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Investment Excellence in a Transformed Real Estate Market

A compendium of institutional real estate thought leadership

In Partnership with

Richard Edelheit
Partner,
National Real Estate
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RSM US

Real Estate Deals for the Disciplined

The markets are awash in capital again. This scenario seemed unthinkable during the lean years of the global financial crisis, but this influx of capital is driving an impressive real estate recovery and another year of strong growth. Transaction volumes are nearing pre-crisis highs as foreign capital is flowing in from Asia and Europe.

Real estate investment trusts (REITs), private equity firms and pension funds are pouring cash into a wide range of assets. Indeed, deal flow is expected to rise about 11 percent from 2014 to $470B in 2015—the highest level of transactions since 2007—according to the Urban Land Institute Real Estate Consensus Forecast.

The outlook for investors seeking debt also remains positive. The U.S. commercial mortgage-backed securities market volume is expected to rise to at least $100B this year, up from $94B in 2014, according to the Commercial Mortgage Lender. And debt is still comparatively inexpensive.

Against this backdrop, megadeals have been staggering in scope. The flood of available capital has opened doors for many real estate investors. Yet decades of experience in the real estate industry have taught us that markets can and do change on a dime. Patience is the watchword: Investors will be better positioned to realize profits if they stay true to their underwriting standards and take the time to protect themselves from future volatility.

In an increasingly competitive market, real estate transactions require experienced professionals who understand a fund's strategic needs and can provide on-point recommendations to ensure that their investments are successful. That's why we think that you will find this Investment Excellence Compendium to be a valuable resource to your organization.

The executives profiled in the following pages share their advice, solutions and unique perspectives on today's real estate investment life cycle on topics including sourcing transactions, due diligence, deal structuring, and ongoing property ownership and management.

We believe you will find their insights informative and useful.

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Striving for Investment Excellence

Zoe Hughes
Editor,
PrivcapRE

Welcome to the *Investment Excellence in a Transformed Market* publication. In a world of unprecedented cross-border capital flows and rising valuations, it has become increasingly important for institutional real estate investors to ensure investment excellence from all of their partners. Including sourcing, underwriting, and structuring, there is no aspect of a commercial real estate deal that isn't facing greater scrutiny today.

This report, produced in partnership with RSM, taps into PrivcapRE's extensive network of experts who provide comprehensive intelligence on the issues facing dealmakers, investors, and advisors as they confront the challenge of finding relative value in highly competitive global property markets.

Among the insights, experts from Zurich Alternative Asset Management, Prudential Real Estate Investors, and Dune Real Estate Partners discuss the risks they're willing to take today; a professional from Clarion Partners explains why it's good to be an active core player; and portfolio managers from New Mexico Educational Retirement Board and the State of Oregon Treasury talk about how they structure their portfolios for dynamic investing.

For more thought leadership from the world of institutional private real estate investment, be sure to watch out for PrivcapRE's ongoing coverage. Enjoy the report.

ZHughes

Zoe Hughes

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Sourcing

4 Rules for Dealmaking

Experts from Bentall Kennedy, Clarion Partners, and RSM talk sourcing, underwriting, and what makes a successful transaction

RULE #1
There's No Such Thing as Off-Market Deals

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 from 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, acquisitions teams need to get an edge over their 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 USA, 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 who 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…that advantage, when you then go in to underwrite something, often helps dramatically."

RULE #2
Relationships Are More Critical Than Ever

Never has there been a greater focus 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, advisors, friends, or family. However, knowing exactly who your partners are, and the culture of their organization, is vital.

"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?"

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RULE #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."

RULE #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." ■

Selling When the Job Is Done

Sustained capital flows into U.S. real estate mean it's a good time to sell—but only when GPs have done their job, says Carlyle's Rob Stuckey

Property prices in core markets may be exceeding peak levels, but The Carlyle Group's head of U.S. real estate, Rob Stuckey, argues that income-producing real estate still affords attractive risk-adjusted returns for investors.

"Think about the total return. The risk premium is still wide by any historical measure," says Stuckey, comparing real estate returns with the risk-free reference rate.

That means for value-added and opportunistic managers, it's a good time to sell when their jobs are done. "We work to deliver premium returns for our investors, and we do that through the arbitrage between core and non-core real estate—taking non-core property, spending cap-ex, leasing it, and selling it to a deep-core investor," Stuckey says.

In 2014, Carlyle exited almost 30 deals in the U.S., according to data provider Real Capital Analytics (RCA), including the $120M sale of 920 Broadway in New York, acquired in February 2013, in a joint venture with operating partner ClearRock Properties, for $58.5M. After more than $10M of equity investment in the property, RCA data shows Carlyle and ClearRock sold the property for $1,113 per square foot—a record for the area, according to the New York Post.

Explaining Carlyle's philosophy in today's globalized property markets, Stuckey says the firm's continued focus is on "underpriced fundamentals," particularly in traditional prime markets being driven by demographics and job growth.

And it is this granular focus on demographics and job growth that is shaping Carlyle's equity deployment going forward, which historically has been approximately $900M a year. As part of that focus on the millennials and baby boomers, Carlyle is currently developing 88 condominium apartments in Long Island City, Queens, as well as a 157-unit apartment building, including affordable housing units and retail space, in downtown Brooklyn.

"Demographic shifts have resulted in very different real estate needs, and that's true whether you are talking about apartments for millennials or senior living for baby boomers," says Stuckey. "Are we seeing different demographic dynamics than before? The answer is yes, and [that's why] it's important to pay attention to demographics."

The slow pace of job growth, however, has presented challenges for the real estate industry, and as Stuckey explains, the protracted recovery in the labor market has made the post-financial-crisis recovery "much different than any other cycle."

As a result, it is incumbent on real estate managers and investors to always be mindful of when the cycle may turn, says Stuckey. "I think there's more runway [in the current real estate cycle]. But it's not a question of if we'll have another recession, but when. The longer we wait for the next one, the more severe it will be." ■

Multifamily Outlook Best in a Generation

Carmel Real Estate Partners CEO Ron Zeff talks about closing the firm's fifth fund at $1B, the risks in multifamily investing, and why the sector is still a great bet

PrivcapRE: Given Carmel's longevity in investing in multifamily, how have you seen the sector change?

Ron Zeff, Carmel Real Estate Partners: The current supply-demand dynamics for rental housing in the U.S.—and the outlook—are both better than they were for most of my career. Prior to the Great Recession, from the mid-1990s to 2007, in the U.S. there was no net demand for rental apartments. Since [the financial crisis], we've had a decline in household growth, but more than 100 percent of net [housing] demand has been for rental housing. Now that the economy is starting to improve, you have much more household growth, but with the vast majority of that going toward rental housing.

The other big change I've noticed is that there is increasing urbanization and the desire to live in the inner city. We're finding a huge demand both from younger people who want to live in the inner cities and from empty nesters without school-aged kids, who also want to live in these areas.

Where are you focused geographically?

Zeff: The markets we focus on are Seattle, the San Francisco Bay Area, L.A., Orange County, San Diego, Honolulu, Denver, the Washington D.C. metro area, and the New York metro area. Of all those markets, Denver is probably the least supply-constrained market. But they all have much more supply constraints, and though it seems like there may be a lot of buildings going up as a percentage of the total housing stock, it's actually quite small. Compare that to the commodity markets, which would be Atlanta, any of the Texas markets, Phoenix, Las Vegas—those types of markets have tremendous ability to add supply. Over the long run, the supply-constrained markets will have better rental growth prospects, and they also have deeper investor demand characteristics.

Carmel closed Carmel Partners Investment Fund V at more than $1B in 2014. Can you talk me through that fundraising?

Zeff: All of our funds have been oversubscribed, and this one wasn't any different. The time of the total fundraise was about nine months, and initially we focused on our existing investors. The majority of our investors have been in the endowment and foundation area. We wanted to make sure we had enough capacity to meet the demand of our existing investor base, even though we did have a desire to diversify that. Then we had a small amount of room for new investors, and we specifically targeted a few corporate defined-benefit plans that are now part of our group.

What are the biggest challenges facing U.S. multifamily LPs and GPs?

Zeff: People are taking more risk in the multifamily space. I'm seeing a lot of acquisitions of existing apartments, significantly above replacement cost. Sometimes buildings that are 20 to 30 years old are trading above what we can build a brand-new project for in the same area. That means the people who are doing that are taking some risk around what their prospective rent growth will be. ■

Notable Quotes:
Where Are We in the Cycle?

As capital continues to flow into global property markets and valuations continue to rise, PrivcapRE asks experts how they view the real estate cycle

"The average recovery in the U.S. has lasted about five years. Our longest expansion is exactly 10 years… That means at some point in the next five years, we are likely to encounter some period of significant economic stress."

Sam Chandan,
Founder and Chief Economist,
Chandan Economics

"Anytime somebody tells you it's an off-market deal, you should expect that you and your six best friends are also looking at it. But having said that, a deal is something to everybody."

Gary Rufrano,
Director,
Clarion Partners

[New capital flowing into real estate] is one of the risks we face. There's every reason to believe that it is more permanent capital. [But] if some of that money were to leave, we would be looking at something of a disconnect."

