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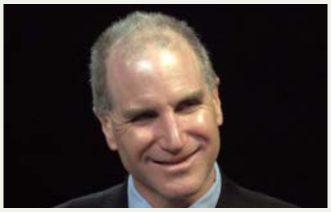
VIDEO SERIES

Briefing

New Rules of Dealmaking

Three experts talk sourcing and underwriting in today's competitive markets, and what makes a successful transaction



Stephen Coyle
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Stuart Taub
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Gary Rufrano
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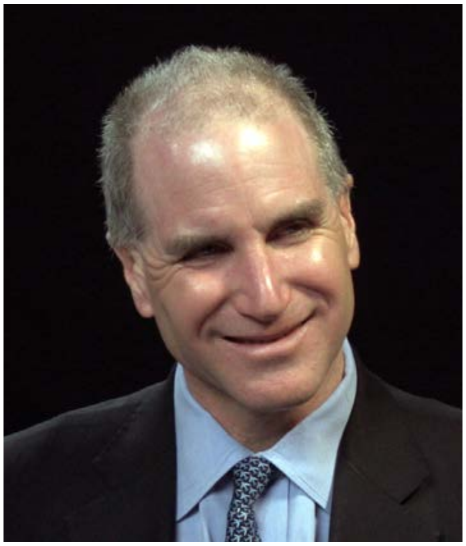
The New Rules of Real Estate Dealmaking

Key Findings

1. There's no such thing as an off-market deal
2. Relationships are more critical than ever
3. Capital markets will challenge future deal flow
4. When underwriting, focus on tenant quality
5. Have realistic rental growth assumptions

The Panelists



Stephen Coyle
Senior Vice President and Portfolio Manager
Bentall Kennedy

Stuart Taub
Partner and Northeast Regional Leader
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Gary Rufrano
Director of Acquisitions
Clarion Partners

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1 THERE'S NO SUCH THING AS AN OFF-MARKET DEAL

Unprecedented volumes of capital are flowing into U.S. commercial real estate markets, presenting great opportunities to be a seller as well as a buyer.

However, when it comes to sourcing deals, there are consequences of the intense competition for assets and rising property valuations. "Almost everything is widely competed," says Stephen Coyle, senior vice president and portfolio manager at Bentall Kennedy. "There is no such thing, or almost no such thing, as an off-market deal."

As a result, acquisition teams need to get an edge over rivals by ensuring they understand the detailed nuances of prospective deals and—where possible—get early information regarding deals that might come to the market.

Clarion Partners' director of acquisitions, Gary Rufrano, argues that a "deal is something" to someone and that, by putting in the time and due diligence to understand small details and potential strategies that can drive returns, an acquisition professional can use that intelligence to be more competitive on pricing.

For Stuart Taub, a partner and Northeast regional leader at RSM, being early to a deal is critical in providing an edge in today's property markets. Whether that sourcing is done through an internal acquisition team or through operating partners, he says that it's not just about drilling down into the economics of an asset, but also about "looking at the people that are going to be helping you possibly reposition that asset."

Coyle agrees on getting into a deal as early as possible. "A lot of times, even if you find an off-market deal, it becomes very quickly not off-market," he says. "But getting that early look and being able to do more of that homework up front before...that advantage, when you then go in to underwrite something, often helps dramatically."

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2 RELATIONSHIPS ARE MORE CRITICAL THAN EVER

Never has there been a greater onus on the quality, and depth, of relationships within commercial real estate than in the current competitive landscape.

In an effort to stay ahead of market deal flow, it's critical to go deeper and broader with your industry relationships, whether that's done through operating partner networks, brokers, advisers, friends, or family.

However, knowing exactly who your partners are, and the culture of their organization, is vital.

A Time for Experienced Judgment

Stuart Taub
RSM

When it comes to underwriting a deal, acquisition professionals have to be confident in their assumptions. Every potential transaction—rental growth projections and leasing strategies, local comparisons and discounted cash flow analyses—requires intensive due diligence. But what it also requires is experienced judgment, says Stuart Taub of RSM.

In a highly competitive market, some aggression with assumptions will be required to win a deal, he says, noting that the highest bid typically secures the property. "I think financial rewards tend to drive all," Taub adds.

However, the current competitive environment also requires having the experience to make a judgment call on exit returns. "If you're a buyer in the deal, you're going to have to maybe be somewhat aggressive," Taub says. "I know a lot of our clients aren't really factoring large rental growth, they're really looking at the leases in place, possibly what they can do to repurpose the property."

He advises "kick[ing] the tires on [your] modeling, make sure that [your] assumptions are sound, but at some point you get to the point where you may have to make a judgment of what spread you may have to put in to win a particular deal."

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A Diverse Buyer Pool

Gary Rufrano
Clarion Partners

Having acquired and sold more than $6.5B of assets across the U.S. in 2014, Clarion Partners has a keen sense of the makeup of the buyer pool for commercial real estate. And it remains exceptionally diverse, even given the significant increase in foreign capital flows into the U.S. over the past 12 months.

