

**Pramerica's Adler: Shorter RE Cycles in Future
With Eric Adler of Pramerica Real Estate Investors**

Zoe Hughes, PrivcapRE:

I'm joined here today by Eric Adler, CEO of Pramerica Real Estate Investors. Eric, thank you so much for joining me today.

Eric Adler, Pramerica Real Estate Investors:

Thank you.

Hughes:

We talk a lot within commercial real estate about the wave of capital that's impacting our deal flows and our strategies. Yet when we talk about these significant capital flows coming into the market—particularly the major markets—one question I certainly have is, what exactly do we mean by that? Is this hot money that's going to be out at the next sign of any volatility or is this capital that's here to stay for the long term?

Eric, as CEO of Pramerica Real Estate Investors, you have an exceptional view globally of what's going on. Talk to me about cross-border capital flows. What are you seeing on the ground?

Adler:

Yeah, it's a great question. As cycles move along, you always see this wave of capital coming in and out of real estate. But this time, it is a bit different and there are two reasons for that. First, I'll take your point about hot money. I remember the last cycle—you will have the various financial institutions that find that real estate seems like a better value play than some of their classic assets, whether that's hedge funds or private equity firms. But the amount of hedge funds, private equity firms and others I've never heard of before coming in this time is quite surprising, frankly. There's a lot more of it. Some of it sticks. We know some of these players have been through several cycles, but many of them will move on as the cycles move on.

The other big change is the flow of sovereign wealth money and, particularly, some of it coming from the East. This money has been in real estate for a long time in Asia and now, as it's coming west, it's bringing a pragmatism and a flexibility we haven't seen before. And I think much of that is here to stay. These are long-term investors. They do not need leverage, so they probably won't get

burned by that like the last wave of capital came in and got hurt in the last cycle. And they don't necessarily think in terms of pure IRRs. They're ready to have very long hold periods and they're very cash flow. They're ready to work hard at an asset to get that cash flow to build up over time and be a real inflation hedge for them.

Hughes: Obviously, you talk about the appetite of these types of investors—these longer-hold investors—and the sovereign money. We've all been talking about them going to the core markets—the New Yorks and San Franciscos—and we've seen valuations really increase. Are they looking now at secondary, tertiary markets? How exactly are they beginning to look outside that core market?

Adler: Some are thinking very long term and they're saying, "We do want to stick with major markets. We're ready to pay a little more to build a portfolio that'll be bullet-proof over multiple cycles." But other ones are, again, very flexible and very pragmatic. They were all coming in thinking, "I want major markets, stabilized buildings." But as they see the competition revving up for that, they're ready to move to secondary markets and they're clearly ready to move up the risk curve.

Because of that other base of money that's staying in the core markets, a lot of the traditional investors are also being forced to move up the risk curve. So it's creating an interesting dynamic where taking more risk is some of the newcomers, but many of the established players are looking at the major markets thinking that there's a lot of competition and having to go up the risk curve. We're no exception. We're doing the same thing.

Hughes: We are seeing higher valuations, in the core markets particularly, valuations that have gone beyond 2007 peak levels. Does this mean we're now in a new era of compressed returns, higher valuations and higher pricing?

Adler: We've been around for over 40 years, so we've seen cycles come and go. And you hate concepts of new paradigms, so the idea that there's a new normal—I'd say you can't bet on that. You have to expect that cycles will remain part of real estate and that prices will come down. I do think, however, that some of this new money that's here to stay in these major cities is going to make some of these cycles more short. The fact that, at some kind of top of the market, or when interest rates spike up, you're going to have people pull out of real estate temporarily. There's such a backlog

of long-term money looking to own those assets that if you do see cap rates expand, you'll see them compress back to these kinds of levels quickly. So you may be consistently coming back to this...what we're feeling is a high-water mark. I think it's one we're going to be testing regularly.

And if you add another phenomenon, which is urbanization, you're seeing more and more people coming back to these major cities—whether that's the U.S. or Europe. That means there's a possibility that you'll see rents continually come down, but cyclically come back up to new levels. So there's a high likelihood that there will still be cycles. You'll still have to time your entrances and exits, but you may be coming to numbers that we're never going to look back on. These numbers won't look so high in 10 years.

Hughes: It is very difficult in terms of sourcing deals—prices are high for absolutely everybody. You're obviously looking at a lot of the major markets, particularly in North America. How do you overcome the challenges in terms of deal flow and acquiring properties? How are you facing the challenges of today?

Adler: I think our footprint gives us a big advantage—[that] and the amount of experience we've had over many cycles. Because when I look at the business from a global standpoint, I see opportunities and challenges everywhere. But we're in enough different regions and different asset classes and strategies that there are always relatively interesting plays. Others where you have to be ready to walk away from and having a large footprint allows us to be disciplined. If you're very mono-product, you live and die by that product. It takes incredible discipline to say that it's overpriced and you're going to walk away. Whereas I think the way you do it is by being diversified and being able to offer large investors many, many options.

Hughes: You did talk a bit in regard to adding risk. Where does it feel right to actually add risk today?

Adler: Without doubt, in the U.S. right now and Europe—I think a lot of the risk has been added. A lot of high-risk money has come in. That may have been a bit premature, but we think the time is right to be ramping up for that. So we're very much looking at adding risk in Europe. The dynamic between the U.S. and Europe is very different, so there are different reasons for doing it.

Hughes: Where are you most bullish in terms of the U.S.?

Adler:

[In the] U.S., really it's across the board. If I think about what we call the main food group (office), this is a good cyclical time to be in the office market. Again, a lot of this is underpinned by a lack of supply for five, six, seven years. That supply is coming back on market, so the supply side is a concern three, four, five years from now. But demand is so strong, it's still a good time to be buying.

Residential is another big one that people may be concerned about. The multifamily sector was the first one to really take off, and it's true. The supply's been building up for a while, but if you look at new-home creation, it just keeps on going. Again, we're very cautious. There are some areas we're more concerned about regionally, but generally we still think it's a decent time to be buying into the multifamily market because of this incredible amount of new housing formation.

Industrial's the same. There are all kinds of things happening with the internet that mean industrial's really taking off. That's an area where supply has picked up very quickly. So, our sense is that industrial might be a quick cycle. And then, retail hasn't fully taken off, so there's some good value there. You just have to be mindful of which concepts you're betting on. Some concepts were misguided and won't work.

Hughes:

You're a significant player in Europe and Asia and I'd love to get your thoughts. Are you still maintaining that discipline in terms of your strategy? Are you focusing in on few key markets when it comes to Europe and Asia?

Adler:

Yeah, that's a big change for us from the last cycle. Again, we've been in those markets quite a long time—both of them. And, in Europe, I don't think there's a market we haven't invested in at some point in our history. Asia's a bit less of an extreme, but over 10 markets we've invested in. We've cut that down greatly and there are two reasons for that.

In Europe, we definitely are looking at the three big markets for us, which are UK, Germany and France. Also, the other Western European markets—Italy, Spain—have their own dynamics. But those are places we believe we want to have a local presence.

If you're going to be a serious player, you have to decide where you're going to bet enough to be able to build local teams that are sustainable. You have to have a reduced amount of cities.

The other one's liquidity. It's an illiquid asset class. People forget that at the top of every market; there are some markets that look very exciting and a lot of people are talking about, but they're small. So if you buy any kind of meaningful stake there, if the markets turn, you're going to have a hard time getting out of them. Those two criteria—where we want to build that local presence and feel we have an expertise and where we have true liquidity—leads to five or six countries we're going to focus on in Europe. In Asia, it's four or five countries: Japan, Australia and Singapore because we've always had a big presence. And you have to be in China. China's quite a ride, but it's such an important part of the future of the world economy that you have to be there.

Hughes: Talk to me for a minute in regard to the growth prospects, particularly for the UK, France and Germany. It has been anemic, particularly for France and Germany. How do you balance the investments against such anemic growth?

Adler: The first thing to say in Europe and that's the big advantage of Europe (if you think about the U.S., where there were five years of little supply-side growth and now it's starting to pick up) is that here's been no supply-side growth. There's been no building in Europe for six or seven years now. And it's not really taking off. Outside of Central London, there's very little building going on and the economies have adapted to zero growth. [With] 1% growth, there's a bit of a floor under rents. It means this recovery will be slower, not as predictable, but it'll last longer. So we think it's a great time to be looking at Europe again because there's just no supply whatsoever.

Hughes: One thing I do get from what you're saying is that, in this market and this cycle particularly, you really have to be focused and very disciplined in terms of how you approach commercial real estate investing. Does that mean, then, that you foresee perhaps greater volatility over the short to medium term?

Adler: Yeah. It's interesting, because the world feels more volatile. But it's happening, the volatility we're seeing geopolitically, for example—or even economically, if you think of China—is happening at a time where the real estate cycle is very favorable. It takes a lot to knock an early-stage cycle off of its trajectory.

I'm surprised by how little we all talk about what's going on in the world and that prices just keep rising. I do think it's because of the phase we're in now and that'll change.

Hughes: When you look at commercial real estate investing, one important question is, where are we in the cycle? Where are we today?

Adler: On the demand side, I think we're still fairly early in the cycle. But obviously with cap rates being lower, prices (as we mentioned earlier) are quite high. The supply side is building up and I think it's going to build up quite quickly. The market's really taken off. Three years still feel pretty good, but it's going to be very important to start to distinguish, within the next few years, where you're going to be focusing your energies.

This is a great time to be taking risk. A few years from now, it might be time to reduce some of that risk and stick to some of the more gateway cities. It'll be safer within the next few years to focus more on those core assets. Ideally, if you own them, you just want to keep them. It'll continue to be hard to buy new ones. But some of the risk—you're going to want to start reducing within the next few years.

Hughes: As you look at Europe, where are we in the cycle there and particularly for Asia as well?

Adler: Europe is further behind. Obviously, that means we have a further runway to play, particularly when you see the supply side. The demand hasn't totally picked up. So I think there's more room to run Europe. I'd say three years from now, we're still unsatisfied with the strength of the recovery, which is a good thing for long-term investors that want to buy assets over a period of time.

Asia's interesting because it's probably the one that survived the crisis best and just kept rising. A lot of that's on the back of China's strength. As we see China trying to manufacture or create a soft landing, just that bit of air coming out of the Chinese economy is starting to take some of the air out of the real estate markets. Interestingly enough, this is probably that time now to be sticking with really good assets, being careful on risk, but preparing yourself for—a few years from now—taking big risk again. I think Asia's going to be an interesting one. As the U.S. is starting to slow down, Asia's going to be taking off again.

Hughes: How do you actually grow the firm over the next 12 to 24 months?

Adler: There are two answers to that. One is that we have some areas we think are very exciting for the future. Asia is one. We're very well known for our open-ended funds in the U.S. Outside the U.S., it's harder to build those. You don't have a lot of core assets and

markets to choose from. But, in Asia, with all the development that's been going on, I think you will. The idea that there's more open-ended product in Asia is a big push for us.

Building a debt business in the U.S.—debt's very mature, but being able to be more competitive doing whole loans in the U.S. is going to be very important for us and this value-added play in Europe.

If you really want to look for a dark horse place to grow a footprint, I'd say it's Brazil. Brazil's probably the major market that's looking like it has the most volatility. Clearly, whether that's political or economic—but if you really believe that country is going to continue on a path that's it been on for the last 15 years, there's going to be some great opportunities in Brazil a few years from now.

Probably more importantly, because if you look back at cycles, if you want to build your footprint you really have—if you think of a cycle as 10 years, just take an example, you really have two years out of those 10. It's the two years at the bottom, after you've come out of a downturn. And the players who treated their investors right, who did the right things to reduce risk coming into that downturn, are the big winners of the next cycle.

The real thing we're doing is just making sure we're making good investment decisions for our clients and treating them the way they should be treated with transparency, communication and focusing very much on risk. The question you asked before is key to our minds. A few years from now, when are we going to start pulling back in the U.S.? Because that's how you grow your footprint. The winners out of that, handling the downturns, are the ones that have a great trend in the next cycle.