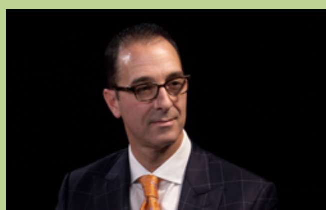
Privcap/ Video Briefing

Q2 2016

The Realities of Repositioning Real Estate

An executive summary of the video series
"Real Estate Transformation and Value-Add Investing"

Chris Balestra
Taconic Investment Partners



Jason Sevier
RSM US LLP

Kevin Smith
TIAA Global Asset Management

Sponsored by

The Realities of Repositioning Real Estate

Key Findings

1. *Overthinking Building Improvements Can Cost You*
2. *Keep Existing Tenants Happy*
3. *WeWork and Others Are Redefining Lease Terms*
4. *Pre-Built Space Could Be a Thing of the Past*
5. *The Best JVs Plan a Graceful Divorce*

The Panelists

Chris Balestra
Senior Vice President,
Taconic Investment Partners

Jason Sevier
Partner,
RSM US LLP

Kevin Smith
Senior Director,
TIAA Global Asset Management

↓ CONTINUES ON NEXT PAGE

© 2016 Privcap LLC

1 Overthinking Building Improvements Can Cost You

Landlords eyeing a renovation of their building need a clear understanding of their future tenant to avoid overthinking—and overpaying for—building improvements.

While property owners are required to be more "creative" in how they renovate real estate spaces—not least in the office sector, where tenant demand for open-plan, collaborative space is leading to higher buildout costs—there is a danger of overthinking the process, says RSM US LLP partner Jason Sevier. That could ultimately lead owners to waste equity dollars, and returns, on unneeded improvements.

"Owners have to be creative, but sometimes they overthink it," says Sevier. "Then they can get in trouble with taking on way more costs than they [planned] because they think they have to."

For Kevin Smith, senior director at the investment-management firm TIAA Global Assest Management, investing in building improvements means it's critical for owners to understand a property's prospective tenant audience—and what makes sense for those types of tenants.

"If you're trying to attract city-government-type tenants in your building, you're not going to build out a very robust fitness center [or...] high-end food service. You're going to cater your amenities or your building improvements to that group of tenancies," he says, warning that some landlords have attempted to appeal to technology, advertising, media, and information (TAMI) firms—known for renting brick-and-beam or loft-style offices—for their high-rise office towers.

"You can't create the same authenticity that you can create in a pre-war building that you would get in [New York's] Meatpacking District or something of that nature," he says. "You have to know who your audience is."

Anticipating the Unexpected on Fifth Avenue

Kevin Smith
Senior Director,
TIAA Global Asset Management

In renovating and repositioning the New York office property at 475 Fifth Avenue, TIAA learned lessons, says senior director Kevin Smith. At the top of the list: Even partially demolished buildings hold surprises.

After buying the almost-vacant property for $144M in 2011 from Barclays, Smith says TIAA undertook a "soup-to-nuts" redevelopment of the 24-story property, including the building's entire systems; upgrading the elevator banks and moving the property entrance to 41st Street to maximize the retail space along Fifth Avenue.

"It was a project that took about two years to fully complete ...[with] both great things happen[ing] on it, as well as some lessons learned," Smith says, including the lesson that even when buying a property in a "state of demolition," there are things "you're not going to be able to anticipate."

Another lesson was the interest shown by technology, advertising, media, and information (TAMI) tenants as opposed to the expected boutique financial-services firms.

Smith says: "Thankfully it didn't cost us a lot of dollars [in retrofit costs], but...it could have been much different had we pre-built a lot of the space."

↓ CONTINUES ON NEXT PAGE

© 2016 Privcap LLC

Don't Forget the Infrastructure

Chris Balestra
Senior Vice President,
Taconic Investment Partners

Taconic Investment Partners is no stranger to renovating unique properties: not least Google's three-million-square-foot headquarters on New York's Eighth Avenue, and the office tower 450 Park Avenue, which, when sold in 2007, reportedly achieved the highest price per square foot in the U.S.

For Chris Balestra, senior vice president of Taconic Investment Partners, the key lesson learned through all of that is communication with partners. "Honesty is the best policy, and if something isn't quite going right, it's better to deal with that sooner than later."

