Privcap/Report

Real Estate Game Change Conference

A collection of thought leadership, and the people behind it, presented at Privcap's first full-day real estate event

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Game Change Conferences

Real Estate
Nov 2, 2016,
Chicago, IL

Healthcare
Nov 16, 2016
New York, NY

Energy
Dec 8, 2016
Houston, TX

Privcap brings together authoritative experts to network and exchange intelligence about the evolving private equity opportunities. Expert panelists will discuss cultural, economic, and technological trends that are profoundly changing the U.S. economy, fundraising, the state of joint ventures, and more.

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About Privcap

Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. www.privcap.com

Zoe Hughes
Editor,
PrivcapRE

Striving for Investment Excellence

It's undeniable that the private equity real estate investment world has undergone seismic shifts during the past decade. And whether it's increasing cross-border capital flows, demographics, or wholesale changes to investor risk tolerance—the forces impacting today's real estate investment strategies will also define tomorrow's.

So at Privcap's inaugural Real Estate Game Change conference, held at Chicago's Gleacher Center in November 2015, we sought the answer to a complex question: What game-changing trends will LPs and GPs need to understand as they construct their portfolios and prepare for the next cycle?

With some of the best of the industry's thought leaders in attendance, the one-day event—which attracted more than 180 attendees—explored how key real estate food groups, as well as LP and GP portfolios, will withstand changes in consumer and tenant behavior, capital flows, and risk appetite.

And we're pleased to announce that Privcap's second Real Estate Game Change event will be held at Chicago's Gleacher Center on Nov. 2, 2016. Stay tuned to Privcap.com and our real-estate-focused newsletters for updates on the conference agenda and speakers.

Cheers,

ZHughes

Zoe Hughes

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Why a Flight to Quality Is Here to Stay

There's a flight to perceived quality in real estate fundraising, with LPs turning en masse to core real estate, developed markets and mega-GPs

Anthony Frammartino, Principal, Townsend Group

Hugh Macdonnell, Managing Director, Clarion Partners

John Ferguson, Partner and Co-chair, Goodwin Procter

Key Thoughts

Big Names, Steady Markets Rule
"A flight to the perception of quality has occurred, and that's visible in the capital flows to the core space…. You've also seen that [with] the top 10 names raising about half the capital in the industry today…. I [also] think there is a preference for developed markets in the U.S., disproportionately, over emerging markets."
Anthony Frammartino, Townsend Group

Fees Are Down, and Incumbents Grow Stronger
"Fees…industry-wide, apples-to-apples, they're down across everything. That means that the people most successful at navigating through that are those that are already established, [and] where every incremental dollar is a higher margin. Question when it starts to cut the other way and you limit the development of brand-new businesses in real estate."
Hugh Macdonnell, Clarion Partners

A Defensive Mindset May Be a Permanent Shift
"Most investors are targeting closer to two-thirds [of their portfolio in core real estate]. That's clearly different—and maybe it's just that we're not far enough along in the cycle and memories become short again—but it feels like a…permanent shift of position."
Anthony Frammartino

Sector-specific Strategies Win Out
"Sector-specific strategies, where you're able to execute them, have continued to have a lot of resonance. And if you can bolt together an allocator model and an operator model with actual operating expertise, that's very powerful."
Hugh Macdonnell

International Flows Are Changing the Scene
"Investors have gone in very disparate directions since the last go-around…. There's also been a scene change, particularly as more international investors have stepped up to fill the capital void. There's less acceptance of a blind-pool, traditional, committed structure."
Anthony Frammartino

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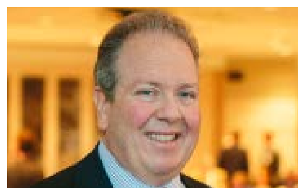
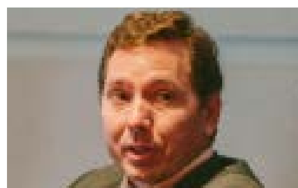
Real Estate's Seismic *Shift*

Technology, demographics, urbanization, retail investors—real estate investing is undergoing seismic shifts in a number of ways. However, Colony Capital, Dune, and LaSalle all warn it's vital to keep an eye on market cycles, not least in the U.S.

Dan Neidich,
CEO,
Dune Real Estate Partners


Jeff Jacobson,
CEO,
LaSalle Investment Management


Kevin Traenkle,
CIO,
Colony Capital, Inc

Zoe Hughes, Privcap: As you look ahead at commercial real estate and to what your portfolios will become, how does that compare to the changes you've seen during the past decade?

Dan Neidich, Dune: It's a different world. The main thing about [our] portfolio is the way we think about leverage. We think about de-risking—the different ways we can manage risk, whether it's selling assets early or doing financing early—and the way we control leverage. We grew up in a world where a developer could get 85, 95, 105 percent financing. Today that's really 60, 65 percent financing in the bank world, depending on other layers of capital.

Jeff Jacobson, LaSalle: An area that's been growing for us, particularly since the financial crisis, is listed global real estate securities, which is $13B of our total. Our bias is towards core-plus. We're trying to make sure we can go through the cycles. As you're investing later in a cycle, it's more about protecting yourself if the world starts to change. Right now we're skewing towards that when we have to make trade-offs.

Kevin Traenkle, Colony: Ten years ago we were much more focused on the opportunistic equity end of the spectrum, shooting for 20-percent-plus rates of return. Today we're skewing towards the conservative end of the spectrum. A lot of our clients didn't necessarily need real estate to deliver a 25 percent return in their portfolio, and when you get to managing tens of billions [of dollars], it's just too hard to pull that rabbit out of the hat year in, year out.

How has the globalization of capital changed your game?

Neidich: Capital flows have been global for a long time. Everyone has a little bit of a short memory—even the people who pull back—so there's always an ebb and flow. All of us remember when the Japanese were here. Now it's the Chinese or the Koreans, and the Middle East has been here for a long time. The German banks are starting to look at coming back to the U.S. Even the Japanese are coming back to the U.S.

