deals, where you're going to make a significant amount more, and that dynamic is new to the marketplace. And so we are starting to see a little bit more of that real asset focus and real asset experience be shifted to think about the relative value opportunities up and down the capital stack.

Stewart: That's really helpful, thank you. And so when we think about historical performance of real asset debt, both real estate and infrastructure and the fundamentals of those markets, what can you tell us about that?

Matt: I think that probably dovetails a little bit onto what we were just talking about before. The ways that you could access some of these real asset opportunities were either through securitizations, specifically with real estate pre-GFC, and it just became part of the Ag Index in a lot of ways. You got your exposure to the commercial mortgage market through some exposures, up in quality there. But if you really started to, take real estate as an example, really started to pull out historical return performance information, we did a study very recently where we just looked at the last 13 years, 2010 and beyond, which gives you the sense for post-GFC normalization. Obviously some dips through that time period, but real estate debt, both core and high yield, have a meaningful impact on portfolios from either you're going to get comparable returns or pickup from investment grid corporate bonds with less volatility or comparable returns with significantly less volatility. And as you move up into the high yield space, it's been even more pronounced to a couple hundred basis points from a standard deviation perspective and volatility and return enhancement.

And you're doing it in a way that is also, in most instances, additive from a diversification perspective, because correlations with real estate debt or real asset credit have been pretty substantial in terms of their ability to enhance efficiency in an MPT sense. And I think infrastructure debt is follows the same thesis there where you're effectively saying, "Hey, we have these credit instruments, look largely like other credit instruments, but the financing is on an asset that is critically important to the operation of the economy." If you look historically at default recovery rates, if you can get paid the same on an infrastructure asset or paid a little bit more, because there's liquidity, give up, and the default recovery experience is significantly better, which typically it is. And as you would expect, from an allocation to an infrastructure asset, just again given the importance to the economy, there's really an opportunity to deliver outsized returns and really enhance the benefit in the overall portfolio construction context.

Stewart: That's really helpful. And I heard on a podcast that something on the order of 65% of CRE is financed in regional banks and we know that there's stress there. So can you talk a little bit about trends in alternative real estate financing and that stress that I just discussed and the impact on the real estate debt market? I think that people want to hear; what are you seeing? Because it feels like there's a big shift here and it seems like there's an opportunity.

Matt: Yeah. I assume how you slice the data is probably important when you think about the exact number. But whether it's 50%, whether it's 65%, whether it's slightly higher, whether it's some combination of, depending on the asset type that's being financed, whether it be construction or stabilized or whatever the case may be, definitely regional banks had been playing a very significant role in the financing of these assets. And we're hearing all of this scary talk about the doom loop. Obviously there was some financial institutions that fell victim to a little bit of asset liability mismatch. There's lots of micro reasons that built themselves into the environment we have today. But definitely there has been a pullback. And what's interesting is you look back in history, the regional banks stepped into a vacuum that was created by the CMBS wheels grinding to a halt post-GFC.

So, we've seen this before, where alternative lenders in the sense of you had your large banks that were doing the lending, CMBS was a significant portion of that new loan origination, GFC happens, you have this huge void and the regionals did step into that in a meaningful way. You also had some insurance companies, some real estate debt funds, some other things that picked up the slack. And what we expect to see happen is that those alternative investors, and this is sort of what we talked about in the first question you asked me, there is this growing real estate debt as an alternative asset class feel. And this is just going to, I think, create more opportunities in that sense.

I think one of the things to think about, which is interesting, and again you hear the doom loop and every office loan is a bad loan and the bottom is nowhere near in sight for office in the US, and I don't know that we as a firm fundamentally believe in the doom loop. I think we think that there's going to be some troubled assets, there's going to be some workout, there's going to need to be some creativity in the office space, almost like there was in the retail space when the big-box mall had all that stress. But what we really are finding interesting right now is you're still seeing opportunities to lend that aren't really on a spread basis. If it's a high-quality asset that's owned by a high-quality sponsor and the valuations are fair, you're still getting spreads that were free hiking cycle type. What you might just see is opportunities to lend against assets and investment types that didn't exist prior.

We're seeing a little bit more activity where alternative lenders can step into the industrial space, for example, whereas that was almost a unicorn. People would say, "Oh hey, I love industrial and multifamily." It's our firm call and I think it's been a pretty common real estate firm call for a while. Industrial has just been hard to lend against because there's been so much competition for the paper. Everybody had such confidence in the deals, a lot of assets being invested with cash from some larger obviously real estate funds. But now what's happening is this step back from the banks, this little pause in, I think that's being created by the fear in office, but a little bit of contagion is creating opportunities for alternative lenders to step in, asset managers and the like, insurance companies, and take advantage of opportunities in certain sectors that they hadn't really been able to participate in before.