Sean Bannon,
Managing Director and
Head of U.S. Real Estate,
Zurich Alternative Asset Management

"Thus far, everybody knows the [U.S.] core market is heated, but there don't seem to be too many signs of that tailing off."

Greg MacKinnon,
Director of Research,
PREA

"You have to be a little more imaginative to make money in real estate in the U.K. You can't just rely on the market. We still think there are pockets of opportunity, but … you have to create your value now."

Richard Croft,
CEO,
M7 Real Estate

"I've been in Asia for 16 years [and] from a vintage perspective there were only two bad years. So 14 out of 16 is pretty good. The biggest risk we talk about are rates moving up in the U.S. If it did happen, there would be a knock-on effect."

Mark Gabbay,
Co-CEO, Asia Pacific,
LaSalle Investment Management

"For 15 years, all we had was growth [in Brazil]. I made the joke about hearing too much English on the airplanes to and from Brazil. That's bad. We're not running into people we know anymore."

Gary Garrabrant,
Managing Partner,
Jaguar Growth Partners

"We don't see it as being 2006-2007, because debt is much more conservative than it was. We think people still have a lot of runway to go, and there's room in rents to move up."

Steve Grant,
Co-founder, Managing Principal
ClearRock Properties,
talking about New York City office properties

A Slow Approach for BlackRock

Jack Chandler, the chairman of BlackRock Real Estate, explains how the $4T asset management firm plays recovering markets in the U.S., Europe, and Asia and what LPs want from their GPs

PrivcapRE: How do you play markets that haven't really rebounded as quickly as we've seen in the U.S. and parts of Europe?

Jack Chandler, BlackRock: The answer is slowly, carefully, one asset at a time. If you look at the values and where things have rebounded, we're clearly past the momentum stage in several markets, so our focus is on asset specifics and submarkets specifics. Why can an asset outperform? The question we're focused on these days is how you can generate that operating-income growth greater than inflation.

How do you view pricing versus fundamentals?

Chandler: The fundamentals are fine. They don't necessarily justify the capital-value increases, so the key for investing now is to figure out where the fundamentals will continue to be strong and where they might accelerate.

Where are you looking?

Chandler: We've been very focused on prime assets in prime markets for many reasons, including liquidity. A lot of it is driven by where we see job growth. We've been very sector-focused, investing in not only the gateway markets but in markets where sectors we really liked have a strong influence. We've also seen the prime assets rebound more dramatically in value than secondary assets. And given the state of the capital markets and the geopolitical [outlook], it's not out of the question that we have another shock in the next three to five years. We are looking to make sure our portfolios will be resilient.

Are you looking for value-added assets where you can drive NOI growth?

Chandler: If you buy a building and market rents go up, that's great, but you didn't actually do anything. You just showed up. We're focused on markets where we believe in beta, where we can do something with the assets, even in our core funds—some actual physical work that can either increase the income stream or make it more durable—and try to get the capital value up that way.

Where do you see the best risk-adjusted returns globally?

Chandler: We're seeing very specific themes, country by country. We've been very active investors in the alpha and beta in Tokyo offices. In China, we've been spending a lot of time investing in existing or new shopping centers. In the U.S., we've been big investors in the residential space—building apartment buildings, buying land, taking it through the entitlement stage.

Where don't you see relative value?

Chandler: Fully leased, with a long-weighted average lease expiration, major U.S. cities that are being broadly marketed are attracting some of the lowest-cost capital in the world. Those are going to be harder investments to play out over time. But even within office space in the U.S., there are still some interesting investments to be made.

What do investors want from their managers today?

Chandler: They're very interested in understanding the length and breadth of an investment idea. Specifically, how will you know when to stop, and how will I know that you will, in fact, stop? ■

When Losing Retail Anchors Is a Good Thing

Sterling Organization did two deals where anchor retailers had gone dark, saying it could help insulate from the risks of retail real estate

The revolution in shopping trends that may be seen as widespread disruption for retailers is also presenting clear value-added opportunities for some U.S. real estate operators and managers. For Sterling Organization, that was precisely the case in acquiring the Roswell Village Shopping Center in Roswell, Georgia.

Purchased out of special servicing for $10.6M in October 2014, the grocery-anchored retail specialist was faced with an occupancy rate at the shopping center of just 31 percent after the two key anchors, Publix grocers and Rite Aid Pharmacy, decided to vacate the site.

However, Sterling principal and chief marketing officer Adam Munder says that despite allowing their stores to "go dark," the two firms were still paying their rent, meaning the economic occupancy of the site—the cash flow from rental income—was at 65 percent. What helps even more is that typical anchor tenants in Class B centers, such as Roswell Village, are paying below-market rents.

"If a big-box retailer goes dark at $6 per square foot and we know that, with improvements, the market can afford $14 per square foot, we'll take that deal every day," says Munder. "That insulates us from a lot of the risks you see when you're buying retail assets today and gives us cash flow and time to decide how we want to reposition the center and backfill the space. The strategy is to take some risks where others won't."

Given rising capital flows into the retail sector, not least grocery-anchored retail, Munder accepts there are huge challenges facing retail investors and managers today. "It is imperative that we stay disciplined," says Munder. "We cannot change our underwriting based on what the market is doing or [based] on deal flow."

That is evidenced by Sterling's latest deal, the $58.8M acquisition of Golf Mill Shopping Center in Niles, Illinois. Housing such retailers as Target, J.C. Penney, Kohl's, and Sears, the 1.1M-square-foot mall—of which Sterling owns 886,000 square feet—will see 86 percent of its leases roll by the end of 2016.

For Sterling, however, the deal centers on the lack of improvements made by the previous owner. Its plan involves creating numerous out-parcels of retail space—single-property pads usually housing restaurants, banks, and coffee shops located on the perimeter of the main shopping complex—to help drive retail traffic to the mall and reposition the tenant mix.

"The Golf Mill [Shopping] Center has an amazing location and anchor rents in the low single digits, but the previous owner didn't want to make the investment to develop the out-parcels," Munder says.

In today's competitive retail industry, he says, it is critical to stay ahead of tenant needs. "Competitive properties will attempt to steal tenants, even if a retailer has five years left on their lease. If you haven't made improvements and they see two years' free rent elsewhere, they might move," he says.

Golf Mill Shopping Center in Niles, IL

Roswell Village Shopping Center in Roswell, GA

Mike Butler Photography | www.mike-butler.com

Risk, Real Estate, and Capital Flows

Commercial real estate is entering a new era, thanks to unprecedented capital flows. Experts from Zurich Alternative and PREI talk about the flows' impact on their strategies and the new risks they're underwriting.

Commercial real estate is undergoing a paradigm shift, thanks to unprecedented capital flows targeting the asset class.

But will this capital-driven paradigm shift be a permanent change for real estate, marking a new era for commercial real estate investment strategy and allocations?

For both Eric Adler, chief executive officer of Prudential Real Estate Investors (PREI), and Sean Bannon, managing director and head of U.S. real estate at Zurich Alternative Asset Management, the "tsunami of capital"—as one institutional investor has called it—targeting commercial real estate is here to stay for the long term.

"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," says Adler, noting that during past cycles he's never seen the volume of "hot money"—including private equity and hedge fund capital—that is currently targeting real estate.

For Adler, though, the biggest change has come from sovereign wealth funds, and he believes it's here to stay. "These are long-term investors," he says. "They do not need leverage...and they don't necessarily think in terms of pure IRRs. They're ready

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“Obviously there is a [cap rate] below which you would not go or you’d migrate into another asset class,” says Bannon. “But I’m not sure that we’ve found that point, and I think that other core buyers in major markets are also struggling with that question. It’s really a function of the rent growth expectations, the earnings growth, and the appreciation potential, which have been very, very good in major markets recently.”

Adler says it can seem challenging, competing against today’s wall of capital, but insists diversification is key to any success. “I see opportunities and I see challenges everywhere,” he says, noting that various strategies and asset classes look attractive at different times in their respective cycles, allowing you to “walk away” from some markets when they become too frothy and jump into others when the opportunities present themselves. “If you’re very mono-product, you live and die by that product,” he says. “It takes incredible discipline to say that it’s overpriced and you’re going to walk away. The way you do it is by being diversified.”

But even diversification requires a disciplined approach, Adler stresses. He adds that in Europe and Asia, PREI is focused on just five or six key markets within each region, representing “a big change for us from the last cycle. If you’re really going to be a serious player, you have to decide where you’re going to bet enough to be able to build sustainable local teams, so you have to have a reduced amount of cities.”

Another factor is the illiquidity of real estate and the need to ensure that if a market turns, markets and asset classes have viable exit liquidity options, he says.

But it is risk—and the adding of risk to strategies and portfolios—that remains a key focus for all investors and managers globally in 2015 and beyond.

Zurich Alternative expects to expand its market focus in the U.S. over the near term, thanks in part to increased staffing levels. However, Bannon stresses how vital it is to get compensated for taking additional risk and for investors to fully understand the risks involved in strategies. There are “very, very good opportunities on offer in some of the secondary markets,” Bannon says, but “it’s making sure that we understand where that perception of risk is real risk, and that those risks are adequately compensated.”