Jacobson: Real estate is becoming more and more a global financial asset. What continues to change is where real estate capital is going to come from. Look for where the money is: in markets where they don't have the ability to invest in their home market. And a portion of that will go into real estate. A tremendous amount of global savings over the last decade has come into commodity-rich countries—the Middle East, Norway, parts of Africa, Australia, and Canada—and countries with a big current account surplus. So Germany is going to be big.

Traenkle: Colony is raising even more capital from international sources. Those capital sources have gotten a lot bigger in the last 10 years, and liquid capital is looking to find safer places to invest. The

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Panelists answer questions from Privcap's real estate editor Zoe Hughes.

world today is volatile, and the U.S. offers a pretty safe environment relative to other big markets. When you think about preservation of capital, you probably think about U.S. dollar-denominated assets that will at least keep up with inflation. Real estate does a really good job of that.

And how will you be raising capital in 15 years' time?

Traenkle: One of the things we're starting to see is capital coming into institutional real estate from retail sources. Some banks are giving their clients access to products and services that had only been available to the biggest of institutions. Technology has made it feasible and efficient to provide what we offer to individual investors. The amount of capital coming through those channels is growing exponentially.

Jacobson: Individual investors are coming in, and there are a lot of people, ourselves included, trying to put together lower-fee, higher-quality products with greater liquidity. If you come up with the right product, there will be huge demand. A lot of us are also focusing on the defined-contribution space. There is a lot of complexity, but 15 years from now that will be a big source [of capital].

How will demographics, technology, and urbanization impact real estate investment in the next decade?

Jacobson: Those trends are secular, and within those long trends we get cycles. Technology is driving the market today. There will be a year where we'll all forecast office absorption in San Francisco is going to stay at the current level, and there's going to be a year where it goes negative and everyone will say, "Oh no, rents have fallen!"

So where should investors be betting big today for tomorrow's returns?

Neidich: We wrestle with emerging submarkets in the gateway cities. The one question I haven't really heard a good answer to is, what happens with schools? What happens when all these millennials have families? Can the schools accommodate them? For urbanization, we're all going to have to make bets on schools.

Traenkle: I don't see trends changing anytime soon. People are putting off getting married, household formation is slowing, and people want to live in more urban areas than suburban. People are renting more. Home ownership rates are down, and it looks like they are going to continue to go down. So they are not going to buy the house out in the suburbs, they're probably going to be in an urban core. I'd rather make a bet in urban retail than in a suburban mall anchored by a JCPenney and a Sears.

So where are we in the real estate cycle in the U.S.?

Neidich: Seventh inning. My concept of the seventh inning is that on one hand you think you're near the end, [and] on the other hand, you just had six innings of great experiences, so it gives you a confidence that probably shouldn't be there, given you are late in the game.

Jacobson: Everyone says seventh inning, so it's probably wrong. We do a lot of scenario planning. But the fact that we all think it's good… We've had a great run, but going to extra innings is probably unlikely.

Traenkle: It feels a lot like 2005. Everything is going really well; it looks like there are no roadblocks in our way. But in two years' time, 2007 hits, and it all can come to an end. ■

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How to **Win 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

Michael Schwartz
Principal,
RSM

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.

He recounts receiving 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. "[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 [recent 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." ■

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How to Avoid Common JV Pitfalls

Joint ventures are integral to institutional real estate investing, yet dangers abound. Our experts describe how to avoid them.

David Rosenbaum, Founder, Managing Partner, WHI Real Estate Partners

Suzan Amato, Managing Director, Head of Managed Accounts, TIAA-CREF

Tom Green, Partner, National Real Estate Practice, RSM US LLP

Key Thoughts

Find Partners Who Want More Than Capital
"The wrong JV partner, for us, is one who is going out to the market looking for the cheapest capital. If they're doing that, it really implies they view equity capital as a commodity...rather than looking for a partner to own a piece of real estate with through[out] the life cycle of that investment. It's a fundamental mismatch."
David Rosenbaum, WHI Real Estate Partners

Plan for the Breakup
"The most important thing is, how do you get divorced so that it's graceful?... Strategy is really important. Hopefully, you exit when you want to exit. When you started in the marriage, you had an exit date in mind, but if you can't exit on that date, how can you exit without too much disruption?"
Suzan Amato, TIAA-CREF

Find Hometown Experts
"Honesty, integrity, and transparency. When we get past that, we're really looking for deep subject matter expertise... [people] who are sharpshooters...who know every building, every leasing agent, every investment-sales broker, and [who are] really never going to be 'home-towned,' because they are the hometown expert."
David Rosenbaum

Leasing Conflicts Can Be Deal Breakers
"Leasing conflicts...[are] a hot-button issue for development partners and co-investors. How do you deal with owning many buildings in the same neighbor-hood? We've got elaborate procedures in place for early identification of potential leasing conflicts, monitoring, and putting different leasing agents on it."
Suzan Amato

Fee Streams Aren't Profit Centers
"The bulk of [an operating partner's] compensa-tion through the holding period of an asset is going to come in the form of management and leasing fees. That's pretty good alignment.... The fee stream shouldn't be a profit center; it should fairly compen-sate the partner for keeping in place the team it needs to keep in place, at a fair amount of compensation, to operate the buildings for us and others."
David Rosenbaum

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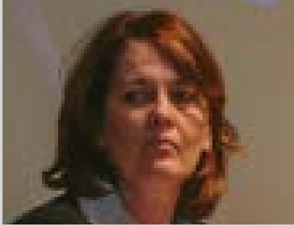
Prashant Tewari,
Principal,
Head of Investment Strategies,
Townsend Group

Judy McMahon,
Portfolio Manager,
Real Assets,
UPS Investment Trust



Paige Mueller,
Managing Director,
RCLCO

Drew Ierardi,
Senior Portfolio Manager,
Exelon Corporation

How Future-Proof Is Your Portfolio?

Investors are turning to secondaries, debt, open-ended funds, wider target allocation ranges, and even mining to provide some downside protection, say panelists from Exelon, UPS, RCLCO, and Townsend

Zoe Hughes, Privcap: In trying to future-proof portfolios, it's vital to ask what's the role of real estate. Are you becoming more defensive at this stage of the cycle as you look for liquidity or optionality?