Stewart: Really helpful. And so, when we think about your business, real asset private debt, can you talk a little bit about the asset opportunity set, what your areas of focus are and where you see relative value?

Matt: One of the things that I think is remarkable that I'm not sure a lot of people fully understand... First of all, we talk about private credit meaning a lot of different things to a lot of people. Infrastructure I think means a lot of different things to a lot of people. I think some people hear the word infrastructure and they immediately think like, "Hey, it means toll roads and airports." And there's other people that understand a little bit more of the nuance and the drill-down layers.

When we think about infrastructure debt and the way our team approaches it, we talk about up to, and I think there's maybe new sectors that come on a regular basis, but we're north of 60 plus sub-sectors that are all very unique and different in the way that the underlying assets behave based on what the demand drivers of whatever's being provided are. So, infrastructure's an interesting one to look at, because when you think about that investment opportunity, Europe was ahead of us, the data over there is a little bit richer, because they've been investing longer, more opportunities as you... I don't know if you've traveled internationally recently, but you're usually flying from an airport that needs some love in the United States to an airport that looks brand new and sparkly, public transport overseas.

So, there is a huge need in the United States right now. So it's not only just that, "Hey, if you can find the assets, they're interesting to invest in." But there's a huge need in the United States for investment in infrastructure. So, the American Academy of Civil Engineers issued a paper and they said, and I think this might even be a couple years old, that there's a gap, a funding gap of what they think is necessary to improve or effectively rightsize five sectors within the infrastructure space that are important to US citizens. So surface transportation, electricity, airports, water and wastewater infrastructure, and inland waterways, and marine ports, a $6.1 trillion need over the course of the next 10 years, with only visibility to $3.5 trillion in funding for those projects. So that's a $2.6 trillion funding gap.

There's a huge need for capital in this space. And people are going to say, "All right, well there's a huge need. Where's it going to come from?" On the come, to back that point right up, we also have, it's dipped a little bit, but at the end of the year last year, and this is because fundraising has slowed a little bit with uncertainty around rates and everybody's waiting to see where the macroeconomic backdrop settles, but at the end of last year, there's over $130 billion of dry powder in infrastructure oriented private equity funds in the United States. So, there's a ton of money there if you think about the way that the capitalization of those projects would work, even if you assumed the conservative 50% LTV, you're talking about $250 to $300 billion of capital that is ready to go. And a significant portion of that is the debt capital stack.

For us, we think there's a huge opportunity given that there is a need first and foremost. It's not like we're going to be shaking the trees trying to figure out who wants to do infrastructure projects. And there's a bunch of capital that's lined up and ready to go on the equity side. So we continue to be pretty bullish on this opportunity for investors to deploy capital in the debt space. And then I think at that point it's just a question of; how do you think about infrastructure debt as a component of your overall asset allocation? Where are you going to get those exposures? Are you going to get them in your liquid portfolio? Are you going to try to get them in your private portfolio? Access, et cetera. But at the end of the day, we think huge opportunity based on the need. The equity capital's already lined up. Yes, fundraising has slowed, but we expect it to pick back up once there's a little bit more certainty on what the future holds relative to rates, et cetera. So, we're pretty bullish on the infra opportunity.

And then when you think about the real estate opportunity, the question I think is less about; will there be opportunities to invest? And more about; what are the right levels? And how do you think about the opportunity and when do you enter? Another pretty staggering number is $900 billion of refinancings that are coming due. Maybe you've heard about this refi wall, it was two years out maybe a couple months ago. So it's coming closer and closer. A significant portion of that refi wall is, it's opportunities to lenders or borrowers that needed a refi in the middle of COVID. Maybe those things get kicked down the road and you're getting to a situation where a lot of it is stacked up and there's going to need to be some people that will step in with capital and be willing to support some of these projects.

I guess on both sides of the equation, we don't feel like there's any shortage of opportunity and it's really making sure that, you had mentioned still at the top of the call, everybody's risk appetites are different and where do you want to play? How much capital do you have to deploy? How does it fit in with the rest of the portfolio? But definitely, ample opportunity to invest in both of these spaces and high-quality assets over the course of the next couple of years.

Stewart: That's terrific. That's great insight. And so can you talk a little bit about your approaches to assessing the investment opportunities? I realize that some of your process is proprietary, but just to the extent that you can.