Adler agrees that the focus on risk is critical today as managers enter the next real estate downturn. “The players who treated their investors right, did the right things to reduce risk coming into that downturn, are the big winners of the next cycle,” he says.

For now, Adler agrees that the U.S. and Europe are good places to take added risk, thanks to improving fundamentals and historically low supply levels. Within the next few years, though, it could be time to start reducing risk in the U.S. and “really sticking to some of the more gateway markets.” In Europe, “there’s more room to run…which is a good thing for long-term investors that want to buy assets over a period of time,” while in Asia today it’s time to be careful, but also for “preparing yourself to take bigger risks again a few years from now.” ■

to have very long hold periods, they’re very cash-flow-orientated, and they’re ready to work hard at an asset to get that cash flow built up over time to act as a real inflation hedge for them.”

It’s a sentiment echoed by Bannon, who leads Zurich’s $2.5B U.S. real estate program. “There’s every reason to believe that it is more permanent capital” he says. “A lot of the new entrants aren’t just sending money, they’re sending people over. They’re hiring people. They’re building out infrastructure, which would suggest that they’re committed to the space.”

Eric Adler, PREI

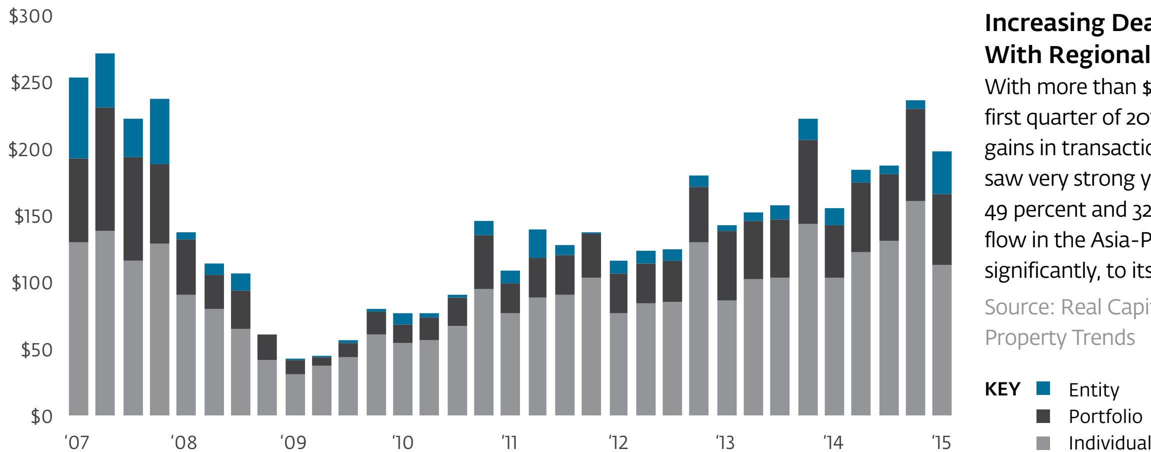
Such permanence of new capital in commercial real estate globally has major implications for investors and managers alike, not least when it comes to competition for assets and valuations.

As a direct investor targeting major U.S. markets and the primary food groups, Bannon admits it can be hard for 20-year professionals in the industry to “get their mind around the yields.” But he stresses that core real estate—the primary target of new capital sources—continues to offer “very, very attractive risk-adjusted returns,” not least relative to alternative asset class returns, the 10-year U.S. Treasury, and corporate spreads.

Sean Bannon, Zurich Alternative

Where Are We in the Cycle?

Global property transactions continue to break post-crisis records as the scale of cross-border capital investment shows no sign of slowing



Increasing Deal Flow, With Regional Differences

With more than $207B of property sales in the first quarter of 2015, every property type saw gains in transactions. While the U.S. and Europe saw very strong year-on-year increases of 49 percent and 32 percent respectively, deal flow in the Asia-Pacific region slowed significantly, to its lowest level in three years.

Source: Real Capital Analytics, Q1 2015 Global Property Trends

KEY
- Entity
- Portfolio
- Individual

Ranking 2014	Market	Sales Volume	YOY Change
1	NYC Metro	$57.0	19%
2	London Metro	$42.9	-2%
3	Tokyo	$38.9	15%
4	LA Metro	$28.8	5%
5	San Fran Metro	$26.6	51%
6	Paris	$24.5	45%
7	DC Metro	$14.3	-19%
8	Chicago	$13.6	9%
9	Sydney	$13.1	16%
10	Dallas	$13.0	5%

Top 10 Global Property Markets

There has been no change in the ranking of the top five property markets, with the New York metro area continuing to lead the charge of transaction volume in 2014. Sydney and Dallas made it into the top 10 for the first time since the financial crisis.

Source: Real Capital Analytics, 2014 Global Property Trends

Top 5 Buyers 2014	Volume ($B)
Blackstone Group	$16.8
Hyundai Motors/KIA Motors	$9.9
ARCP	$9.7
Greenland Group	$7.9
JP Morgan	$7.9

Top 5 Sellers 2014	Volume ($B)
Blackstone Group	$11.4
KEPCO	$9.9
Cole REIT	$8.6
Deutsche Bank	$7.4
Hong Kong Government	$6.1

Top Five Buyers and Sellers in 2014

Blackstone topped the rankings of the largest buyers and sellers of commercial real estate in 2014, with more than $28B of transactions in 12 months, according to Real Capital Analytics.

Source: Real Capital Analytics

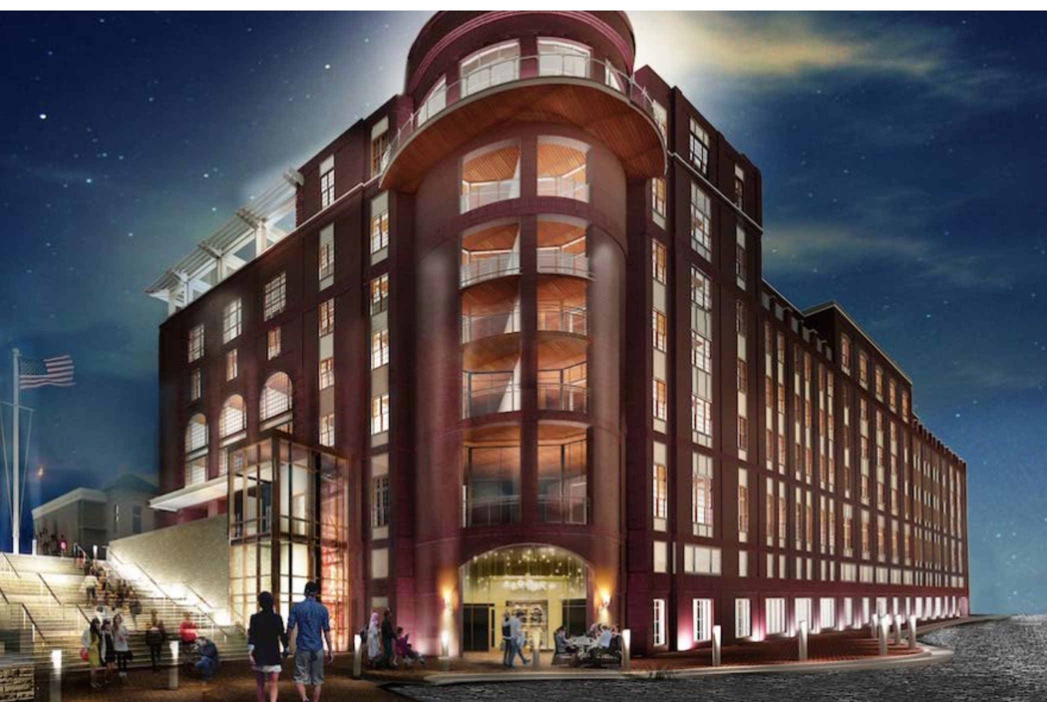
Deal Data Points

- **Biggest property sale of 2014**
  Hyundai and KIA Motors paid $10B—almost three times the appraised value for the 79,342-square-meter headquarters of Korea Electric Power Corp.
- **Biggest property sale of Q1 2015**
  Ivanhoé Cambridge and JV partner Callahan Capital Properties acquired the office property 3 Bryant Park in New York for $2.2B from The Blackstone Group.
- **Biggest portfolio sale of 2014**
  American Realty Capital Properties closed on its buyout of Cole Real Estate Investments, spending $8.6B, according to RCA data, and becoming the largest owner of U.S. single-tenant buildings in the process.
- **Biggest portfolio sale of Q1 2015**
  GIC and Global Logistic Properties acquired the Indcor portfolio of 117M square feet of U.S. industrial assets from Blackstone Group for $8.1B.

Source: Real Capital Analytics

Managing Distress in Hospitality

James Merkel, CEO of Rockbridge, explains how demographics have shaped his firm's investment strategy and how there's still distress in the hotel sector



▲ Rockbridge's latest hotel development project in Savannah, GA

PrivcapRE: What is the state of the U.S. hospitality sector at the moment?

James Merkel, Rockbridge: The hospitality industry has been setting all-time records in demand for hotels—as many people are surprised to know. The fundamentals of the business are at all-time highs, and supply growth still remains muted and well below historic growth levels. We're finding a lot of success today in the industry, and fundamentally because of the downturn, there are a lot of assets that are under-positioned and under-renovated and need capital.