Judy McMahon, UPS: I don't know that the role of real estate has changed, but what we do and how we get there may have changed. We have a clear mandate from our actuaries as to the returns we need to generate, a very short-term annual hurdle that we have to hit. We are definitely in the mature phases of the cycle, so we're looking to have liquidity and capital so that we have options. Nearer term, we're interested more in immediate investments; we're looking at secondary investments and avoiding J curve exposure.

Paige Mueller, RCLCO: Over the last few years we've seen strategies to embrace the J curve, to do more development as an opportunity to get in at a lower-cost basis on investments that you want to hold for a very long time, and a willingness to accept that risk because of where we were in the cycle. We're seeing those opportunities become fewer and fewer. We're also thinking about how [to do that] over some part of a 10-year cycle so we have more options than just being in a lot of closed-end funds.

Prashant, if investors want more options and liquidity at this part of the cycle, is this the time to avoid investing in closed-end funds?

Prashant Tewari, Townsend Group: I'll take on controversy and create a bit more—if you're looking for liquidity, this is the wrong asset class. This is an asset class where you place your bets for the long term. The question now is how far down are we going to go once supply starts exceeding demand. Supply is building, assets have started trading above replacement value, and capital has become more easily available, even for speculative developments. To future-proof things, I don't want investments building a J curve, hoping for returns when the cycle turns. I want investments to start generating returns today. On average, if someone comes in and says, "I've got a three-year investment period and then seven years to harvest it," we're sort of avoiding that.

So how is Exelon positioning itself?

Drew Ierardi, Exelon: [In 2015] we've gotten distributions back from funds, so we're averaging down

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as our denominator has grown, with the option to come into a final close based on what's happening in those markets and how we feel about those investments. And two of the last three things we've done have been real assets investments, taking some of those real estate distributions and going into not just infrastructure or things tangentially related to real estate, but things like metals and mining, moving very differently.

So what's the most dramatic thing you would do when the next crisis comes?

McMahon: When we have the next blip, there are going to be people who need some liquidity, and there are going to be LPs that would like to get out of their fund commitments. We'll be looking to invest at that time, and we probably would get those at a bit of a discount. Right now, we have a real estate credit-debt focus. We're invested in a couple of debt funds, and we've also been doing direct-debt investments.

Do investors have the courage and the mandate to actually pull the trigger when the next blip hits?

Mueller: First you have to know what's in your portfolio, which is amazingly difficult when you have a mix of funds and separate accounts. The technology industry is set up to provide technology to the advisors of "Here's what's in your portfolio." There's really nothing that's set up for the sources of capital, the plan sponsors. We've been setting up dashboard systems for investors, tracking the construction, financing, and other risks they have, so long before things happen, they know what's in their portfolio.

"To future-proof things, I don't want investments building a J curve, hoping for returns when the cycle turns. I want investments to start generating returns today."

–Prashant Tewari, Townsend Group

Prashant, you think there's four to five years before the next blip happens. Will investors be ready?

Tewari: It is not going to be easy from this point on. Strategies that have worked over the last four or five years might not be the best ones to follow going forward, and if there's ever a time for global diversification, now is a good time. If I have to construct a model portfolio that fits a big chunk of our client base, here's what it would look like: a sliver of emerging markets, a skew towards European markets, and a laser focus by sector and region in the U.S.

So what's the most important thing you have in your asset-allocation toolbox for future-proofing your portfolio?

Ierardi: We don't get a budget handed down to us from our investment committee; we manage it more dynamically. We work within a range from 4 percent to 9 percent, and our target is 6 [percent]. It's asymmetric, because we don't want to be called out of the market just because public equities have dropped and we're in a long-term asset class. It was 4 to 8, and last year we said, "At some point we're going to see a snapback in markets globally, and we're sitting on this illiquid portfolio, so let's make it 4 to 9. Maybe next year we'll make it 4 to 10."

McMahon: We do not specifically have a real estate or real assets allocation. We have a public market/private market allocation; our public side is somewhere around 75 percent of our portfolio, and our private market is around 20 percent at the moment. Real estate is about 5 percent. We will never go above 10. Could we go down to 2 percent? Sure. We don't have an annual allocation that says you have to put out X number of dollars. I might be looking at something that generates a 10 percent return, and our PE team is looking at something that generates that, and we allocate to the best risk-adjusted return. That helps us construct our portfolio to be ready for the changes that will be coming. ■

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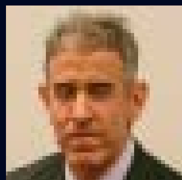
New Frontiers of Real Estate Debt

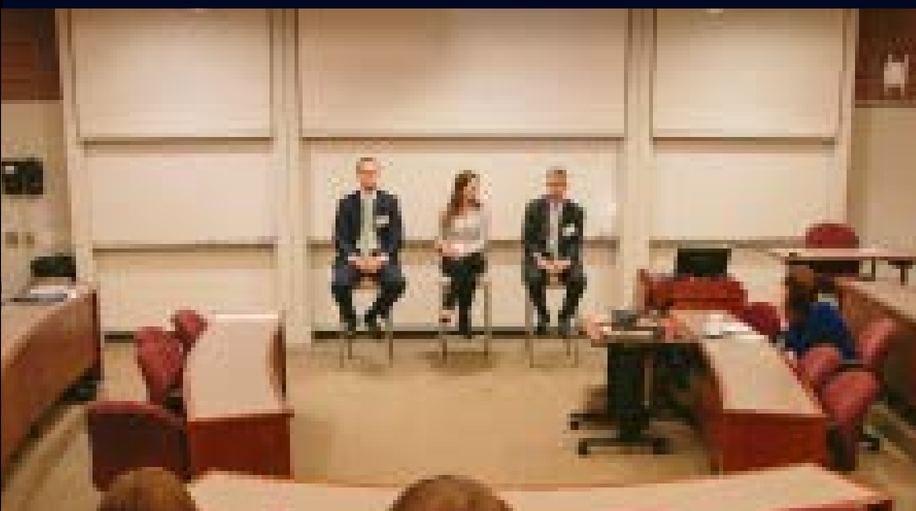
The debt landscape has been transformed in the wake of the financial crisis, with nonbank lenders now a permanent part of the market. But all eyes in the sector are open to future risks.