"One surprising aspect is there's no one most active buyer," Rufrano says. Although Clarion has worked with some foreign investors on recapitalizing existing deals on a 49 percent to 51 percent basis, Rufrano says foreign LPs and high-net-worth investors have been most active in major markets across the U.S., particularly Boston, New York, and San Francisco.

Investors targeting core Class A assets are often being driven by a desire to preserve capital, he says. "And when you're bidding against somebody who simply says, 'I need the best location, and I want it to yield a few percentage points,' we aren't going to be a buyer of that." On the flip side, Rufrano notes selling to investors with low return requirements means rethinking exit strategies. "You'll rethink your whole strategy when somebody says I'll pay you a lot more than you think it's worth."

"A lot of times people think they're going to co-invest or get into deals together and really just rely on the financials and looking at how maybe the financial interests align," says Taub. "It's got to go deeper than that."

He adds that you are developing a long-term relationship and want to know that when things go bad, you're still going to have that strong relationship going forward, "because every deal isn't a home run."

That additional relationship due diligence should also include an understanding of a partner's own networks, Taub says. He gives an example of a mid-Atlantic client developing a medical complex who needed to understand how to navigate state and municipal authorities and asks, "How do you find the right operating partners that are going to help you navigate through some of those channels?"

3 CAPITAL MARKETS WILL CHALLENGE FUTURE DEAL FLOW

Deal flow is on a tear, with U.S. transaction volume in 2014 matching 2007 peak levels, according to data provider Real Capital Analytics.

Yet the pace of acquisitions and dispositions in the U.S. could slow in the near future, thanks to the very same capital flows that are fueling growth.

For Coyle, part of the challenge is the fact that a significant number of assets have already traded, sometimes multiple times, over the past three to four years—and as such, he says, there will probably be a slowing of those assets returning to the marketplace.

One possible driver of that expected decline in deal flow is the challenge of capital redeployment, says Rufrano. "I do think there will be great investments, but several of these other transactions that have been acquired over the last 12 to 18 months are generational holders. People see that and therefore maybe change their buy-sell recommendations, considering they don't know what else they're going to redeploy into."

This situation is forcing LPs and GPs to be more focused in their acquisition strategies, with a push towards urban markets being targeted by millennials, Taub says. "You see a lot of the foreign capital, the institutional money, focused on the cities. The millennials are going to have a huge impact going forward."

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4 WHEN UNDERWRITING, FOCUS ON TENANT QUALITY

In underwriting deals, historical rent prices, performance, and local market comparisons remain key. But if the financial crisis has proven anything, it's that a good-credit tenant today isn't necessarily one tomorrow, Rufrano says.

As a result, Taub says, managers are paying greater attention and doing more due diligence around the tenants they lease space to. "Tenant quality is a huge issue," he says, noting that when it comes to multifamily assets, tenant quality is often less of a focus. "[People] tend to treat it as a homogeneous population, but if you move up the scale overall with your residential tenant populations, that's going to have some impact on lowering costs in those properties."

Rufrano agrees that there is much more attention paid to tenant quality, not least in areas outside high-demand urban centers where vacancy is typically easier to fill. He also notes that buying a building because of a high-quality sitting tenant can impact pricing. "Basis becomes increasingly important. Buying an asset because of tenant credit might be 1.5 times the cost per foot that you'd get for a multi-tenanted building."

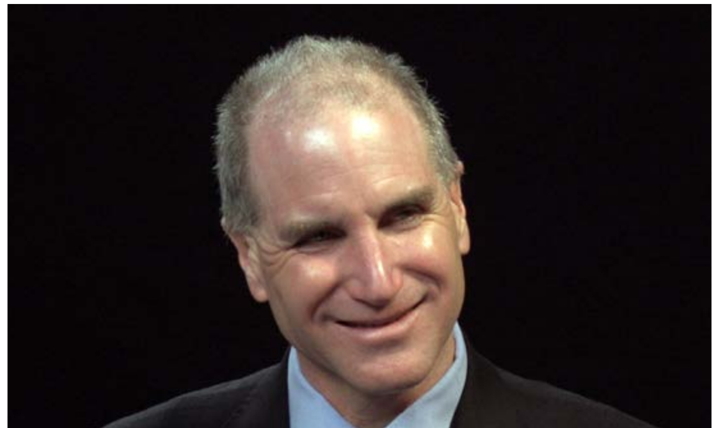
5 HAVE REALISTIC RENTAL GROWTH ASSUMPTIONS

The pace of rental growth within U.S. commercial real estate markets has been surprising over the past few years. While rising rental revenues will undoubtedly continue amid a recovering economy and job growth, the rate will be much more muted, says Rufrano.

"We still think there's a lot of positive momentum...but it's as if you were going 85 and you slowed down to 65," he says. "So in these major markets, we still see pockets of pretty strong rent growth going forward. I think it's finding those pockets and feeling comfortable about them that potentially wins you an investment over the next person."