Speaking about Taconic's latest project—Essex Crossing, the 1.9-million-square-foot residential, retail, office, and community redevelopment of six acres of underutilized land in New York's Lower East Side—Balestra says that things are running smoothly so far but that roadblocks could come at any time.

"We're going to hit some hiccup, and you're going to want to let your partner know that 'Hey, we've got to make these adjustments.' If you do that, and you do that up front, things are usually okay."

Balestra also sees being a long-term owner of real estate as beneficial in today's markets, although it's certainly not critical.

"A capital partner who absolutely has to get out in three or four years is not going to be a great partner if there's a bump in the road," Balestra says.

2 Keep Existing Tenants Happy

Repositioning and renovating a property isn't always about attracting new tenants. Often it's a critical way of retaining existing tenants in a location.

Chris Balestra, senior vice president of New York–focused operating partner Taconic Investment Partners, says the growing importance of TAMI and tech-focused firms in the U.S. leasing market and their call for more open and amenity-heavy space has led to a wave of renovations, not least in offices in prime core locations.

"[TAMI tenants] tend to be more creative tenants. They tend to work different hours. They tend to be interested in different things. They like open space," says Balestra, whose firm previously owned and now manages Google's three-million- square-foot headquarters in New York at 111 Eighth Avenue. "That's been a huge driver of tenant demand in some buildings these days, whereas 10 years ago you didn't really think of a rooftop as a nice place for [anything other than] mechanical equipment."

However, he warns, improving an existing space isn't just about appealing to new tenants: These same amenities help keep tenants in the building so that the space doesn't have to be re-leased after a first-generation lease.

Both Sevier and Smith agree that keeping existing tenants happy is as important a role for landlords as trying to improve the tenant mix—and drive rents higher.

"It's a combination," says Sevier. Smith cites TIAA's recent renovation of One Boston Place in Boston—conducted largely to retain the existing anchor tenant, the Bank of New York Mellon, which had been in the office tower since 1980—as a prime example of the need to listen to existing tenants. BNY came to TIAA early in the renewal discussion, saying that they loved the building but desired certain upgrades. "In order to recruit the talent, in order to build on some of their business lines, they needed more amenities in the building," says Smith.

↓ CONTINUES ON NEXT PAGE

© 2016 Privcap LLC

3 WeWork and Others Are Redefining Lease Terms

The traditional 10-year lease is under threat from the "WeWork phenomenon" of startup firms demanding shorter lease terms of just two to three years.

As newer, smaller firms become a growing presence in commercial real estate leasing markets globally, landlords and investors are facing the challenge of trying to accommodate companies with not only less financial backing and track records but that are also demanding shorter leases.

"I would call this the WeWork effect," says Smith.

He explains that an increasing number of tech-focused companies, as well as smaller boutique financial firms, are asking for two- or three-year leases, calling it an interesting problem for an institutional landlord like TIAA when it is investing in tenant improvements and building renovations "It's definitely having an impact on how we look at [spending on] pre-built spaces," says Smith.

For Sevier, though, the growth of shorter leases could be a sign of things to come for commercial real estate landlords. "I think the typical 10-year lease may not be the lease of the day anymore," he warns. "You're going to see different versions of the lease agreement [in the future]."

4 Pre-Built Space Could Be a Thing of the Past

The days of building out an office space before signing a tenant could be over.

While landlords are trying to better understand their prospective tenant—and what they demand in an office space—there is no guarantee that property owners will get the buildout exactly right for every prospective tenant.

Don't Forget the Infrastructure

Jason Sevier
Partner,
RSM US LLP

When considering the redevelopment or renovation of a building, real estate owners and investors are paying close attention to the changing preferences and behaviors of end users.

However, Jason Sevier, partner at RSM, says one challenge remains for owners and investors when considering any redevelopment or renovation project—the infrastructure surrounding the property or development.

Sevier highlights the city of Baltimore, where officials are making a major push to attract a greater diversity of business to the region. In January 2016, the sports apparel firm Under Armour unveiled its plans to consolidate its Baltimore employees on a new 50-acre campus that will include innovation labs, sporting fields, fitness centers, manufacturing facilities, public parks, and green spaces.

Yet Sevier says that questions remain about infrastructure—and even school systems—in cities such as Baltimore and in large gateway markets including New York: "The infrastructure issues are huge in a city like Baltimore. And, to me, that causes a little bit of an obstacle to fully getting to where you [as a developer] want to be."