Jeff Friedman
Co-founder and Principal, Mesa West Capital

Richard Ratke,
Senior Principal, Walton Street Capital

Rachel Brown,
Partner, Kirkland & Ellis



Key Thoughts

Commercial Banks are Squeamish
"Commercial banks that are left are active…but what's really interesting is they are not aggressive…It's not a question of taking any risks, it's like we don't even want to think about whether or not we're taking risk"
Jeff Friedman, Mesa West

In Pricing Risk, Structure is Key
"Pricing risk is [about] how we set the table, our loan-to-value limits, and the type of assets we [will and] won't finance…You are putting all the bells and whistles into [structuring and] actually making sure you're well-aligned with the borrower. We don't want any cash leaving the asset until they reach a certain performance."
Richard Ratke, Walton Street Capital

Fear Big Shocks, Not a Rate Increase
"It feels like we're in a low-yield environment…[But] there's good reason for [rates] to go up if they're steadily rising and GDP is growing at 2 to 3 percent and unemployment is staying low. It's more the unexpected rise in rates and something dramatic happening that is more concerning."
Jeff Friedman

Risk Retention is Vital
"I'm worried about CMBS floating-rate lenders or a CDO market with a cost of capital 30 basis points over Libor [getting more aggressive on loan issuance]. As long as people hold the risk, as long as they're living with the risk, not a whole lot of bad is going on in the lending market floating-rate side."
Richard Ratke

Play Nice
"Try to keep in mind it's not a sprint, it's a marathon, and how you treat your relationships is going to make a difference in the future."
Jeff Friedman

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The Commingled Fund: **Alive and Well**

The blind-pool fund is a great structure for real estate's illiquid asset class and has come back in favor among many LPs, says John Ferguson, a partner and co-chair of Goodwin Procter's real estate practice

John Ferguson,
Partner, Business Law Department,
Co-chair, Real Estate Private Investment Funds Practice,
Goodwin Procter

PrivcapRE: How has the real estate capital-raising landscape transformed in the wake of the financial crisis?

John Ferguson, Goodwin Procter: We're seeing a lot of activity focused on real estate in the U.S. The commingled fund structure is alive and well. We're also seeing a lot of separate accounts and programmatic joint ventures. There is still some activity on the club-arrangement side, but that's tailed off over the last couple of years. Coming out of 2008, a lot of the institutional investors were much more focused on direct [investment] into real estate [and] swearing off funds. Over the last two to three years, the pendulum seems to have swung back a little bit. Today, deal flow—as compared to capital—is by far the scarcer commodity.

So what's driving that move back into commingled funds?

Ferguson: It's a number of factors. There's a lot of non-U.S. capital coming into U.S. real estate on a global level. The U.S. is a place of relative geopolitical stability as compared to many other regions. Interest rates have been low, so there's a lot of opportunity to seek yield from other, more nontraditional asset classes and real estate has filled that void. There's been a big focus on core and income-producing properties over the last four to five years. Now, we're seeing people go a little further out on the risk spectrum in terms of more opportunistic investing as well as into secondary and what might be considered tertiary markets.

CalPERS is using its stature and size in the industry to reduce its fee load for private equity and real estate investments. How do GPs structure around such issues?

Ferguson: On both the LP and the GP side, the hot-button topic at the end of the day is trying to properly align interests so that the GP is acting and is incentivized to act in the best interest of the LPs. You see that in the carry structure—the GP gets substantially rewarded, but not until the LPs get their money back and some return on their money. There are a variety of other issues that come up in negotiating fund documents that are all driven by the same desire: How can we try to encourage behavior from the LP perspective that is consistent with what we're expecting of the managers? ■

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Lunch Keynote

Making the Most of Real Estate's Technological Revolution

The interplay of technology and demographics promises to transform the drivers of real estate investment performance for the foreseeable future, says Dan Tangherlini, COO of Artemis Real Estate Partners

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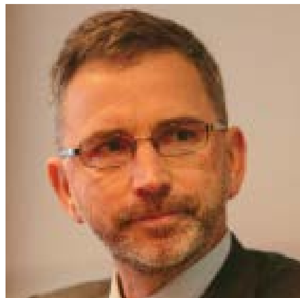
Demographics and technology will continue to impose "massive disruptive change" on the commercial real estate sector, said Dan Tangherlini, the chief operating officer of Artemis Real Estate Partners and former chief of the U.S. General Services Administration, during a keynote address at Privcap's Real Estate Game Change event.

As the former head of the U.S. General Services Administration, which manages federal government property, Tangherlini engineered significant savings on electricity and spearheaded efforts to reduce space usage. He's now bringing that insight into the private sector.

The U.S. population is growing older at the same time that millennials are exerting massive influence on home ownership, retail shopping, and other fundamental drivers of real estate use. "That's going to have tremendous impacts on the way people relate to our industry, what their expectations are on our culture, and the way people make investments," he says.

"I saw a Google [delivery] truck in my neighborhood the other day.... That, in and of itself, is an implication for logistics, for storage, for transfer, for our industrial space."

–Dan Tangherlini,
Artemis Real Estate Partners



Technology transforms industrial and retail

As the population evolves, Tangherlini says the increase in Internet connectivity is "the tip of the technological iceberg...that's dramatically changing the way people relate to each other and to the economy."

In 2014, two-thirds of American adults had a smartphone—up from just 35 percent in 2011—while 2.3 billion people globally had broadband Internet access via smartphones. That means the best-performing retailers will be those that have both a successful brick-and-mortar strategy and a successful e-commerce strategy, he says.

The rise of e-commerce is, in turn, driving changes in industrial property as major tech firms like Amazon and Google re-engineer the country's logistics system. "I saw a Google truck in my neighborhood the other day," says Tangherlini. "It wasn't the Google Earth one. It was a Google delivery truck. That, in and of itself, is an implication for logistics, for storage, for transfer, for our industrial space."

Aging population pushes capacity

By 2030, nearly 17 percent of Americans will be 65 or older—the largest proportion of older people in the country's history. That promises to fuel increased investment in real estate designed to meet increasing demand for medical services delivered in a homecare environment. "Older parents are getting a lot older, and their medical intensity is increasing dramatically," Tangherlini says. At the same time, he adds, the capacity to actually deal with that in-home is limited.