What's driving all of this demand?

Merkel: What's interesting is that the demand base for hotels has changed. In 2013, the millennials became the largest demand generator across the U.S. and in global hotel markets. The millennials in that demand segment want a different product from what our parents wanted. They want to be in urban environments, not just in the gateway markets, but also in places like Louisville, Nashville, and Indianapolis.

How has all this impacted the Rockbridge strategy?

Merkel: We've always had a core competency in fixing broken hotels. The opportunity today is even more significant because of the transformational change of the underlying demand generator. We're very focused on the end user and the end-user demand—what do those millennials want? They want an experience. They want to know that they're in the city they're in, and they want to experience the culture.

What's helping drive NOI growth?

Merkel: What's great about the market today and the cycle we're in is that demand has to come back first before you can drive the average rate. The bottom of the market for room nights sold in the U.S. was in February 2010. Since then, we have set records in demand every month. Demand is very strong, and what follows is pricing pressure. Today we're able to drive the average rate in our hotels. When you're able to drive rates, you can drive the profitability and the margin of your hotel. That's the point in the cycle we're in.

Is there still distress in hospitality?

Merkel: You can't just buy today, be a sector player, and hope that the wind's going to go in your direction. You have to fix what's broken to get the expected returns for your investors. If you're a stabilized buyer, you can get stabilized returns, but you're not going to get the outsized returns you may have gotten had you been able to identify opportunities in 2009 and 2010. Today you have to be a hands-on fixer of the asset. You have to have a strategy that's going to create value in the hotels. That's what we do, and what we've done over 300 times. ■

4 Questions Office Investors Should Be Asking

Experts from Clarion Partners, Reis, Rockspring Property Investment Managers, and Shorenstein Properties talk about their outlook for office and the questions all LPs need to be asking

ARE VALUATIONS AHEAD OF FUNDAMENTALS?

When central business district offices can trade hands for sub-4 percent cap rates, it's time to ask whether office property valuations are ahead of fundamentals.

The reality is complicated, says David Gilbert, president and chief investment officer of Clarion Partners. "Values are nothing more than the intersection of capital flows, rents, and fundamentals, and it's impossible to disaggregate them." But while the impact of capital flows into—and within—the U.S. is being felt in an array of markets, with aggressive pricing in some areas, it doesn't mean fundamentals are lagging behind.

Glenn Shannon, president of Shorenstein Properties, says demand for U.S. core office has never been stronger and isn't going to weaken soon, because it represents good value relative to other investment options. In a few key markets, such as New York, Boston, San Francisco, and Silicon Valley, Shannon says, there are "some very astute investors selectively making the bet that we are going to have very significant rental growth [in the office sector] over the next three to five years."

Given the track records of the investors and the amount of equity being committed to the markets, Shannon says "you have to take seriously the possibility that their investment thesis will prove correct."

For Shorenstein, the focus is broader. "We believe there are going to be 15 to 20 distinct [U.S.] office markets and submarkets that will outperform," he says, "because they offer a confluence of factors that produce a vibrant live-work-play environment that will attract the employee base that companies are seeking."

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IS NEW SUPPLY A CONCERN IN CORE OFFICE MARKETS?

The topic of supply is critical to any conversation about valuations and fundamentals.

Given the slow pace of recovery in Europe and the U.S., there's little concern about an oversupply of new offices and a subsequent rise in vacancy rates and fall in rents, says Reis senior economist Ryan Severino. But there are pockets of development in the U.S. to be aware of.

"A lot of the construction that's occurring [in the U.S.] now still requires a significant amount of pre-leasing in order for the construction financing to become available—probably at least 40 percent to 50 percent, if not greater," says Severino, adding that the industry is "a ways removed from seeing construction come back in any meaningful fashion."

Gilbert agrees, saying there is a "narrow list" of markets where new office construction makes economic sense. Where development is occurring, it is clustered in submarkets such as New York's Hudson Yards and the downtown World Trade Center area. San Francisco and Houston have also been home to significant new development, Gilbert says, but these markets have seen exceptional demand and pre-leasing as well.

For Europe, the supply story is much more muted, says Rockspring Property Investment Managers' head of research, Jose-Luis Pellicer, with a lack of financing and stricter planning systems constraining new development.

"Never forget that the fundamental difference between Europe and the U.S. is the supply," Pellicer says. "Planning in Europe is far more stringent than the U.S., so you don't need to be consistently investing in assets to keep them competitive."

IS IT ALL ABOUT THE TECH INDUSTRY?

The technology, advertising, media, and information technology (TAMI) industries are shaping demand and rent dynamics in certain office submarkets across the U.S. and Europe.

"It's about the 'next big thing' in business, and targeting businesses that are willing to pay a premium to be in the very best locations," says Pellicer. During the financial boom, the next big thing was hedge funds; today it's the tech sector, Pellicer says, but he warns that not all tech firms are created equal.

Gilbert agrees that the high prices being achieved in core U.S. markets could result in a "wake-up call" regarding affordability and occupancy costs, pushing tenants into other areas.

"For Google and Salesforce and the like, they want unique high-quality real estate, and occupancy costs are not their top concern," Gilbert says. But for smaller, niche firms currently paying $50 a square foot and faced with rental increases of up to $80 a square foot, it will only push them to the peripheral.

For Shannon, success in the office sector is all about differentiating the product. Today that often means more efficient—and flexible—floor plates, higher ceilings, increased light and air flow, and in the case of older offices, "an authentic feel." However, redeveloping older office space is not for the faint of heart, Shannon says.

"Some older properties, not withstanding the amount of capital you pour into them, will never be sufficiently distinctive or efficient to command premium rents," he says. "And the costs of these types of renovations can be difficult to estimate and hard to control. Mistakes will be made, I'm afraid, by investors who try to play into the creative office trend with the wrong projects."

SHOULD ALL OFFICES BE OPEN-PLAN, COLLABORATIVE SPACES?

Reis' Ryan Severino says the answer is no, pointing to recent studies that indicate a decrease in worker productivity when traditional service and finance firms convert to open-plan office layouts.

For TAMI industries, open-plan is here to stay. For more traditional industries, such as law firms, banks, and real estate service firms, Severino says it could end up being an "unmitigated disaster," and there could be a backlash against this style of workplace.

"If someone comes from an industry that's not used to this format, the research pretty conclusively shows that it actually decreases productivity," he says. "Now, there are some industries that will probably stick with this format, but there are a lot trying it out right now, and—this is just some of my own anecdotes—the more I hear about business and professional services firms that haven't used this space [and are] trying it out, it just ends up being an unmitigated disaster." ■

Taking Risks the Dune Way

Dune Real Estate Partners isn't afraid of concentration risk, investing large equity checks into single-asset deals. CIO Cia Buckley Marakovits says the strategy can result in better risk management.

> "When it's a concentrated deal, our whole team spends time on it. And that's part of risk management."
>
> –Cia Buckley Marakovits, Dune Real Estate Partners

PrivcapRE: What is concentration risk, and how does it fit into your investment thesis?

Cia Buckley Marakovits, Dune Real Estate Partners: We look at risk in a couple of different ways. The market often looks at size, geographic diversity, and product type, which are all risks that have to be evaluated. But for high-yield investing, attention to each deal individually is just as important. One of the reasons why we do a limited number of larger deals is that it really gets our focus, and every deal matters to our fund. And that's a little bit of a lesson learned when you talk about a $960M fund. If you're investing $10M of equity in a transaction, sometimes it's a slippery slope of talking yourself into "Well, it's a good deal. I'm a little nervous about a couple of things, but if it doesn't go well, it's only $10M in a large fund." When it's a concentrated deal, our whole team spends time on it. And that's part of risk management.

How do you ensure that the fund is diversified enough to offset challenges to certain key assets?

Buckley Marakovits: We are really aware of concentration, and we know that our investors don't want to wake up one day and have us invested 100 percent in an office in the Southeast. But the flipside is, we don't think they expect to see a pie chart that's showing we're hitting all sectors evenly. When you go back to the history of high-yield funds, they're meant to be taking advantage of dislocations in the market. It's hard to create diversification when, during your investment period, different things are happening in different geographies or different markets.

Dune's strategy focuses on distress and dislocation. Are you still seeing those opportunities?

Buckley Marakovits: We're still de-levering. Real estate is a capital-intensive industry, which means it's a debt-financed asset class. And—like the rest of the market—people are de-levering the household balance sheets. I wouldn't call that extreme distress, but there still isn't as much debt capital as there used to be. We only do four to five deals a year, so we might have a different perspective. We focus a lot on working with borrowers, and there still are people who—because it's been a long recovery—are in situations where equity needs to recapitalize things rather than debt. And it creates opportunity. I think of it as less about distress and more about restructuring and recapitalization.

What does it take to be an opportunistic fund manager today?

Buckley Marakovits: You have to be flexible. What's very hard is that if you try to just stick to your strategy, if that's not there, you have to be able to adapt. You need to pivot. Your role is recognizing where the opportunities are. ■

A Great Time to Play in Active Core

Having bought and sold more than $3B of assets over the past two years, Jeb Belford, managing director of the Clarion Lion Properties Fund, talks about the opportunities in major U.S. markets and the need for greater discipline amid increased competition

PrivcapRE: What can you tell us about the Lion Properties Fund?

Jeb Belford, Clarion Partners: The overall portfolio size is about $8B, and that's spread across about 135 investments. We're 85 percent or so in major markets, about 8 percent in high-growth secondary markets, and about 7 percent in other geographic areas. As for property types, roughly 96 to 97 percent of the portfolio is in the four major property types; 94 percent is stabilized assets, and the other 6 percent is in some sort of value-creation phase. And typically we carry less than 2 percent cash.

How active are you in U.S. real estate today?

Belford: It's been a good market in which to be active both as a buyer and a seller. We've bought about $1.7B worth of real estate over the last two years in the order of 23 individual transactions. And we've sold about $1.4B over that same time frame in 20 transactions.

What does pricing for core real estate look like?

Belford: The high number of investors from all different sources creates competition. Therefore, it creates pricing pressure. Some assets that are super high quality in the best markets have gone off at what people believe are eye-popping numbers. And in almost every transaction you're competing against up to eight other serious bidders. It puts a big premium on being disciplined about what you want, and staying on your strategy. It puts a big premium on your research and on-the-ground knowledge to try to figure out exactly what investments are going to be the ones that outperform and what ones are not. So it puts heightened pressure on everybody to be better.

Has this pricing pressure changed how you go about sourcing deals and due diligence?

Belford: In most ways, no, it hasn't. We're still doing the very thorough underwriting that we typically do. But there are plenty of other investors that are also extremely thorough on their diligence. I do not see diligence levels slipping out there. Where it has changed is speed. If you can get your same thorough diligence done faster than someone else, that's actually an advantage in the market.

How long will real estate's strong fundamentals last?

Belford: Most people think we are somewhere between the middle and the later innings of the game, but we are in the "earlier in the game" camp. We have a very healthy operating environment. One of the most important factors is low [rates of] new construction, which is the one thing we can control [as a sector]. But it's also been our nemesis in the past. So if we can keep new construction at a reasonable, moderate pace, we can prolong the good operating environment for real estate. That gives me a pretty strong feeling that we're in the early-to-middle part of the game as opposed to the latter part of the game. ■

Gateway Markets Ripe for Risk-Taking

Philip McAndrews, CIO of global real estate at TIAA-CREF, explains the focus on gateway cities, running the risk spectrum in those markets, and how real estate is about the long-term view

"Our philosophy is you stay in the core gateway cities, but you run the risk spectrum."

–Philip McAndrews, TIAA-CREF

PrivcapRE: As you look to the U.S., where are you most bullish, especially given cross-border capital flows into the market?

Philip McAndrews, TIAA-CREF: If we talk about the U.S., typically we really like the core gateway cities, even given pricing, because we understand the durability of those returns and the window of opportunity for liquidity. Relative to replacement costs, we're still in a good position. There are various metrics we look at to determine whether or not we're comfortable where we are. That's not whistling through the graveyard. But that's exactly why you gravitate toward a city like New York or San Francisco or Washington or Boston, to these very tight infill gateway cities that have supply constraints to them—that have strong employment and demographic-growth components that have durability of return.

Our philosophy is you stay in the core gateway cities, but you run the risk spectrum. In other words, we don't believe there are value-add markets and opportunistic markets; we believe there are value-add real estate assets and opportunistic assets—meaning we build from the ground up in New York. We don't want to double down on our risks.

You're taking both market risk and development risk. So I'm using that as a contra play. We'll use a city like New York—strong durability of return, strong employment growth, strong demographics, diversity of an economy. [There's] a lot going on there, and we'll use the full risk spectrum—core opportunistic, value-added—to really deploy our capital in the markets that we truly believe in.

You've been through three full cycles. What are the key lessons you've learned?

McAndrews: The lesson learned is that cycles are cycles. They have tops and bottoms and middles, and the key thing to do is to be very controlled and balanced. When you're at a point that you're at the bottom of the cycle, you need to recognize it and try to exploit it, which a lot of investors don't do. Then, as you're nearing the top, you have to be controlled and not [have] a panic sale because [you think], "We're at the top, and we should sell everything off."

Can you ever time the market?

McAndrews: You certainly can in real estate. The challenge, though, with entering and exiting quickly, is that it puts your portfolio in a very awkward condition when you want to come back in, because you can't replicate your portfolio. It takes years to construct the quality of assets and the durability of return that we've been able to achieve over 10, 15, or 20 years.

Does that mean real estate is always a long-term play?

McAndrews: You need to have that [long-term view for] the bulk of what you're doing. You especially need to ask, "What am I investing for?" There are basically portfolios that are designed to be complements to the equity and fixed-income portfolios. Therefore, we need to be generally core and long-term. That doesn't mean we can't, within that portfolio, embellish the returns by taking on a tenure of risk, adding value and opportunistic at the appropriate times to enhance those returns. ■

Underwriting

Five Ways to Reduce Tenant Risk

Are LPs and GPs doing enough to ensure tenant diversification within their portfolios? Experts from Keystone Property Group, The Peebles Corporation, and CoInvestment Partners discuss how to reduce tenant risk.

1

Avoid Industry Overexposure

In the rapidly rising real estate market of the past few years, many trophy properties in major markets are heavily comprised of financial services, technology, and other high-growth industries.

"If you have portfolio investments in London, San Francisco, Singapore, and New York and they have a tenant roster concentrated within a single industry—for instance, financial services—you are not diversified," says Piyush Bhardwaj of CoInvestment Partners. "In another downturn, you will see a greater impact when compared to your benchmark."

Bhardwaj offers the example of grocery-anchored shopping centers and the impact of industry consolidation. "It means a lot of tenants might roll up into the same parent company. How are you protected against that?"

The same issue can be applied to big-box and third-party logistics. "Here is where digging beneath the surface can really help," says Bhardwaj. "A portfolio may have the same third-party logistics company as an anchor tenant in two properties, but the tenant could be providing services to two different industries."

2

View Tenant Exposures as Dollar-Weighted

Many properties that have benefited from recent market conditions are occupied by large anchor tenants.

"The value of an investment is dependent on the value of the rent roll," says Chip Walters, chief investment officer at Keystone Property Group. "If a tenant ceases to pay, then what's my opportunity for a replacement tenant at the same rent?"

He says there is a challenge to measuring the weight of large tenants, along with their long-term sustainability, and ultimately gauging the impact of any potential attrition on the property.

"If I have a big tenant with questionable credit that is paying above-market rents, I have a problem," adds Walters. "If I have a big tenant with below-market rents, I have an opportunity. Those risks need to be dollar-weighted."

3

Look Beyond Tenant Size

Although there are clear benefits to leasing up with national-credit tenants, there are other ways to maximize value.

"When you are looking at a building, tenant size and liquidity are indeed big issues," says Tawan Davis, chief investment officer for The Peebles Corporation.

"However, while it's great to have large tenants such as big banks and insurance companies, we like to mix them with growth tenants such as technology and media companies, who may not have the same size but possess growth potential."

He also encourages investors and managers to "think through lease terms. Rollover risk is a question of timing. Diversifying the lengths of leases in a building and staggering rollover offers protection."

4

Offset Risks With Credit Enhancements

Maximizing a portfolio by diversifying across tenants of varying size and liquidity requires additional risk mitigation.

"It's ideally balanced between larger and smaller credit players," says Walters. "From there, you cover credit risks, where they exist. It's best to avoid overexposure to one tenant or industry [and] secure letters of credit from tenants where you have exposure."

Davis agrees about the importance of obtaining necessary credit enhancements as a best practice, adding: "With subsidiaries, affiliates, or portfolio companies, if the actual signatory is not the parent company or sponsor, make sure to obtain a letter of credit, guarantee, or deposit as a backstop."

5

Regular Portfolio Reviews Are Needed

Staffing constraints put institutional investors at a disadvantage when trying to analyze their holdings at the tenant level. However, regular reviews—either annually or biannually—are highly recommended.

Bhardwaj advises that investors lean on their investment consultants for help, as well as conducting internal reviews, to ensure a clear picture of portfolio risk.

When the strength of tenants is in doubt, Bhardwaj recommends that investors "spend the money and hire a third-party credit analyst," not least where single tenants account for 30 percent of a property's income. ■

As the field of institutional real estate investors has expanded, so has the number of hats worn by chief financial officers. Professionals in that position from Dune Real Estate Partners, Alcion Ventures, Madison International Realty, and LEM Capital weigh in on how their jobs have changed.

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PrivcapRE: How have your roles as chief financial officer evolved?

Darren Berk, Dune Real Estate Partners: We all wear an increasing number of hats as our organizations have changed over time. Depending on how you define the responsibilities that we have, I generally wear several different hats that include responsibilities for cash management, financial reporting, asset valuation, tax, performance measurement, and monitoring covenants with respect to investments or subscription lines. As CFO, you could also have responsibility for IT, setting policies and procedures for travel and entertainment, overseeing and working with senior management to operate the management company. It's all the things that go into helping run the day-to-day business.

Eugene DelFavero, Alcion Ventures: I agree that the number of hats keeps growing as our roles evolve. Our roles have also transitioned from more of a reporting role to a strategic role at times.

Brad Nemzer, LEM Capital: My role has really become more operational than I originally expected, and it seems that operational focus continues to grow. There are components such as investor relations, IT, HR, and compliance, but overall risk management may be the most significant. The regulatory environment seems to be constantly evolving, and you always want to make sure you're protecting the company and your investors.

Yehuda Hecht, Madison International Realty: A short answer is "Yes, the hats are increasing." The CFO has a lot more responsibility. The compliance overlay is definitely a big part of that. I was very involved initially in setting up Madison's compliance department, including determining the chief compliance officer within my team. I still participate as an active member of that compliance team. Madison's IT platform falls directly under my responsibility. I was involved in recruiting and hiring an IT director, with key IT issues flowing to me. We're very focused on cybersecurity and have conducted related security audits as it relates to our general compliance overlay.

What have been the key drivers behind your expanding roles?

Hecht: Institutional investors are certainly more demanding and want to spend time with the CFO. I remember five or six years ago, you went into a capital-raising meeting with prospective investors and they wanted to make sure there was a CFO and [wanted to] meet you, but now there are six and seven hours of diligence sessions, as LPs want to understand everything about the back office. That speaks a lot to how institutional investors—as well as our internal management—view the importance of the CFO.

DelFavero: I agree, we are getting more and more involved, and we're seeing the same exact thing from our investors. Five years ago they weren't spending a lot oftime with the CFO. Now they're putting equal weight, if not more, on the back-office diligence.

Berk: To supplement that, I think all of our roles are growing, especially with respect

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to the strategic way that we can help our firms. I don't know that 10 years ago people looked to the CFO role to be as value-add strategically as they do today. Firms look to us to be strategic in how we structure funds to accommodate capital, implement a fund control environment, in addition to being a part of the investment committee. I think this has changed for us all.

When dealing with investors and potential LPs, what are some of the biggest issues you face?

Hecht: Proactive investor diligence is something we spend a lot of time on. One of the things that we've been doing recently is reaching out to investors to understand their tax overlay, what matters to them, and how they prefer to have investments structured. By the time we get into a meeting or on a call with them, we can have something catered to their specific needs that shows them how they can come into our fund and invest in a fairly efficient way. You want to be able to articulate that you have a structure in place that's efficient but is also not too aggressive.

DelFavero: One thing to add is all the different structures we've seen from multiple investors wanting to come in [to our funds]. One example was one investor who, rather than coming into the fund, wanted to invest in 25 or 30 feeder vehicles for the fund. Even though it was a sizable investor, we just couldn't accommodate that, and we had to find a structure that would allow him to come in.

How do you handle the extra diligence and reporting being asked for by LPs?

Nemzer: We receive several unique due diligence requests from both our current and our prospective LPs. To the extent we've been able to, we've tried to standardize our reporting on recurring requests to make our process more efficient. However, each LP is different and may have a slightly different reporting preference or look at things through a slightly different lens, so there is a degree of customization. Our investors are our lifeblood, so we put a big emphasis on making sure we have a good process that allows us to provide timely and accurate responses, no matter how detailed the request.

When is it right to say no to an LP?

DelFavero: We've never said no as of yet to an investor, but we've been constantly looking at ways to improve our internal systems. But it's getting more and more complex in how to do that, as the investor requests are getting deeper.

Berk: I don't know that it's about saying no, but sometimes it's managing expectations as to what we can and cannot do while trying to give them what they need. At one time we had customized requests on capital accounts from a handful of investors, which were time-consuming to prepare. We took the similarities in the different forms we were completing and worked with our fund administrator to just make that part of the capital statement that everybody received; all the limited partners were satisfied with the new format, and the customized reporting for multiple limited partners was able to be reduced.

Hecht: The one area that can be challenging at times, and to which we do need to reconcile investors, is the timing of reporting. Very often investors want information sooner than what we typically can provide. What we do in cases like this is agree to provide a draft of net-asset-value estimates to investors who have their own specific deadlines so they can have something that's pretty solid for their financial reporting, but doesn't put undue pressure or risk on the level of reporting that we already have in place.

What about today's regulatory environment? How do you balance that need for much greater compliance?

Nemzer: We put a significant emphasis on documentation when we make decisions as a company. Expense allocation is a good example of that. We always stress the importance of documenting our thought processes around our decision-making.

DelFavero: We were able to hire an outside chief compliance officer, and I agree, the biggest change we experienced as a firm is more to do with documentation. We'll do a much more thorough documentation, or coming out of investment committee there's now a formal memo showing we all approved an asset and acquisition. It's become more formalized–and being a small organization with only 23 people and five partners, that took a lot of getting used to. ■

Darren Berk,
CFO, Dune Real Estate Partners

Eugene DelFavero,
CFO, Alcion Ventures

Brad Nemzer,
Controller, LEM Capital

Yehuda Hecht,
CFO, Madison International Realty

Winning the Deal With Early Due Diligence

To win deals and stand out from the crowd, acquisition teams are completing due diligence ahead of sale agreements and sometimes before they even bid on an asset, says RSM's Michael Schwartz

No one in the institutional real estate investment world wants to repeat the mistakes of the 2008 financial crisis, not least when it comes to underwriting and due diligence.

However, that need for deeper and wider due diligence is being challenged by rising competition for deal flow and increasing asset valuations, forcing some GPs to complete much of their due diligence work before they even put in a bid, RSM principal Michael Schwartz says.

"[There is] more of a focus on the crux of the deal," he says. "On the financials, on the leases, the income stream, looking at problematic borrowers or questionable issues that we just don't want to see a repeat of."

But he notes that given growing competition for assets across U.S. property markets, acquisition teams are also coming to the deal table with much of the due diligence work "pre-packaged before they even sign the purchase and sale agreement" as a means of standing out from the crowd.

"What we're seeing are clients approaching us saying, 'Hey, I want all these lease abstracts, I want the Argus models, I want to reconcile all this'—and that's before we go hard or before we put our bid in, because we want to win this property," says Schwartz.

"We're seeing that more and more these days. In fact, I just got a call from a client who wanted to engage us regarding the purchase of a medium-sized retail center, and they wanted everything done in a week before they put their bid in. Then [after that work was done] then they negotiated the purchase and sale agreement. It's becoming more common to get the deal and win it that way."

Increased competition has also forced GPs to cut the amount of time spent on due diligence by roughly half, Schwartz says, even though acquisition teams need to dig deeper and wider than ever before.

"We had one client recently that came to us with a suburban large industrial portfolio of between 100 and 150 leases, and they basically had 10 days [to complete due diligence]. By the time we actually signed everything up and got the leases [in front of us], it was down to about seven to eight days."

Despite such "abbreviated" time frames for due diligence, Schwartz argues that some clients are walking away from deals when the figures simply don't add up.

"We have seen more [people walk away from deals] in the last 18 months than in the eight years from 2000 to 2008, with people saying, 'You know what? I don't want to make the same mistake.' If the numbers don't match and if there's a material disconnect or a big variance, they are walking away, on both the loan and on the acquisition side. They still want to make the deal work, but people are willing to walk away if at the end of the day it just doesn't make economic sense." ■

> "If the numbers don't match and if there's a material disconnect or a big variance, they are walking away."
>
> –Michael Schwartz, RSM

Structuring

Dynamic Investing the New Mexico Way

Mark Canavan, senior portfolio manager of real assets for the New Mexico Educational Retirement Board, talks about the challenges of being a more active investor, and how co-investments will play an increasingly critical role

PrivcapRE: What is driving your plan's preference for dynamic asset-allocation models?

Mark Canavan, NMERB: You don't want to be forced to invest because policy says you have to. Why have a policy or allocation that dictates that kind of behavior? In 2006 and 2007, if your policy and pacing plan mandated a strict target for core and you were underweight in your allocation, you had to invest in core anyway. This would have been the worst time to invest in core. You should have the latitude to do what's best for the portfolio, and you shouldn't be making decisions solely based on strict preset mandates.

What role does the co-investment program play for you?

Canavan: To continue to be tactical, you need to move towards co-investments or direct models. You need to have flexibility over entry and exit—when the play is over you want out. It's important to have liquidity mechanisms. Our mandate has ranges that allow us to maneuver, and I do have authority to sell secondary positions into the market if I have to.

If you're a large enough plan, you can run a co-investment program in-house. We created a compromise and made our own private-label funds—a "fund of one"—so we had a platform to execute. We are the LP, and we outsourced staff for co-investments to [consultant] Real Asset Portfolio Management. They have discretion within a box.

First, I get a pipeline report that I can use to steer my consultant staff in the direction I want them to go in on a macro basis. Then they pursue opportunities, for which they will send me a "heads-up memo" on the investments they like. At this point I can say yes or no. Then I get a final recommendation, and again, at that point, I can give them discretion to execute, or I can veto. Once I've given them execution authority, they have full discretion to close without having to come back to the investment committee.

Given staff constraints, how is your team structured, and whom do you lean on most?

Canavan: There are a few layers. You need to start with a good generalist consultant who can see the overall lay of the land. Then it requires adding consultants with a tremendous amount of area-specific expertise. Lastly, in executing specific investments you need a rifle-shot level of expertise. It's also important to have a high level of collaboration between the consultant and the staff, where they make decisions through consensus.

How do GPs fit within the scope of your program?

Canavan: While we're really focused on our co-investment program right now, we still value our manager relationships. They bolster our capabilities by creating access to additional co-investment flow. Without access to co-investments, there's a lower probability I'll work with you. ■

The Case for Breaking the Fund Mold

Drew Ierardi, senior portfolio manager of private markets at Exelon, asks GPs to think more creatively about fund structures and investment periods

GPs should think more creatively about the structure of real estate commingled funds and not be afraid to "break the mold" of the private equity model, says Exelon senior portfolio manager Drew Ierardi.

As the $15B corporate pension plan juggles the challenges of redeploying early fund distributions back into strengthening real estate markets, Ierardi calls on investment managers to be innovative and candid about the best ways to invest in the asset class today.

"Traditional closed-ended vehicles are ripe for innovation," he says. "I'm open to seeing more new types of fund structures that attempt to break the mold in whatever direction that is."

One of the key challenges Ierardi and Exelon face is earlier-than-expected distributions back from value-added and opportunistic funds that have sold assets following strong capital appreciation. By using real estate as a pure total-return play rather than needing a component for current income, the early distributions have generated great IRRs but impacted equity multiple expectations.

For Ierardi, the early distributions have also left him facing the risk of investing capital into a rising market that could peak during a new fund's investment period. As a result, Ierardi wants to see managers think differently in terms of fund structures in an effort to help investors "embed optionality" in their own portfolios.

While there is no "silver bullet," Ierardi suggests there is a "place in the universe" for longer-life vehicles in the value-added and opportunistic world, where managers could afford to be "a little bit candid and willing to say that maybe the best decision we can make right now isn't to reinvest the gains [in a new fund] but to hold those assets longer."

The pension is also trying to give itself more options by introducing a tiered commitment for some of its real estate re-ups, whereby the plan commits to a follow-on fund at the same level as the prior vehicle but reserves the option at a later stage in the fundraising process to commit a further 20 to 25 percent capital.

Exelon has 6 percent of its total fund allocated to real estate, investing in REITs, core, value-added, and opportunistic strategies. However, owing to a separate $5B liability hedging strategy, Exelon can focus its real estate investments purely on generating returns and doesn't need to invest if the opportunities aren't present in the market.

"The way the pension is structured allows us a lot of flexibility to pick investments based on where we are at any point in time, what we are seeing, and what we think makes most sense on a risk-adjusted basis," says Ierardi. ■

> "Traditional closed-ended vehicles are ripe for innovation."
>
> –Drew Ierardi, Exelon

Achieving Meaningful Portfolio Diversification

Real estate risk has changed dramatically in the wake of the financial crisis. Michael Humphrey, co-founder of consultant Courtland Partners, explains why all investors need to question whether their diversification is meaningful enough.

PrivcapRE: Diversification is a critical component of every investor portfolio. Why is it getting so much more attention?

Michael Humphrey, Courtland Partners: Diversification has always been a part of risk mitigation. The question is whether the diversification we previously did was really meaningful, or meaningful enough. In the past, we used to talk about diversification in terms of property type and regional diversification here in the U.S. Today, many of our clients have global portfolios, and those global portfolios have exposure to property types other than the traditional property types and to markets outside the U.S.

Is risk different today than what it was pre-crisis?

Humphrey: There are new macroeconomic conditions. Mix that in with some of the political risk and you've got a new risk environment that we all have to be mindful of. After the crisis, one of our clients said, "We lost 10 percent of our portfolio value in one focused area. Come in and help us determine what caused that loss." It just so happened that in that portfolio there was a significant amount of investment in non-core, highly leveraged mezzanine debt and other stuff that got hit severely when values adjusted. What wasn't being tuned into as much as it needed to be was that the mezzanine managers were leveraging their positions—sometimes with repo'ed debt.

Can you actually mortgage away diversification benefits with leverage?

Humphrey: That leverage in the non-core portion of the portfolio was a primary risk after the financial crisis. What's interesting now is, if you look at the non-core exposures, you don't see the same type of leverage, at least not yet. What's happened for many of our clients [is that they've] moved down the risk-return spectrum. The concern is [that] there's risk associated with that lower-risk part of the risk-return spectrum.

Does this all come back to the role of real estate in the portfolio?

Humphrey: After the financial crisis, people reassessed what the role of real estate is. Is it cash flow? Is it preservation of capital? That has become a much more important discussion.

Does it also matter where the investor comes from?

Humphrey: Absolutely. The first Northern European client we picked up, for example, has a pretty significant multibillion-dollar allocation in real estate. And they're a direct investor. They said, "We need to diversify. We want some exposure in the U.S. We're looking at the major markets. We're looking at major properties." And they already had a building in New York City in mind. ■

The Easiest JV Mistakes to Make

For Kenneth Munkacy, senior managing director at GID International, it's vital to trust JV partners, but he says you also need to verify and ensure interests are aligned

PrivcapRE: As a vertically integrated development and investment management business and family office in the U.S., Brazil, and India, you know what it takes to get JV partnerships right. How do you source partners?

Kenneth Munkacy, GID International: That's always the tricky part of venturing into any new market. You first have to decide what sector you're in and what segment you want to penetrate, and then find out who the best in breed are. On one level, it's about checking the boxes on the markets they're in: the product type, their execution, and their systems back of house.

But it comes down to the chemistry with the partners. There's an old saying about how organizations don't do business; people do business. It's about getting in people's heads and understanding what motivates them. So when we pick a partner, we want somebody who has that same kind of DNA and also has an incentive structure. It's very important that their management team can participate in the success and that they aren't as well off when things go bad.

How do you benchmark JV partners in emerging markets?

Munkacy: We wrestle with that a lot. It's basically going around, project by project, getting to know the brokers. There's wining and dining, shopping projects, and asking 5,000 questions.

What happens when things don't work out as planned?

Munkacy: There are certain universals that we hold true, and if a local partner doesn't perform, we have the ability to step in. But first, there's a cure period. Partners can be removed for bad-boy acts, so to speak. We're very collaborative and consensus-oriented. During our asset management reviews, we have a definite process where if we see things starting to go from bad to worse, we require them to take a corrective action, and we'll monitor it. The best hedge is getting involved with your partner early on and jointly saying, "OK, this is how we're reading the data. How are you reading it? Let's agree that if it reaches a certain point, these next three things happen." You want to be proactive.

What's the easiest mistake to make in a JV partnership?

Munkacy: Real estate is something we do in the same language everywhere. There are no Chinese numbers, Hungarian numbers, or Brazilian numbers. They're just numbers, so it's all about understanding that there is a pro forma out there, and those numbers are sacred. If there can be variances from those—up or down or in between—we want to talk about it, and we want to understand that they're deliberate tactical actions we as a partner or partnership can take. The lessons learned are that you've got to trust your partner, but remember the old Reagan notion of "trust but verify." You always have to second-guess. It's not really Monday-morning quarterbacking or backseat driving; it's just being entitled to having input on saying, "This is how we see the world. What's your research that determines how you see the world? Let's see how we can put it together." ■

Oregon's Long-Term Strategy

Anthony Breault of the Oregon State Treasury, explains how he invests for the long term and how JVs and open-ended funds are helping achieve his goals

As institutional investors look to become more dynamic with their asset-allocation strategies, the Oregon State Treasury maintains its emphasis on long-term strategies in real estate—and sees joint ventures and open-ended funds as a means of achieving that goal.

"Reinvestment risk is my single greatest concern," says **Anthony Breault,** senior real estate investment officer for the Oregon State Treasury, discussing the challenges of keeping money deployed in a market where manager relationships are typically built around finite fund-life terms.

It's an investment hurdle that Breault eloquently refers to as "timeline angst," and something his team has been trying to overcome with the increased use of JVs and open-ended funds while at the same time maximizing risk-adjusted returns for the plan.

Breault speaks about Oregon's $8B real estate portfolio and the challenges he and his staff face. The team collaborates with consultants to recommend diversified investments that target 30 percent core real estate strategies, 30 percent opportunistic, 20 percent value-add, and 20 percent public REIT investments. Additionally, the total portfolio has a tactical allocation, separate from real estate, where shorter-term or "nonsustainable" opportunities such as public-private investment programs and similar opportunistic plays can be pursued.

Within the real estate portfolio, Breault's team employs "large enough" allocation bandwidth that allows it to respond more dynamically to market conditions by going overweight or underweight within the pre-specified risk buckets.

"We have bandwidths that allow us to tilt our exposures," says Breault. "For example, in our

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> “It takes too long to shift the portfolio, so we are making micromovements every step of the way. It takes time to get money out to the market.”
>
> Anthony Breault, Oregon State Treasury

opportunistic or core portfolios, we have a 30 percent target, and we can go plus or minus 10 percent based on market conditions. This gives us a lot of leeway.”