↓ CONTINUES ON NEXT PAGE

© 2016 Privcap LLC

Balestra says Taconic tries not to use pre-built spaces, "because more often than not you end up ripping out this conference room, putting an office in, or putting in cubicles where you had offices."

Sevier agrees there is no such thing as a "cookie-cutter" office design in today's commercial real estate markets and says that you have to look at your options differently now. "The pre-build, to me, is almost out the window. It's more about the space," he says. Identifying who you think will lease the space—and then, once you have them, looking at the space and working with them to retrofit it to how they want it—is the way to go, Sevier adds. "I think you have to rethink your leasing options."

For Smith, one interesting opportunity in the current real estate cycle is pre-built office space catering to the growth of creative startups backed by venture capital.

While most pre-built space in commercial real estate has traditionally focused on the 3,000-to-5,000-square-foot office space, creative startups—which are growing fast owing to their VC backing but don't yet know their future requirements—are causing demand for 10,000-to-20,000-square-foot pre-built space.

There have been a couple of key examples where buildings have done 15,000- and 20,000-square-foot pre-builds and they're leasing them up quickly, says Smith. "But they're leasing them up to startups that are maybe in their second round of [VC] funding."

5 The Best JVs Plan a Graceful Divorce

The most successful joint ventures [JVs] are ones that plan—from the outset—how to divorce gracefully should one partner need to exit early.

While transparency and open communication among operating partners and capital partners are critical in ensuring—and maintaining—a true alignment of interest, planning from the outset how to break up the partnership could be another key to success.

Balestra says that for operating partner Taconic, planning for the unexpected, and asking for terms such as lockout provisions and the right of first refusal to buy out a partner, are vital elements when considering value-add JV deals, not least those involving renovations and ground-up developments.

"It's ugly if you've got a partially demo'ed building, your capital partner needs out, and you need to bring somebody in and they need to do all that new diligence," he says.

The first step is to look and make sure that they have a lockout for a certain length of time during construction, says Balestra, adding that it could be for one year or for two or three years—whatever the right timeframe is for the asset. Then, after the lockout, if the other partner needs to sell or wants to sell for some reason, "we just want the first opportunity to take them out at a sensible price."

Sevier adds that "ironing out" those issues up front is critical. "If [a JV partner] wants to get out, if you want to have that divorce, how do you do it? Because there could be a property that needs to be monetized and the market is at such a point where it makes sense to get out now, but maybe the JV partner doesn't want to get out, or vice versa."

Transparency, communication, and reporting also remain vital features of successful JVs. Smith says it is about working with people you trust.

The TIAA senior director says: "It's doing the due diligence of your operators and making sure it's somebody that's been successful in the past, that has not had any major issues with partners in the past… [It's] bringing [an] issue up as soon as possible, as opposed to letting it sit and not knowing about it." ■

© 2016 Privcap LLC

By The Numbers: **Value-Added Fundraising**

Almost $22B of equity was raised for dedicated value-added closed-end funds globally in 2015, according to data provider Preqin—a decrease of 18 percent from 2014. However, manager appetite for the strategy shows no signs of abating in 2016, with 181 value-add vehicles currently in the market searching for LP commitments—more than any other real estate strategy.