Building management takes center stage

The greatest opportunity for improvement resides in the building-management and administrative functions of real estate investment companies. "Technology is really going to have a dramatic disruption in the near term in the way that we actually go about our business," Tangherlini says, adding that Artemis invested half its money through emerging manager operating partners—only 14 percent of which used any kind of energy-management software.

"Given the fact that, in commercial real estate, the estimates are as high as 30 percent potential savings through improved energy management, there's a huge opportunity for dramatically improving NOI," he says. ■

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Co-investments, Capabilities and Comfort

When it comes to co-investment deals, investors don't just need bandwidth and the capabilities to do the deal; they also need to get investment committee and risk professionals comfortable with the transaction, say panelists from Allstate, GTIS, and Metro-politan

Andrew Jacobs,
Managing Director,
Metropolitan Real Estate

Tom Shapiro,
President, CIO,
GTIS Partners

Michael Moran,
Managing Director,
Real Estate,
Allstate Investments

Andrew Jacobs, Metropolitan: How is co-investment today different from deals historically?

Tom Shapiro, GTIS: Historically, real estate wasn't even an asset class. It's been an evolution to where we have a fund, and for whatever reason—maybe concentration in that deal or maybe concentration within an asset class—it's too large a concentration for the fund, and we will now bring in co-investors. A lot of LPs like this because it allows them to over-allocate to a deal that they like and alter the size or profile of their portfolio.

Michael Moran, Allstate: The difference today is that we want more transparency. The broadly diversified fund portfolio was good in some cycles but not good in others, and we felt that we could take greater concentration risk in assets but preferred transparency, greater control, and lower fees, quite frankly, in a more negotiated, direct model.

Are a lot of managers saying, "Come into my co-investment—use it as kind of a trial run for coming into the fund"?

Shapiro: We see that all the time. But the punch line is, we are fiduciaries to the LP base of the fund. So we set it up that every LP—it doesn't matter if you invested $1M or you invested $200M in our fund—has a right to co-investment on a proportional basis.

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Moran: We have opt-in rights on any deal. But the fund operator who has a deal that's too large and is looking to syndicate to LP investors, we just don't see [that] a lot. How many funds do you think are doing that? And how many LPs are able to take advantage of it?

Shapiro: We've never done a fund that hasn't had one or two deals that have co-investment opportunity. So we do it, but it's a small group—usually some high-net-worth investors and a couple of the large LPs step up.

We see the same thing both of you have mentioned. [There's] a wonderful co-investment opportunity, large and small investors have rights to it legally, but when a deal comes across the transom, very few can actually execute. What types of co-investors are able to execute in a relatively short time frame?

Shapiro: It runs the gamut. One thing we try not to say is, "You've got 10 days to decide." A lot of them have already underwritten us and have given us significant capital, so they have a comfort level with us but don't have the time to really go through and underwrite an opportunity. Some investors get into the weeds as if doing a direct investment. Other investors say, "Well, we've already allocated, and we want more hospitality exposure in our general portfolio…This looks interesting." And sometimes the answer will just be simply, "It sounds interesting, but I don't have the time to look at it."

Moran: When I think about co-investment, I think about a strategic relationship, partnering with an operator who has some discretionary capital, but the majority of the capital is not discretionary. With shortened time frames, you have influence over structuring—at least in most of the deals that we do—so we had to retool everything, from how a deal comes in to how quickly it moves through our prescreening process, so that we can all have conviction around it.

1. GTIS' Shapiro talks with Metropolitan's Jacobs.
2. Allstate's Moran weighs in.

Shapiro: Do you have to have every deal approved at the committee level?

Moran: No, but we don't want to do anything that they wouldn't approve.

So you'll do a vetting memo to them?

Moran: Absolutely. We're not going to do the same co-underwriting that the sponsor does in a co-investment, but we're going to make ourselves and our investment committee comfortable with the transaction. As important as having the bandwidth and capabilities to co-underwrite is the rhythm of vetting a deal—getting ourselves comfortable and being transparent with our investment committee and risk people." ■

> "So we see a wonderful co-investment opportunity, large and small investors have rights to it legally, but when a deal comes across the transom, very few can actually execute."
>
> –Andrew Jacobs, Metropolitan

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Healthcare Deals are Hot, but Hard to Get

Demographic trends have turned healthcare-related real estate into an institutional asset class, but industry fragmentation means deals are hard to find

Chris Merrill, CEO, Harrison Street Real Estate Capital

David Hirschberg, Managing Director, Co-head, H.I.G Realty Partners

"You can make mistakes in this asset class. You'll see what we 'call need versus want procedures.' How are they going to do in a tougher market? You have to look at the use of the facility and in tougher economic cycles, [ask] what's the volatility of your cash flow."

Chris Merrill, Harrison Street

Key Thoughts

There Are No Doctors in the House
"The challenge in the medical space is that there's more and more people who need healthcare. The question is, where are all the doctors going to come from? That's the bigger issue in this country now. How are we going to deliver healthcare to the masses?"
Chris Merrill, Harrison Street

Incentivize Your Operating Partners
"Everything we do is with operating partners—local and regional, very high- quality, best-in-class operators—but making that structure so that everybody's incentivized to row in the same directions [is vital]. Start with how you think about a partnership and go into it with the same sense of emergency, or at least a relevant allocation or apportionment of risks and rewards."
David Hirschberg, H.I.G Realty Partners

Accessing Deals Is the Arbitrage of 2016
"A very interesting arbitrage exists right now. There's a lot of capital out there. It's just hard to access [deals]. They're small, fragmented [with as little as] 10 to 15 percent institutional ownership.... [But] there is a portfolio premium."
Chris Merrill

Underwrite Tenant Credit Carefully
"You end up having a lot of one-off tenants that are good, strong theoretical credits, and then, when the hospital system buys that physician practice, now you have AAA credit. But you're also subject to whether the hospital wants to stay there or not."
David Hirschberg

It's Not Just About Medical Office
"There are a lot of ways to deliver healthcare within the real estate space. It can be a surgery center, an inpatient rehab facilities, wellness centers... You're seeing a big change now with the consolidation in the physicians' groups.... The hospitals are trying to get into the communities."
Chris Merrill

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Keith Dunkin,
President, Asset Optimization and Business Intelligence, RealPage

Mark Hafner,
Senior Managing Director, Greystar

Ways Multifamily Is **Building for the Future**

Greystar manages and owns more than 415,000 multifamily units across the U.S., with roughly $7.5B of development deals currently capitalized or under construction in the U.S., Europe, and Latin America. Senior managing director Mark Hafner talks with RealPage's president of asset optimization and business intelligence, Keith Dunkin, about demographics, affordability, and international growth.