For Oregon, having the latitude provided by such bandwidth is critical to maintaining valuable long-term positions in the face of a rising market, rather than being forced into selling in order to rebalance rigid asset-allocation buckets. “It’s a continual process and not that fluid,” says Breault. “It takes too long to shift the portfolio, so we are making micromovements every step of the way. It takes time to get money out to the market.”

Given such a strategy, Oregon is increasingly looking beyond traditional closed-ended fund investments and, over the past three years, has given a growing role to joint ventures.

“With closed-ended funds managers with a finite fund life, their underwriting standards can be limited to a hold period that does not match the specific investment opportunity,” says Breault. “This can hamper the needed flexibility for achieving the best risk-adjusted returns for the real estate asset class. With our closed-ended funds, we often find large portions of our portfolios selling at less than maximum value due to a termination date that doesn’t match with the market cycle.”

Breault says he ultimately wants “less of this timeline angst” and greater simplicity to create longer-duration structures “that provide the management team the needed flexibility to do the right thing.”

The evergreen nature of joint ventures is therefore appealing, Breault says, offering “tremendous flexibility without a looming date to trigger a sale.

“[JV] vehicles have the ability to naturally outperform, on a risk-adjusted basis, by achieving greater consistency in long–term returns without complete reliance on market timing,” he says. Fee efficiencies and transparency also add to the appeal of JVs. For similar reasons, Breault believes the open-ended fund structure also provides improved alignment for the real estate asset class.

While the liquidity function of open-ended funds may be more perception than reality, Oregon’s team is also considering future investments in these structures to take advantage of the evergreen design. For a long-term investor that has a need to be “always in the market,” open-ended funds help minimize the constant frictional trading costs created by the closed-end model, Breault says.

“However, there are limits to the open-ended fund universe,” he adds. “Investors don’t have much of a choice in the opportunistic market, which only provides closed-ended products.”

Describing what Oregon looks for in managers, Breault says a lean staffing model creates a preference for scaling capital with existing relationships. The Oregon real estate team focuses on “structuring investments with managers who have broad enough mandates and that can look out at the bigger universe, so [we] aren’t continually sourcing.”

While Oregon’s portfolio primarily consists of larger, more experienced managers, the investment team is continuously looking for and considering managers with between $300M to $1B of assets under management who can execute on niche or more tactical strategies. “This is the next generation of managers we can grow with over the years,” says Breault. “Our first investments with many of our existing larger managers were back when they were smaller platforms.”

Overall, a blended portfolio of JVs, open-ended funds, and a selective focus on commingled closed-ended funds are proving to be the panacea for Oregon’s long-duration investment goals.

As Breault explains: “For [us], JVs provide the scalability and real-time visibility to keep our fingers on the pulse of the real estate markets, and from a structuring point of view, we can improve our buy-side discipline and alignment by removing much of the timeline angst out of incentives to deploy capital.” ■

The Reality of **Real Estate Fundraising**

Capital raising is increasingly concentrated in the hands of the largest managers. But that doesn't mean midmarket GPs and emerging managers can't break through. Experts from Exeter Property Group, Mesa West Capital, and The Townsend Group discuss what it takes to stand out in the crowd.

PrivcapRE: What is the reality for real estate fundraising?

Anthony Frammartino, The Townsend Group: The time in the market is pretty significantly protracted. And the interesting point is, if you went back to where we would have been in the '06 to '07 time period, we would have seen 350 or so managers raising capital. Today, while the number of managers in the market is pretty close to historic highs, we're seeing maybe 100 fewer managers—about 200 in total—[successfully raising capital] of between $60B and $80B per year.

Also, capital is disproportionately focused in a handful of core names within that group. So the net effect we've seen is that most managers are left searching for bits and pieces of the capital equation, and relatively few are left with the totality of the capital they need in a traditional fund format.

Are there any surprises in terms of fundraising and the trends you're seeing this cycle?

Frammartino: Investors are still pretty patient. There is a huge urgency to put capital to work. Where managers don't feel that urgency is maybe when they show up for their initial fund conversation.

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Rayenne Chen, Exeter Property Group: I agree that it's always hard to create a sense of urgency, and this part of the cycle is really no different. The whole market is active, and everything is urgent. It has nothing to do with your product or the LPs—it's how you can run a better process. I think the most effective process and lever is to create scarce capacity. You just want to set a responsible fund size that's matched to your sourcing strategy, and then set a hard cap and honor it.

Ryan Krauch, Mesa West Capital: There are two sides. On one hand, it feels like there are not a lot of changes over the cycles. People are always busy, as Rayenne points out, and it's very hard to get investor attention. Not because you initially don't have the right product—it's just a matter of understaffing and other things. On the other hand, what's unique about this point in the [real estate] cycle is that there is confusion [about where we are], and people are asking, "Can this keep going, or is the end near?" From our perspective, investors are taking a fairly well-balanced approach [to the challenge of market cycles]; they're looking for parts of their portfolio to produce income and downside protection. Also, they're looking at other parts where they can go out and get a little more opportunistic or add value.

Are investors concerned about deploying capital at this point in the cycle or in this vintage?

Frammartino: The answer is yes. What we're seeing is that investors are looking at opportunities that allow them to focus on more immediate investment. But they're starting from different stages with respect to their programs, and the market has evolved to the point where they can stay active regardless of what their opinion is of the market.

Chen: I've never seen such robust interest for the products across the whole risk-reward spectrum. And it's hard to say where we are in the cycle. Many of the investors I speak to are comfortable with the notion that there is still value growth to be wrought from the U.S. property sectors. What's different at this part of the cycle is that a lot of the market risk has gone out. Demand is very strong across all sectors, all markets, and [as a result] would-be core investors are willing to go up the risk curve on, say, lease term or leverage. That's why I've been seeing more core-plus interest.

Anthony Frammartino, The Townsend Group

Rayenne Chen, Exeter Property Group

Ryan Krauch, Mesa West Capital

Krauch: There is more of a trend to look at real estate as a longer-term hold, more income-oriented. It doesn't mean that there is no value-add opportunistic—quite the contrary. But people are being more realistic about what real estate is supposed to be in their portfolios. With that backdrop, vintage matters a bit less. If you're being more opportunistic, then vintage matters a lot. If you're being a bit longer-hold or being a bit more conservative in how you're applying real estate to the portfolio, then you get less concerned with vintage. You're more concerned with good real estate, long-term fundamentals, and things of that nature.

What can emerging managers expect when out fundraising?

Frammartino: Successful managers are typically raising a fund over a period of 20 to 21 months. But it's probably more typical that the emerging managers are having difficulty identifying their capital partner. I'd say, on average, most groups will spend 18 months to three years in the market.

Chen: For emerging managers, now is the time to craft your product carefully. Because once you create a product, you don't want to keep changing it as you go down the road. In future funds, when you tailor the product, you're not tailoring your fundamental strategy and philosophy and tenants. You're tailoring the structures you provide.

Krauch: You could have the best real estate product known to man, and if you can't convince investors to invest in it, it's just not going to work. So the question is, how do you do that? Generally, as an emerging manager, [there are] maybe three ways you can go about it. One, you can try to build those relationships yourself. You can hire somebody. Or you're going to hire a placement agent, and that can certainly be helpful. At the end of the day, you as the principal still have to be heavily involved. You really need to put your head around the idea it's going to be a two-to-three-year process. ■

Want to Attract Foreign LPs? Be More Nimble

Cross-border capital flows into the U.S. require GPs to be even more nimble than before. And the flow comes with major structural challenges.

Tom Green,
RSM

GPs need to be increasingly nimble in order to attract part of the unprecedented wave of foreign capital targeting U.S. commercial real estate, says RSM partner Tom Green.

As international investors continue to deploy capital in markets and property types across the U.S., Green advises investment managers to "absolutely" tailor products to cater more to the appetites of foreign capital sources.

"There's a tremendous amount of competition out there, so whether it's a separate account or a JV relationship or having investors participate in the fund, you need to be somewhat nimble in terms of what you're really willing to do," says Green.

In the past 12 months, more than $65B of cross-border capital was invested in the five major food groups in the U.S., according to data provider Real Capital Analytics—up from just $38.8B of cross-border investment two years ago, and an almost threefold increase from three years ago.

And that pace of investment is not expected to decline. A survey by the Association of Foreign Investors in Real Estate revealed that in 2015, 90 percent of respondents planned to maintain the same level of investment in U.S. commercial real estate as they had in 2014, or to increase it.

Yet while many foreign investors are targeting core real estate deals in gateway markets, Green says investor appetite for risk and structure is varied.

"We're seeing things across the board. It can range from direct investments to fund positions, depending on the size of the foreign capital and their appetite for returns, which is often different from standard [U.S.] investors," he says. "For some of the larger capital investors...because of the size of investment, they are willing to settle for a little bit less risk and a little bit less return."

As a result, GPs should think carefully about how they market and structure products for new investors. "The biggest challenge is the structuring and the compliance," Green explains, adding that while managers have to be nimble, it's still difficult for GPs to know the ultimate investor mix at the start of the fundraising process.

He also argues that, from a tax standpoint, appealing more to foreign investors presents managers with "a whole host of issues that need to be addressed up front," including distributions, withholding, and how investments are made. ■

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