Key Facts

$107B

raised in closed-end real estate funds in 2015, across strategies

177

private equity real estate funds closed in 2015, across strategies

↓18%

decrease in aggregate capital raised for value-added funds, 2014 to 2015

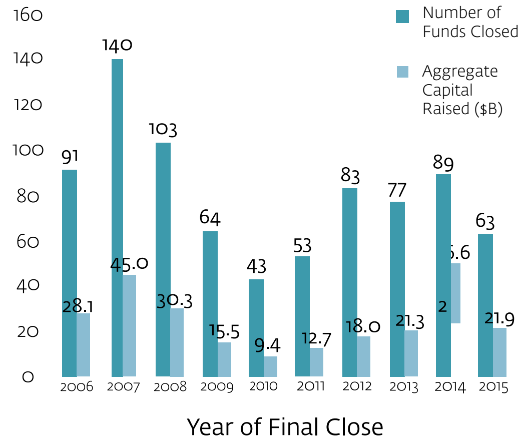
41

value-added funds closed in 2015 that were targeting North America

Annual Value-Added Fundraising 2006-2015

—

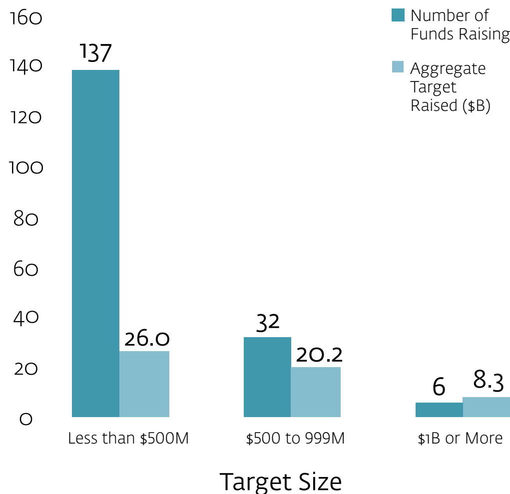
While the amount of equity raised for value-added funds declined slightly between 2014 and 2015, Preqin data reveals a steady increase in LP appetite for the real estate strategy.



Value-added Funds Dominate the Fundraising Market

—

GPs currently in the market raising funds are overwhelmingly focused on the value-added risk spectrum. More than 180 funds are targeting $56B for value-added strategies, compared to 140 funds targeting $51B for opportunistic strategies.



Source: preqin

© 2016 Privcap LLC

Expert Q&A

With Jason Sevier
Partner,
RSM US LLP

Contact
Jason Sevier
jason.sevier@rsmus.com

PrivcapRE: Does the urbanization trend mean we're seeing the death of the suburbs?

Jason Sevier, RSM: I don't think we're yet at the point where we can say suburbia is dead, but the commercial real estate game within cities is changing dramatically. I do think, though, it creates a potential opportunity for developers in suburbia, because they can see what's happening within cities and realize that not everybody wants to live in a city, but they do like what a city has to offer. So maybe [developers and investors] can transform suburbia into a quasi-city. I don't think we can say suburbia is dead yet, but these dense urban areas are going to continue to grow.

What is the biggest disruption facing commercial real estate?

Sevier: The biggest disruption is the unknown, meaning what does this generation want next? The millennial generation doesn't need a lot of space. They want access to a lot of things. They want to be able to get up and move quickly. But if you're trying to develop a building…what if the mindset changes in six months to a year, when I've already dedicated all these dollars to repositioning my property? Does that mean I'm outdated and now I have to invest more?

Real estate is increasingly mixed-use. So what's better, being a generalist or a specialist investor?

Sevier: Where things are going, I almost think we have to be a generalist. If you travel in cities and you look on one corner and you see this building that has four amenities, and catty-corner is a building that has one specialty retailer—the way millennials think is "I can access that if I want, but this is where I'm potentially going to operate on a daily basis, because I want the ease of coming downstairs and being able to either do my grocery shopping, go to the gym, pick up my dry cleaning, all in one spot. Why travel several blocks to get it all done?" If you're not a generalist, you better have one heck of a specialty that's going to attract people.

What will Generation Z demand of real estate investors?

Sevier: We're going to continue to see a demand [for real estate]. What shape and form it takes, that's hard to say. But a lot of it'll be technology-driven. What we're seeing now is, the way millennials interact [with other people] and the way they conduct themselves on a daily basis is [driven by] technology. ■

Privcap/

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

Contacts

Editorial
David Snow / *dsnow@privcap.com*
Matthew Malone / *mmalone@privcap.com*
Andrea Heisinger / *aheisinger@privcap.com*
Zoe Hughes / *zhughes@privcap.com*

Sponsorships & Sales
Gill Torren / *gtorren@privcap.com*
Doug Weber / *dweber@privcap.com*

Briefings/ Repositioning Real Estate

Watch the series in its entirety at **PrivcapRE.com**

- **Don't Overthink—and Overdo—TIs**
- **WeWork and the Rise of the Short-Term Lease**
- **The Right Way to Break Up a JV**
- **Expert Q&A: With Jason Sevier of RSM**

© 2016 Privcap LLC

Source new investors for funds and separate accounts

Identify new investment opportunities

Conduct competitor and market analysis

Compare fund performance against industry benchmarks

Develop new business

Register for demo access to find out how Preqin's Real Estate Online can help your business:

www.preqin.com/realestate

alternative assets. intelligent