Keith Dunkin, RealPage: Multifamily has benefited from the influx of institutional capital in the past several years. What's your perspective on the U.S., going into this portion of the cycle?

Mark Hafner, Greystar: We remain very bullish. The fundamental difference between what's driving values and appreciation now versus back in 2004 to 2007 is that the growth and values we're seeing now are a function, really, of net operating income [NOI] growth and, in particular, revenue growth.

Although we're still anticipating 300 to 450 basis points in rent acceleration in the next several years across the U.S., are people starting to feel we're towards the further end of that continuum?

Hafner: It's just phenomenal, the rent growth we're seeing. Over the last quarter, our average [market] rent growth nationally has been 5 percent across all markets, with a number of markets greatly outperforming that. And what's notable is we're also seeing acceleration in rent growth. We've been at 5 percent for the last three quarters running. Our expense control has been very good, so most of the revenue increases are dropping directly to the bottom line.

The one headwind that everyone talks about is affordability. Are people overpaying for rent?

Hafner: A resident may very well complain about the rental increase, but the fact is they're not going to get a better deal somewhere else. What's really driving the rent growth right now is demand, which is the highest we've seen in a generation. Rent growth in 2011 and 2012 reflected a dearth of new supply. Now we're delivering historically average new supply, but the demographics are powerful. Not only do we have a lot more 21-to-35-year-olds, but their propensity to rent is actually increasing at a greater percentage than the overall population. If you zero in on that 21-to-35 cohort, their home ownership rate has actually dropped at an even greater rate than the population [as a whole], from a peak of about 44 percent down to 34 percent. The other piece of the equation is the single-family market—we're far below historical home-building levels at a time when we expect household formation to be far greater than [it has been] historically.

Greystar has embarked on probably the broadest international expansion of any operator in and around the U.S. that I'm familiar with. What drove you to contemplate expanding internationally?

Hafner: Our strategy started off opportunistically via a deal. We've been in business 22 years, and for the

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1. *Keith Dunkin from RealPage interviews Mark Hafner from Greystar.*
2. *Attendees watch the multifamily discussion.*

first 19 our focus was 100 percent on the U.S. In 2012 we looked at a couple of opportunities in the U.K.; we didn't invest, but that got us looking. The U.K. in 2012 to 2013 felt very similar to the U.S. in 2010 and 2011. We saw a lot of early signs of the market recovery. There was a lack of liquidity. Debt spreads were just ridiculously wide. I remember looking at a portfolio of existing student properties in Central London, all new build, core, at a 6 [percent] cap [rate]. At the same time, we were bidding a portfolio in New York at a sub-3 cap. Obviously arbitrages like that, they're not going to persist.

> "What's really driving the rent growth right now is demand, which is the highest we've seen in a generation."
>
> –Mark Hafner, Greystar

What did you do?

Hafner: Having the benefit of hindsight from the U.S. recovery, we bought about 22,000 beds of student housing, [for] about $4B, over 18 months. The U.K. recovered quicker than we anticipated. We saw cap rate compression of 150 basis points over the course of just 12 months—but we were able to get a lot invested before that capital came in.

How do your institutional partners view the international market for multifamily?

Hafner: Many of our LPs had already been active in those markets. But it's hard to invest in residential. The business model in most markets is a for-sale market. A developer will build a 300-unit tower and sell 30 percent to 50 percent of the units to individual owners who rent those units in a shadow market that's really the rental market in these countries. We allow our investors to invest in a theme that is very attractive—investing in the growing middle class, particularly in the emerging markets.

How do you bring Greystar processes to international markets?

Hafner: In Latin America, Europe, and Asia, the industry really doesn't exist. So we're not only building a business, we're building an industry, and we have to bring a lot of our U.S. resources to these markets. At the same time, real estate's inherently a local business, so we hire local talent and merge them in our U.S. businesses. We have them work on properties in the U.S., and we send our U.S. people over for stints of two years. We build a local team with a long-term strategy, just as we would in the U.S. ■

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Europe's Party Won't Last Forever

There is a remarkable opportunity taking place in Europe's real estate markets, and Tristan Capital Partners is in a "disciplined hurry" to make the most of it, says CEO Ric Lewis

Ric Lewis
CEO,
Tristan Capital Partners

Zoe Hughes, PrivcapRE: You've previously told me that real estate cycles are shorter, faster, and sharper than they have been before. Given that backdrop, how much growth is there to come in the European market?

Ric Lewis, Tristan Capital Partners: Right now, you look at where the economy is, and you look at how it's positioned. You have the most accommodated fiscal policy in 100 years—the lowest rates. You have [the euro] that's down 10 to 25 percent against the major currencies of the world, commodity prices and oil prices down 40 to 50 percent. The patient, as I like to say, isn't primed to stay alive. It's primed to get up, walk, and start running. The windfall profits of moving early into this opportunity—some of those have passed. The smart money and smart investors coming to Europe are those who want to place themselves in the pathway of growth.

What's the impact of the macro environment on Europe's real estate markets?

Lewis: Despite [Europe's] growth, the foreign currency and fiscal policy divergence between the U.S. and Europe is pretty significant, and there's a chance that you're going to see a euro that costs less than $1 in 2016 and 2017. So the entry price into a European strategy is pretty interesting.

How do you view your 2016 deal pipeline versus what you did in 2015?