Coyle agrees that most of the industry has "tamped down their rent growth projections," although like Rufrano, he says there are "pockets" of real estate markets where people are "still being surprised on the upside about how strong some of these rent increases are."

For Taub, the emergence of new supply, in select markets and property types, could be a critical factor in future rental growth assumptions. "The question is, for deals you're sourcing now, who's going to be willing to look out three, five, seven years and be confident that we're not going to be in a different marketplace?"■



The Importance of Capital Markets

Stephen Coyle
Bentall Kennedy

If there's one lesson learned in the wake of the financial crisis, it's that capital markets can have an overwhelming impact on commercial real estate markets.

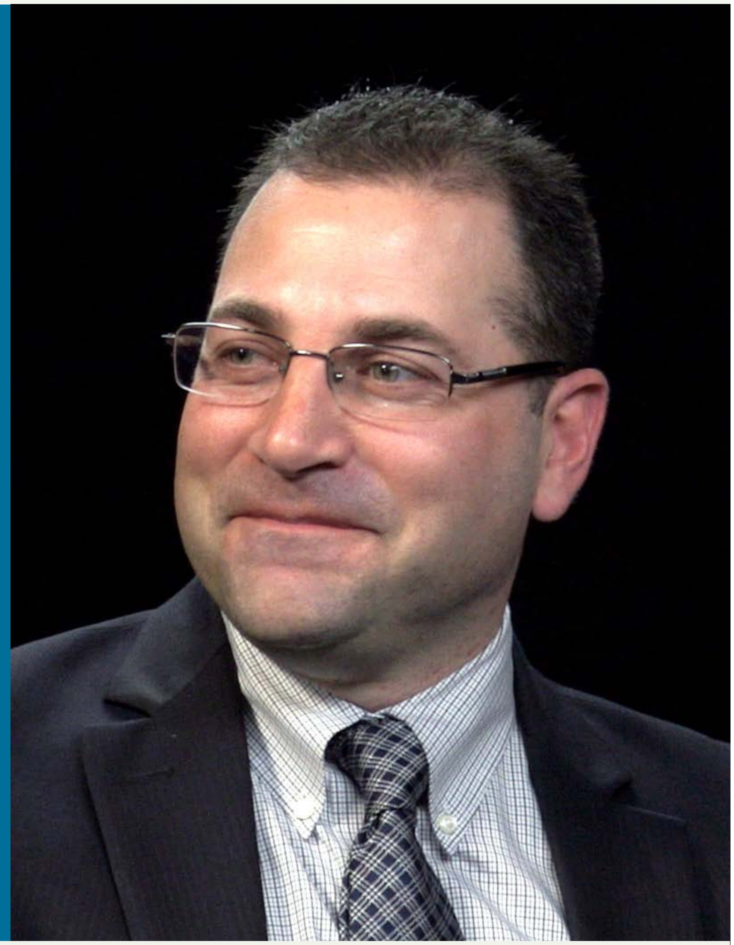
Coyle says real estate professionals often focus much of their attention on the "space markets," or on closely monitoring changes in supply and demand. However, while trends in supply and demand need to be followed, he says that also truly understanding capital markets—and how they're changing—is just as important today, because "the impacts can be tremendous and can overwhelm almost everything else."

"The space markets matter tremendously, but so do the capital markets, and it's something that we often don't spend enough time looking at," Coyle says, adding that when capital markets change "the impacts can be tremendous and overwhelm almost everything.

"And that's why it's a great time to sell, in part because the capital markets are there. It's also a great time to buy, because the capital markets are allowing us to price real estate much more aggressively than they have historically allowed us to."

Expert Q&A

With Stuart Taub
Partner,
Northeast Regional Leader
RSM



Do commercial real estate managers need a better understanding of risk today?

They do a great job taking inventory of their risks, but it really comes down to what comes next. So, nationally, we talk about something like cybersecurity. Clearly, cybersecurity is on the minds of every board, audit committee, and investor, and managers and GPs know that they need to keep track of that. But then the question is, what's the response? Regulatory risks, investor reporting, those are also really key concerns [for GPs]. As we see more of our clients registering with the SEC, there's a focus on investor reporting, disclosure, and risks around not only compliance and reporting but internal risks on how you're operating.

How is the SEC focus on fees and expenses impacting real estate GPs?

There is a lot of latitude taken in disclosures related to fees and expenses. What's helping is some of the standards that are out there to help bring about a meeting of the minds between different organizations as far as how they report. Regulatory bodies in the SEC are going to look for a lot more transparency as far as what comes behind those disclosures and how they're reporting that. But [the standards are] something that need to evolve, and [it] really hasn't come to where there's a meeting of the minds across the entire industry on how to report these types of things.

What advice do you offer GPs when it comes to disclosure and reporting?

One thing that we've been talking to our clients about is a compliance management system. We spoke earlier about identifying all of your risks and inventorying them, but how do you really put that into practice? How do you make sure that you have processes in place to address those risks, and that you have a continual monitoring process? And that's something that I think the regulatory bodies are going to be looking for when they do these examinations. ■

RSM