



*In Conversation with*  
**Carlyle Group,  
Artemis, and  
Fannie Mae**

An Executive Summary of the Privcap  
Real Estate Forum in Washington D.C.



**Kim Betancourt**  
Fannie Mae



**Alex Gilbert**  
Artemis Real Estate Partners



**Robert Stuckey**  
The Carlyle Group

# Real Estate Game Changers— Finding Opportunities in Technology, Demographics and a 2017 Recession

Speakers from The Carlyle Group, Artemis Real Estate Partners, and Fannie Mae challenge attendees at the inaugural Privcap Real Estate Forum to question their assumptions about the impact of demographics and technology on commercial real estate. But delegates to the invitation-only event were also warned about today's cycle risk within commercial real estate—and about a possible recession by mid-2017.

## The Panelists



**Kim Betancourt**

Director of Economics,  
Multifamily Economics  
and Market Research Group,  
Fannie Mae



**Alex Gilbert**

President,  
Artemis Real Estate  
Partners



**Robert Stuckey**

Managing Director  
and Head of U.S. Real  
Estate Funds,  
The Carlyle Group

**Zoe Hughes, Privcap:** Do we have our assumptions wrong about the impact that millennials will have on commercial real estate?

**Alex Gilbert, Artemis:** I was actually somewhat surprised to know that student debt is \$1.2T and credit card debt was only \$900M [in the U.S.]. We do a fair amount of office and had some for-profit education facilities—the University of Phoenix, for example—in our portfolio. In 2000, University of Phoenix students had \$2B of student debt. Today it's \$36B. I don't think we have a millennial problem, I think we have a student loan problem.

**Kim Betancourt, Fannie Mae:** On average, the balance of [student] debt [at for-profit institutions] is \$40,000, whereas at a public college the average debt is \$25,000. We all know the story of someone who is \$150,000 in debt, but that's not so common.

We do need to think about it, as there's some talk that [student debt] is why millennials can't buy single-family homes. I'm here to tell you that's not why. We believe that it is far more likely they don't have the down payment, and that they think they won't qualify for a mortgage.

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**When we talk about millennials, we automatically associate it with multifamily. Are we seeing too much multifamily supply in the U.S. today?**

**Betancourt:** There are more than 500,000 units under [construction today], and you think “Oh my,” and your heart skips a beat. But the problem is we’ve been underhoused for a long period of time and during the Great Recession, construction came to a halt. We lose, on average, about 120,000 units a year just to obsolescence, and we weren’t even replacing that for a couple of years.

What’s of concern is [those 500,000-plus units are] concentrated mostly in 10 to 12 metro areas in a handful of submarkets. So if you go to Austin, [those units are] in downtown. Do we really need all that in downtown Austin, despite the fact that the place is crawling with millennials? The supply is mismatched and not evenly distributed across the country.

"It's a reasonable estimate to think the recession will occur as early as mid-2017. But I think an equally important question is the degree to which it affects real estate."

—Robert Stuckey, The Carlyle Group



**Given that concentrated supply and the impact it's having on rents, what is the sustainability of rental growth within multifamily? Alex, are we going to see a pullback?**

**Gilbert:** We're going to remain underweight but we missed a lot of opportunity—we just didn't see the length of the cycle. But you need wage growth. You need a thriving economy. You need job growth. Those things matter more than anything.

**Stuckey:** Our general view is that over the next four or five years, demand will actually exceed supply on a general level. I agree that there are concentrated pockets of oversupply so we have to be selective. There's runway, but there will be a deceleration in rent growth.

**What about the slowness of wage growth in the U.S. economy? This isn't an issue just for millennials, but for all age cohorts.**

**Gilbert:** Our typical projection is to do something active to the real estate. Renovate, reposition, release to create the cash flow so we are not underwriting anything more than 3 percent rent growth. And rent growth comes as a result of wage growth, which comes as a result of job creation. It's pretty tough to be projecting 5 percent growth in any property type over any four- to five-year period. In fact, you might have less than 3 percent in some cases. So you better be doing something to the real estate to increase the cash flow.

**What are you seeing within your data in terms of job growth and wage growth, and what are the challenges for commercial real estate?**

**Betancourt:** Wage growth isn't where we want it to be. The Federal Reserve wants wage growth to be between 3.5 percent and 4 percent, but it actually has been about 2.4 percent over the past year. What has saved us is the inflation rate, which is about one percent and was lower than that for all of last year. So we're not where we want to be, but it isn't as horrible because the inflation rate's been so low. In May we added 38,000 jobs. Was it an anomaly? We're not quite sure, but unemployment is so low that we're pretty much at full

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“No market is totally recession resistant...The market can make you look smart or stupid, but if you do something at the asset level, you can increase the cash flows.”

—Alex Gilbert, Artemis Real Estate Partners

employment. We've been anticipating that the job growth number was going to slow and that it could slow down next year.

**Alex, Rob, what are your expectations for the next recession?**

**Gilbert:** Valuations have been flat for the last five or six months. I see it in the hotel space and I've seen it in suburban office just in the last quarter. Prices have dropped in suburban office—if you're not a metro—by probably 10 to 15 percent in the last three months.

**Stuckey:** We'll have a recession. Cyclical risk is the number one risk with real estate investing. So with that in mind, we try to mitigate cyclical risk by investing in sectors that are driven, at least in part, by demographics, because the closer you are to being driven by demographics, the

more less correlated you are to the cycle, which is driven by GDP.

It's probably a reasonable estimate to think that the recession will occur in mid-2017. But an equally important question is the degree to which it affects real estate. And this recession will be preceded by more benign debt levels and supply levels in real estate than any previous recession going back to the 1970s. So one could hope that this recession won't be as impactful on real estate, particularly since in the last recession, real estate was at the epicenter of it.

**Have we built up enough downside protection to actually ride out the major troughs of a recession?**

**Stuckey:** No. All real estate will be affected by a recession—it's just a question of [to what] degree.

We saw in the Great Recession that every sector was somewhat correlated. This time around I would expect a sector like self storage to do reasonably well. That's why you see, when you look at the publicly traded companies, the ones that trade at a premium to NAV are the ones that have some non-correlation to GDP.

**If we're in a lower-return environment, how do value-added and opportunistic funds and managers generate their target returns?**

**Gilbert:** For our business we've tried to do two things. One, we have actually reversed to have more core-plus, lower-leverage, longer-term, net 8 percent [return] money. We've tried to diversify at



“We think that unemployment is so low we’re pretty much at full employment.”

–Kim Betancourt, Fannie Mae

the end of the cycle to a more core-plus [focus], and Artemis is much more focused on senior housing and the demographics of the 75- to greater than 85-year-old age group. We’re trying to go down the risk spectrum, given our view that we’re late in the cycle and trying to pick up that age group.

**Stuckey:** The stock market over the next 10 years will produce 5 to 7 percent returns, so with that in mind, this fixed 20 percent number becomes a higher bar. In an efficient market you have to take more risk to achieve a higher relative return. So the question is, to what degree is real estate not efficient and can you find above-normal, risk-adjusted returns?

Real estate’s becoming increasingly efficient, in part because of capital flows. Look at what’s happened in the public market over the last 25 years, and that’s been a key catalyst for market transparency and efficiency. And [for] greater fund flows from foreign investors as well. It will be increasingly difficult to achieve 20 percent returns.

**Are there certain markets that are more resistant to recession and downturn?**

**Stuckey:** Every recession affects sectors and geographies differently. Las Vegas was one of the most affected metro markets in the last recession, but one might expect it to actually perform better in this next recession just based on the simple logic that supply is deferred.

The other angle is to look at the employment base in the market. So about a third of all office absorption since the recession has come from the technology sector, and one would expect that to pull back in the next recession. So that would affect markets that are concentrated in technology—Silicon Valley, Midtown South. Finally, the Florida markets were significantly affected in the last recession, and seem to be propelled now by baby boomers moving there.

**Gilbert:** I agree that no market is totally recession-resistant. [Artemis is] more of a sharp shooter, we’re looking at the [operator] business plan to see how are they adding value to the individual property, such that if we’re buying a 40-percent-leased office building or doing a grocery-anchored retail center, we’re looking at what we are going to do to the asset so that we can increase the cash flow and be defensive. The market can make you look smart or stupid, but if you do something at the asset level, you can increase the cash flows.

**Betancourt:** Metros that have a more diversified economy are usually better positioned to weather recessions. Dallas is a good example. You think about what’s going on with the energy [markets] and everybody’s freaking out. But Dallas is well-diversified. Energy is a much smaller component than it used to be, and there’s education, health, finance.

When analyzing metros, the secret sauce is what kind of industrial diversity is there? There should be enough economic diversity in the metro so it’s not really dependent on any one sector. ■

# Is The 10-year Office Lease Dead?

As investors and managers face increasingly volatile investing conditions, it's essential they question assumptions underlying their portfolio construction strategies. We used our Real Estate Forum in Washington D.C. to convene an energetic roundtable discussion with delegates to challenge traditional assumptions about the performance of the office sector and the sustainability of the 10-year office lease. We presented a series of facts about the growth of co-working spaces in the U.S. and asked attendees whether shared office spaces and the flexible leases they offer would kill the 10-year office lease.

The dominance of the 10-year lease in the U.S. office sector is not expected to fade in the near-term, despite the rapid growth in co-working and shared office spaces, according to delegates at the Privcap Real Estate Forum.

Indeed, attendees taking part in the roundtable discussion argue the rise of companies providing shared office spaces, including the industry leader, WeWork, is helping maintain the traditional long-term lease.

One of the critical factors preventing the move to shorter, more flexible lease terms, the delegates say, is tenant improvement [TI] allowances. Shorter leases of between five and seven years will force landlords to cut TI allowances, leaving tenants to bear greater fit out costs or pay higher rents to offset TIs.

And for some companies, the attendees say, shorter leases are simply not beneficial to the long-term planning required within organizations.

## Roundtable

Price is a factor, with a 10-person shared office space in Washington D.C. saving 15% over traditionally-leased spaces

Flexibility is paramount. "Co-working spaces of today are training the growing army of small businesses that flexibility in lease term and space plan is possible." Bill Bennett, Founder, Level Office

Large corporations are using shared workspaces. One survey revealed 40 percent of corporate CRE executives are using or considering using shared space to cut costs

Co-working spaces will see 21 percent compounded growth each year over the next five years. Already WeWork is NYC's largest occupier of corporate real estate with 2.2M square feet under lease

By 2020, almost half of the U.S. workforce could be freelancing, while new and young businesses accounted for nearly all new net job creation up to 2013

The median age of a shared workspace user is 40. Less than 25 percent of users are millennials

Data sources:  
CBRE; U.S. Census Bureau;  
Intuit and Emergent Research

# Expert Q&A

*The hospitality sector is going to extraordinary lengths to target millennials and attract them to key hotel brands, but will those efforts succeed in the long term?*

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There's a hotel brand explosion taking place in the hospitality investment arena— but RSM's John McCourt says consolidation could soon be on the cards.

Hotel companies globally have dramatically increased the number of brands under their operating banner over the past decade— Marriott boasts 19 brands, Hilton owns 13 brands and Starwood operates 11—in a bid to entice different segments of the population and different generations, not least millennials, to their hotels.

However, when it comes to millennials, McCourt says the strategy may not prove as effective as hoped.

"Millennials are a very different animal when it comes to demographics and what we expect," he says. "The millennial generation is known for wanting uniqueness in a product and are not necessarily aligned to one particular brand as you've seen with past generations."