Lewis: We had a gangbuster year in terms of how much we were going to do. For a small boutique firm, we did €3.2B of transactions [in 2015]. On the investment side, we closed 26 deals. We have 10 more under exclusivity. All of those sound like wonderful numbers, but if you think of us as a firm that started the year with about €5.5B of assets under management and ended the year with €7B and we turned over €3.2B in investments and sales, that's been a pretty busy year. Our stance, which I've said to clients and I think I've said to you privately, [is that] we're in a disciplined hurry.

I like where the European economy is. I like that there's two-way traffic. I like that there's some question about whether growth is going to be enduring and where it's going to happen. I like the fact that there's great fiscal policy, that debt is almost free. We're in a hurry to make value of that, because I don't know whether it will be two years, three years, four years, but all good parties come to an end. There's a closing time at some point, and when that happens, whether I do it or not, I want our portfolio to be in a position where we can be a net seller. ■

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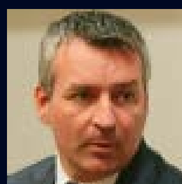
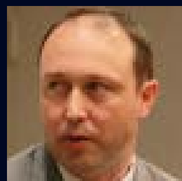
How Tech Is Changing Hospitality

Hotel operators live and die by reviews on TripAdvisor. Yet despite the challenges posed by the Internet, technology is also opening up opportunities for cost control.

Denise Olsen, Senior Managing Director, GEM Realty Capital



Russell Munn, Senior Vice President, Lowe Enterprises Investors



John McCourt, Partner, RSM

Key Thoughts

Technology Is Hospitality's Biggest Disrupter
"One of the key disrupters is technology, whether it's booking a room or rating your experience. It's breaking down the power of some of the branding, and how that room is built and developed. There's nothing like being in a room where the only place you can find a plug is the back of the bed."
Denise Olsen, GEM Realty

A Hospitality Slowdown Is in the Cards
"You have to be a long-term investor, understanding that when you least expect it, there could be another cycle. And you need to have the right asset, the right business plan, and the right capital structure to be able to withstand the cycles of the industry."
Russell Munn, Lowe Enterprises

Operations Costs Are Being Reduced
"What hasn't yet fully played out is the reduction in the cost of running a hotel, based on labor...as technology replaces [some of the check-in requirements]...or what is happening in the back of the house. Many hotels don't need the infrastructure [of restaurants or 24/7 room service]...to service the expectation of today's consumer."
Denise Olsen

Independents Struggle to Keep Up
"We talk about the independent hotels today as if there's a resurgence...but today [there are about] 70 percent branded hotels and 30 percent independent. The brands have a decided advantage, because when Marriott wants to let you enter your room via your iPhone...there's economies of scale. Independents have a much harder time keeping up with that change."
Russell Munn

Energy Management Is the Next Disrupter
"We waste a lot of energy [in hotels]. [At] our hotel in Houston, our air-conditioning bill is unbelievable. We've got a long way to go on the energy-management side that could be a real boost to the bottom line, and there's a lot of companies entering that space, but it's nascent."
Russell Munn

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How the Cloud Is *Changing Office*

As the need for traditional office space shrinks dramatically, tenants are overhauling their definition of what an office is for and how it should look. And it's not just impacting urban downtown locations—suburban office needs to revamp as wel

Gunnar Branson,
CEO,
NAREIM

Jeff Gronning,
Founder and Partner,
Normandy Real Estate Partners

Seth Singerman,
President and CEO,
Singerman Real Estate

Gunnar Branson, NAREIM: One of the things we keep missing in real estate is how technology is eliminating the need for space or changing what people do with that space. What are you seeing happen in office?

Jeff Gronning, Normandy: The '70s, '80s, and '90s, the generation of baby boomers, was characterized by urban flight out of the cities. People made money in the office sector, investing in developing office parks in the burbs right up into the early 2000s. After the financial crisis, there was a changeover in the mindset of companies and the people making up an increasing part of their workforce—millennials—and they're much more urban. So you're seeing movement back into the cities. And technology has certainly had an impact on all that. The average number of square feet per office worker is almost half of what it was 25 years ago.

Our goal is to take buildings that are in fundamentally in-demand locations, but have been mismanaged or need to be redeveloped in some way, and create office environments that are in demand. We can then go from a broken asset to a core asset that somebody wants to buy.

So where are these locations?

Seth Singerman, Singerman Real Estate: Look out the window to two of the large buildings you can see: the Prudential Tower and the Aon [Center]. That's the East Loop of Chicago. Five years ago, from an institutional perspective, that was off limits. The West Loop, where commuter traffic came in from the suburbs, was ground zero for office in Chicago. But in the past two years, tenants have leased more than 1 million square feet in those two buildings, because the people who are the employees there are living downtown.

And the cloud means that if your files are accessible, you can [have your] office anywhere. I have an anecdote in terms of law firms: One law firm reduced its space by a third, and when they finally moved into the new space, they turned to their broker and said, "We should have gone down another third." How does that change the definition of office?

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1. Singerman and Gronning listen to a question from Branson.
2. Privcap's David Snow asks panelists a question.

Gronning: All their record keeping is digital. So they don't need the big library and the file cabinets the way they used to. Law firms are all moving, because they want to completely reimagine their space, and that's incredibly difficult to do in a 15-year-old buildout. So they're picking up and moving to brand-new buildings where they can start over.

Singerman: Law firms are one type of tenant where there's been a dramatic decrease in square feet. The average use was 250 square feet per employee. Now it's down to 180. We have actually done spec suites that have been creative [offices] where we thought we'd get a more techy type of tenant. And we actually got some small-to-medium-sized law firms.

It's easy to dismiss creative office and the shrinking of space when we're talking about millennials and tech firms with pool tables. And yet now we have law firms behaving that way. When are we going to go back to the old days?

Gronning: We're in the midst of a shift, and maybe it's secular, this whole demographic change and urbanization and amenitization. I don't see that going away any time soon. It's still a rising wave.

Singerman: This kind of urbanization is occurring in other, smaller markets as well. It could be Milwaukee, it could be Pittsburgh—even downtown Detroit. The other thing is, you need "we" space for collaboration, but the reality is you also need "me" space where you can do something in private, put your head down, and get some work done. Having the right balance is how you'll see space used going forward.

And what do we do with all those suburban office parks we built in the '80s and '90s?

Singerman: It is a challenge, but suburban office isn't going away. You need to amenitize. You need to have the café, you need to have the health club. You need to create some opportunities for people outside of just the work environment.

Gronning: I agree with that. In suburbs where we own property—mainly around New York City—there's not a lot of organic growth. We're addressing it in a couple of different ways, [like] amenitize it to the extent that you can. But in certain places, you've got office parks, Class B, '80s vintage buildings. We're taking tenants that were in three buildings we own, putting them into three other buildings that we own, making those assets 90 percent leased, and rezoning the three vacant buildings to knock them down and do retail and multifamily. We're sort of solving our own problem by reducing the office supply. And we own it on a cheap enough basis that we can knock down these buildings and make money selling the dirt. ■

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Tom Green,
Partner,
National Real
Estate Practice,
RSM

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. But it comes with major structural challenges.

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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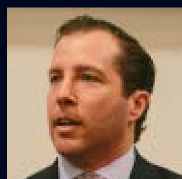
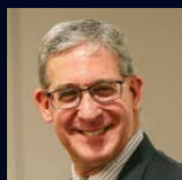
Why Amazon Won't Kill Retail

The death of grocers, malls, big-box retailers, and strip malls is over-hyped, says a panel of experts. Indeed, retail is meeting the challenge of online shopping, but it's important to think creatively about consumer experiences.

Todd Minnis, CIO, Cypress Equities



Adam Munder, Principal, Sterling Organization



Michael Schwartz, Principal, RSM US LLP

Key Thoughts

Amazon Didn't Kill the Power Center
"Retail has met the challenge of the Internet....We thought, three years ago, [that] Amazon was going to significantly impact [power centers and big-box retailers]. But the reality is we're seeing 96-97 percent lease [rates]. We found they could coexist. People are evolving. The businesses are evolving."
Todd Minnis, Cypress Equities

Don't Take Much Reuse Risk When Signing Tenants
"As a landlord, if [Retailer A] decided they wanted the best locations and were willing to pay $30-$40 a square foot...if they ever have a problem, as a landlord you are never going to backfill that space anywhere close to $30-$40. So we're happy buying a Kmart that's paying $6 a [square] foot when the market rate is $15-$16. In fact, we hope they go out of business, or in some cases you may pay them to vacate."
Adam Munder, Sterling Organization

Full-Service Retail Is Key
"In the first quarter of 2015, restaurants outpaced grocery store sales for the first time ever. [You are] trying to capture three or four hours of [people's] Saturday afternoon...which is about full-service restaurants, entertainment, unique shopping, public spaces, food trucks, or farmers' markets."
Todd Minnis

Increased Capital Flows Are Driving Up Prices
"Over the last 12 months, the larger deals that are greater than a $20M equity check, you've got so much capital chasing those deals, it's driven up prices to the point where you can have a hard time making the numbers work. So we're focused on smaller deals in the space, with $5M to $7M equity checks. It's more work for us but gets us to the returns we need for our investors."
Adam Munder

Retailers and Landlords Must Think Creatively
"For 50-plus years, Macy's and most of the department stores said, 'Don't touch my parking lot.' Today they ask, 'Could you put an office building at the front door of that parking lot? [Are] there some apartments you could build up?' It's extremely refreshing, because this densification, urbanization, that's the way the market is going—and a lot of these urban malls have that potential."
Todd Minnis

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Will Fundraising Slow Down in 2016?

Lori Campana,
Partner,
Monument Group

With more than $221B of real estate dry powder and U.S. investors questioning how to position their portfolios for late-cyc le investing, private equity real estate fundraising in 2016 could be on track to slow.

Private equity real estate GPs should brace themselves for a pullback in fresh allocations in 2016, thanks to the overhang of dry powder and maturing portfolios.

Distributions to LPs in 2015 are expected to reach all-time highs of more than $187B, but Lori Campana, a partner at the Boston-based placement agent Monument Group, expects fundraising for commingled funds to slow slightly in the next 12 months as investors—and managers—become more cautious in their investments.

There was more than $221B of dry powder sitting uncalled in private equity real estate funds as of the end of November 2015, according to Preqin, thanks in part to a strong fundraising environment, with more than $96B raised in 2015.

However, Campana says a slowdown is inevitable for managers targeting a fund close in 2016. "There is such an overhang of dry powder facing managers, even though we had some of the most active drawn-down activity we've seen for a while in the second half of the year," she says.

Part of the challenge is balancing "compelling" opportunities in the current cycle, she says, against the limited liquidity within their mature portfolios.

Asian investors, however, could represent a bright spot in the fundraising landscape and could offset any pullback from U.S. and European investors, says Campana. "Cross-border capital is definitely here to stay, and Asia is undoubtedly one of the most important fundraising markets to be in today."

While most investors in Asia have traditionally targeted separate account or club deal structures, Asian LPs are becoming much more sophisticated and diverse in how they invest globally.

Campana adds that fundraising in the region is a long-term relationship. "You don't meet an investor in Asia and come back with a check after one visit. You meet them many times, and you meet the hierarchy within their organization. It's a long relationship-building and educational process," she says. "It's a lot of baby steps and requires patience and flexibility."

One fundraising trend that is set to continue in 2016, Campana predicts, is the bifurcation between the "haves and have-nots," In 2015, the top five real estate fundraises accounted for more than a third of the total equity dollars raised, with Blackstone Group raising $15.8B for its eighth opportunity fund and Lone Star raising $5.8B for its Fund IV.

Monument Group assisted Beacon Capital Partners garner $1.4B for its Strategic Partners VII fund in 2015. Campana says LPs are increasingly looking to value-add strategies across sectors but are also emphasizing the importance of pre-specified portfolios from GPs.

"It's always been part of the format, but in a mature market you need to differentiate yourself, and pre-specified assets give you a competitive advantage," she says. Beacon Capital's fund was approximately 25 percent pre-specified during its fundraising, and the ability to demonstrate such "access to deals was tremendously helpful.

"The difficulty for any manager is, how do you turn those pre-specified deals into closed deals without abundant closed capital?," asks Campana. "It's about a strong and trusted reputation and getting early investors excited to commit to the fund and provide co-investment capital."■

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