Matt: Yeah. Like I said, it's in our DNA, that where does this land? Are they fixed income instruments? Are they real asset investments? Just where you're talking about relative value in the capital stack, and that's really where we've landed. We think that our approach to assessing each opportunity comes from, first and foremost, the assets themselves and understanding the assets inside and out and doing everything in our power, so that we can understand exactly how those assets will perform in any given market environment. And obviously, nobody's got a crystal ball and there's black swan events and sometimes markets move faster than you expect them to. And from an infrastructure perspective, there's lots of regulatory considerations and regulations change, but we are really usually coming at it from the standpoint of a practitioner in the space of operating the real asset. And then how do you think about lending against those assets based on that?

I think one of the things that, and I think more specifically potentially even for insurance companies when we were chitchatting before we started here, Stew, is how do you really access some of these opportunities? The infrastructure debt space I think for a long time had been really, as it related to insurance capital, had really been the large upper mega cap space, huge balance sheets that had a significant amount of capital that they could take the illiquidity premium that were associated with investment grade private placements in the infrastructure debt space. So much so that it's almost more of an asset liability matching exercise, a diversification exercise. "Hey, if 65% to 90% of our portfolio is in credit of some kind and a significant amount of corporate credit, what ways can we think about to diversify that risk?" And I think infra does a great job at that.

But you were still talking about a certain small subset of investors that could access the opportunity and that were doing it for reasons that were maybe not the same reasons that some of the smaller insurance companies would consider doing it. We actually believe that in the infrastructure debt space, there's better relative value in the sub investment grade portion of the market. And some people might say, "Well, that's a very small portion, specifically in the private space." But what you'll find is if you look at the traditional leverage loan index in the US, some significant portion of it, 35%, 40%, will actually be insurance infrastructure and infrastructure oriented. And so the way we've gone about accessing that opportunity…

So I think first and foremost, insurance companies should think to themselves like, "Hey, do I have a bank loan portfolio that uses the leveraged loan index and maybe even some high yield bonds?" And start to think about a comprehensive holistic view to where do I have infrastructure in my portfolio already? But then that follow on is... We've come up with a way, because we were focused on the sub investment grid side to really try to identify those pockets of that market that were the best assets, that are liquid, and then come up with a wrapper that allowed people to, specifically insurance companies, actually at the request of an insurance company way back in the day, to create rated entry points that make it a little bit more efficient.

And I know there's lots of conversation around structured credit and some of the consideration that regulators are giving CLOs and the like. Really the focus of what we're trying to do is not for a capital arbitrage play, it's really just to create flexibility. We're not trying to eliminate any RBC capital, RBC impact to an investment in some of these sub investment grade opportunities. We're just trying to create flexibility into the way that you actually could invest different rated entry points, et cetera. So, I think for a lot of folks, specifically on the smaller end, maybe these larger lumpier investments are harder to access. We think better relative value in sub investment grade. And if there's ways to find opportunities to invest that make the bite size a little bit more manageable, allow you to diversify over time is the best approach.

Stewart: Yeah. And it's always challenging for an insurance company that's not a mega to get access to, efficient access to, the kinds of return profiles that some of the mega balance sheets have. And it allows them to stay competitive, price competitive and competitive in the market. It's just a fact, an economic fact. So, that makes really good sense and appreciate you talking about the ability to access this asset class in an efficient way. I have learned a lot today. I've got two questions for you on the way out the door. These are the fun ones. Some people have chosen to only answer one, but I know that you're not going to do that.

Matt: A challenge. Here's a challenge.

Stewart: Yeah, this is good. So the first one, you can answer either one or both, but it's free optionality, Matt, what more can you ask for in this business?

Matt: Love optionality.

Stewart: The first one is; what's the best piece of advice you've ever gotten? And the second one is; who would you most like to have lunch with, alive or dead?

Matt: I guess I'm going to apologize in advance for being sentimental here, but my father recently passed. He was a very important figure in my life and our family's lives, and it was just at the tail end of last year, so not quite a year out. So, I think I'm going to honor him in both answers. I'll take the second one first and say, if I could have lunch with him tomorrow, I would certainly love to do that for obvious reasons. And then the best piece of advice he ever gave me was the KISS principle: keep it simple, stupid. At the end of the day, I think you keep yourself out of trouble more often than not if you can just keep it simple.

Stewart: That's great. I'm sorry to hear about your dad, but I'm glad that he was such an important figure in your life too. We've been joined today by Matt Addesa, Private Market Specialist at DWS. Matt, thanks for being on. Thanks for taking the time.

Matt: All right. Thanks so much Stew.

Stewart: Our pleasure. Thanks for listening. If you like us, please rate us, review us on Apple Podcast, Spotify, or wherever you get your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast.