PrivcapRE/Presents

A Conversation With
Jason Kern
LaSalle Investment Management

With insights from:

McGladrey
Featured Charity:
International Red Cross

About Privcap Media

Privcap is a digital media company that produces events and digital thought-leadership content for the global private capital and private real estate markets. Privcap Media offers communications services to market participants.

Privcap is known for its authoritative online video programs and digital reports. Since its launch in September 2011, Privcap has produced dozens of focused reports and about 800 video programs—mostly in-depth interviews and panel discussions with private investment experts. In the private equity and private real estate markets, Privcap's audience has grown to about 8,000 unique visitors each month—a mix of institutional limited partners, general partners, high-net-worth investors, and service providers. Each week, Privcap and its sister site, PrivcapRE, release and promote new content.

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If you are a GP or LP and would like to request an invitation to a future Privcap Presents gathering, please email events@privcap.com

If you are a service provider interested in being a sponsor of a future event and report, please contact Gill Torren at gtorren@privcap.com

About PrivcapRE Presents

PrivcapRE Presents is a series of invitation-only networking events designed to bring together GPs, LPs, and other guests. The events are organized by Privcap Media and hosted in partnership with leading professional service providers.

Each PrivcapRE Presents event begins with an intimate onstage interview with a notable leader from the private real estate industry. A transcript of that interview is used as the basis for a digital report (like the one you're reading now) that is made available to Privcap's global audience. Also included in PrivcapRE Presents reports are perspectives from the event partners, including a nonprofit selected by the featured interviewee.

Be *Creative* in Finding Deals, **But Don't Chase Yields**

At the PrivcapRE Presents event on May 28 in Chicago, PrivcapRE editor Zoe Hughes spoke with Jason Kern, CEO of the Americas at LaSalle Investment Management, about the weight of foreign capital targeting U.S. property markets and how investors and managers need to avoid chasing yields into lower-quality markets.

Jason Kern,
LaSalle Investment Management

PrivcapRE: How does the world of real estate investing look from the Americas, Jason? Are we in a new paradigm for commercial real estate?

Jason Kern, LaSalle Investment Management: In a certain sense, yes, the world is shrinking. The majority of the capital LaSalle is investing around the world today has some form of cross-border connection. There was quite a lot of capital coming from abroad in 2006 and 2007 leading up to the global financial crisis, and we have recently seen a big surge. Whereas we typically see about 10 percent of the investing activity that happens in commercial real estate in the U.S. coming from sources abroad, the first quarter this year was about 30 percent—that's a big jump. A lot of that is coming from Europe and a lot from Asia— particularly China.

What are those investors buying and what's that doing to pricing?

Kern: Well, it generates a lot of press when a Chinese insurance company that not many people in the U.S. have heard of buys a famous New York hotel. But statistically, does that really drive pricing in commercial real estate in the U.S.? There are apparently $300B to $350B of real estate transactions annually in the U.S., so some one-off deals from high-profile foreign capital sources are not necessarily changing the pricing dynamic.

There's a stereotype that foreign investors will go into core property in gateway cities at cap rates that would probably scare most traditional U.S. investors. What are you actually seeing on the ground?

Kern: There are a lot of different types of foreign capital. A lot of Chinese developers are doing only development deals; they're not looking for core at all, they're looking to build it rather than buy it. Even for the core capital that we bring into the U.S., we often find that the investors have an outdated or unrealistic expectation of returns. Not that they're willing to pay unreasonably low yields, it's that they're expecting higher yields than the market will bear, and thus often are unsuccessful in getting their investment dollars put to work.

How do you manage those expectations of returns?

Kern: We turn down business if we don't feel confident that we can execute on the returns that they are looking for. As good fiduciaries and with an owner's mentality we co-invest in most of our deals, the transaction has to make sense and we have to believe we're getting the right return for the risk that we're taking, regardless of where the capital is coming from.

LaSalle's U.S. portfolio is 70 percent core and 30 percent value-added and opportunistic at the moment. Do you expect that portfolio construction profile to continue?

Kern: That's the profile today. Over the last two years, we've done about 50 percent of our acquisition activity

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Attendees networking at the PrivcapRE Presents event, featuring LaSalle's Jason Kern

in core deals, and 50 percent has been higher up the risk spectrum. Also, our dispositions have been skewed towards closed-end, value-add and opportunistic vehicles, with a buy, fix, and sell strategy, while our investments tend to be in open-ended funds or separate accounts that hold very high quality assets for the long term.

Given the weight of the capital that's come into the core market over the last few years, do you have to change your definition of core in order to find deals in 2015?

Kern: No, you don't change the definition of core. We've seen that movie before, and we didn't like that movie. The biggest lesson learned in the crisis was the risk of chasing yield by going to tertiary markets when pricing gets full. Assets like those are exactly the assets where liquidity dries up quickly and you find that there is really no institutional capital to buy it from you when the music stops.

What we are trying to do is be as creative as possible in a very fully priced market [in order] to get core assets. We'll take some risks that we hadn't previously, but always with the end game of owning in the long term a high-quality asset in a top market. For example, we'll buy on a pre-sale basis a multifamily development that still has some leasing left to do. So we're taking leasing risk, but you're able to observe that market, it's the right product and the pace of leasing is good. Or we'll get creative with transaction structuring or accelerate due diligence in order to weed out some competition. You have to be smart about it though¬¬––if you're getting no premium for taking that additional risk, then why do it?

Considering the need to find smarter risks to generate yield in the core market, what amount of cap rate expansion are you assuming in your underwriting?

Kern: We're underwriting between 50 and 100 basis points of cap rate expansion, depending on the property type, the market, and the hold period.

What kind of hold period are we talking about?

Kern: Typically five to seven years. The exception would be if you're doing a merchant build over two or three years. But I worry that some of our

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competition is assuming much more aggressive exit cap rates, and that's how they're getting to their pricing and beating us on some of these deals.

So how many years do we have before we start to see some form of a correction, or are we already seeing it?

Kern: We split the cycle into three main components: the economic cycle, the real estate fundamental cycle, and the capital market cycle. In the economic cycle, we're in the middle innings at best. We've had a very slow recovery, and the jobs data would moderate that employment growth will eventually be followed wage growth. Real estate fundamentals are also in very good equilibrium. A bit further along, maybe we're in the sixth inning, but the supply-demand balance is still very healthy. I'm sure you've seen the stats that supply coming online in every major property type (with the possible exception of multi-family) is still below 10- or 20-year trends. Where we start to get concerned is the third cycle, the capital market cycle.

We're easily in the seventh inning stretch, if we haven't already stretched and sat back in our seats for the start of the eighth inning. It's just the wave of capital coming in from every source, domestic and foreign, that you can name. And that's why I say the one thing I worry about is that some are not using the proper underwriting criteria and are fooling themselves into assuming heroic leasing results or flat cap rates. That's not realistic given where we are.

"The biggest lesson learned in the crisis was the risk of chasing yield by going to tertiary markets when pricing gets full. You find that there is really no institutional capital to buy it from you when the music stops."

– Jason Kern,
LaSalle Investment Management

Zoe Hughes interviews LaSalle's CEO of the Americas, Jason Kern, at the May PrivcapRE Presents event

Where is the next growth opportunity for LaSalle?

Kern: Our business has really been predicated on the domestic defined benefit pension plan monies that started LaSalle 35 years ago, but if you're starting a new business today you probably wouldn't pick that as the horse that you would tie your buggy to. That's not a growing pot of money. The way people save for retirement in the U.S. is dramatically changing, and it's going to come through 401k plans, target date funds, and self-directed accounts, so we've created a non-traded, daily NAV REIT that raises capital strictly from individuals. Once we've raised capital, we're great at getting it invested in institutional-quality real estate. It's fantastic for us to [be able to] bring the institutional-quality management that we've given to the most sophisticated, big investors in the world to individuals. ■

Expert Q&A

With Stuart Taub
Partner
Northeast Regional Leader
McGladrey

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

I think they do a great job inventorying their risks, but it really comes down to what comes next. So nationally, we talk about something like cyber security. So clearly cybersecurity is on every board, audit committee, investor's minds, and I think managers and GPs know that they need to keep track of that. But then the question is, well what's the response? I think regulatory risks, investor reporting, those are also really key concerns [for GPs]. I think 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?

I think there is a lot of latitude taken in disclosures related to fees and expenses. I think 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. I think 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 a head 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 CMS, which is really 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. ■

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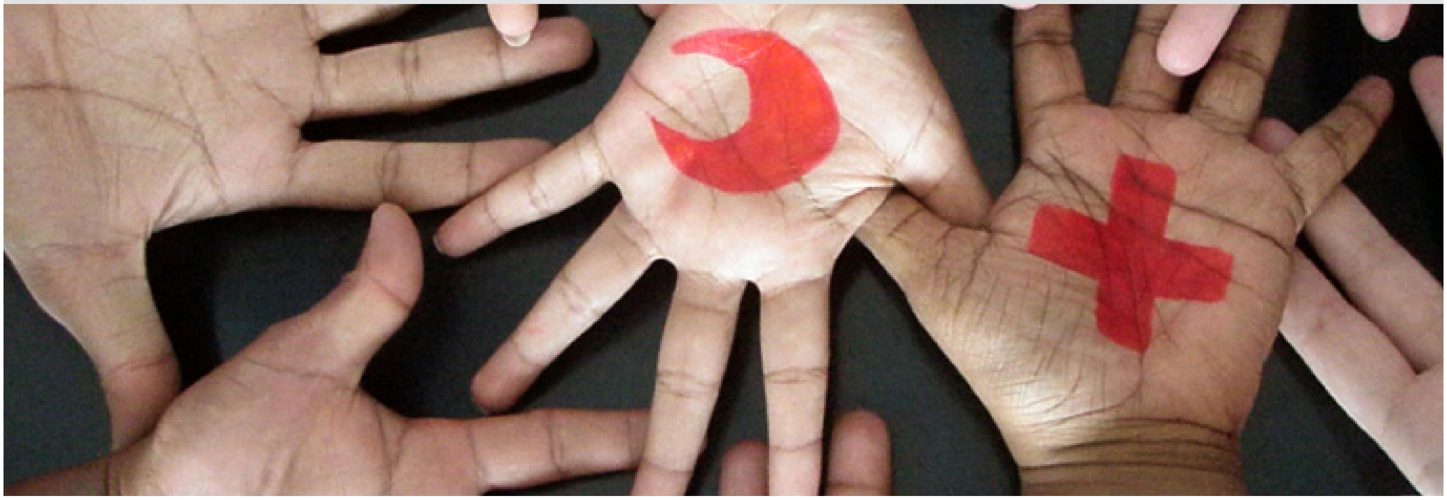
McGladrey



American Red Cross

There's a lot of really good work, and fundraising, that goes on in this industry. You've chosen to highlight the work of the Red Cross—in particular, its Nepal earthquake fund. Why is this important to you?

Jason Kern, LaSalle: I think the Red Cross, which I've given money and blood to for years, is a fantastic organization. All of us sometimes feel we give to charities but wonder how the money is being put to work, how much is actually getting to the people in need. The sort of disaster relief that comes up unexpectedly is very near and dear to my heart and gets me energized, because it is a very immediate and tangible way to help people who are truly in need. I have confidence that the Red Cross has boots on the ground in Nepal helping out in the relief effort.

According to the U.S. Chamber of Commerce, businesses in this country donated only $28M to earthquake relief in Nepal—a small amount when you consider the scale of the disaster.

Kern: That's clearly insufficient. The estimated economic impact of the earthquake could be as much as $10B, which is about half of the annual GDP of Nepal. It's only a country of 30M people, and there are 3.5M people in Nepal who are hungry or need food or assistance in some way as a result of this disaster. In terms of awareness, in real estate we're a little bit more globally minded.

Why not just donate to something closer to home?

Kern: We're a global firm, and I've spent about half of my career living and working abroad in several countries in Europe and Asia. I've spent a lot of time in less privileged places like India, China, Cambodia, Vietnam and Thailand, and when you have that perspective you see that we are very, very fortunate here in the United States. ■