As such, McCourt sees brand consolidation for the industry over the short to medium term. "There are so many individual brands out there, there's almost a brand for everyday of the week. And we are starting to see some consolidation take place. After all, how can a brand with just five properties be sustained?"

That's not to say brands won't ultimately attract the millennial generation in the long run. "I do think that millennial preferences will change as they get older and as they start to have families," says Court. "They will become more brand aware and perhaps become more brand loyal as they go through their lives. But will it sustain all the brands out there today? I don't know."

What will change is hotel companies adapting their products to meet the constantly shifting demands of their guests—particularly with the use of technology.

"That's where things will really change in the short term," says McCourt. "Look to the Yotel flagship hotel in New York, with automated check-in and a mobile concierge app; even your luggage is handled by Yobot, a robotic arm previously used in the automotive industry.

"That's the stuff around the edges where you will see a lot of change by the hotel companies, because we are in a technological era and that's what people, not just millennials, are used to," he says. McCourt also sees foreign investment in the U.S. hospitality sector changing over the coming five to 10 years, particularly with Chinese and Asian institutions and high-net-worth individuals.

In the past two years, almost \$21B of foreign capital was targeted at U.S. hotels, with roughly half of that coming from Chinese investors. And that pace of investment doesn't look like it's slowing down, with more than \$9.8B of foreign capital being deployed in the past six months alone.

"I see there being as much investment coming from China and Asia into hospitality in the major gateway markets of the world as ever," McCourt says. "But there's a change in appetite among this foreign capital. Three or five years ago, this capital was looking for large portfolio acquisitions with 20 or 30 assets or buying very large marquee assets, such as the Waldorf Astoria. But a lot of that capital is now looking for individual properties and not just at the very top of the market. ■"

# Expert Q&A

**Construction loans could face changes thanks to new rules affecting lenders of high-volatility commercial real estate. What happened?**

**Jade Newburn:** The high-volatility commercial real estate (HVCRE) loans relate to acquisition, development and construction loans. In the U.S., they came about when U.S. regulators implemented the Basel III regulations. The HVCRE regulations potentially change the amount of capital that a bank needs to hold for a loan if it's classified as HVCRE. Of course the issue with having to withhold more capital for any particular deal changes the economics of the loan from a lender's perspective, and ultimately, the borrower's.



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**Won't holding more equity in construction deals be a positive move for the industry?**

**Newburn:** The HVCRE rules, by themselves, may not greatly impact the required amount of equity in a project. You can avoid being classified as a HVCRE loan if you satisfy three tests: if at least 15 percent of the capital is contributed as cash or unencumbered readily marketable assets prior to the advance of loan proceeds; if you have a maximum loan-to-value ratio of 80 percent [for most construction loans]; and if you keep the capital contributed in the asset and the net operating income (NOI) in the project through the "life of the project".

So to answer your question, if you just look at the total amount of capital in the transaction, in many development transactions more than 15 percent equity is required.

**Is there concern about the impact of these rules on distributions from projects?**

**Newburn:** To avoid being a HVCRE loan, one of the tests is that all of the capital that you put into the project, as well as all of the capital internally generated from the project— which is effectively the NOI—needs to remain in the project for what the regulations say is the "life of the project", which means the conversion to permanent financing. What borrowers are struggling with more than anything, is the test that all capital internally generated from the project should be held in the project. There's a period, in a development project, that once you complete the asset and before it is stabilized, where there will be positive cash flow. To have to keep the cash at the asset may be a problem in a few different identifiable circumstances.

One is simply from a tax perspective. If a REIT is the borrower, the REIT must make distributions on an annual basis of virtually all of its cash. To the extent it can't because of the HVCRE rules, it could cause a problem for the REIT. Another is taxes. You could owe taxes on money you can't get out of the asset. And the third relates to deal economics. As you think about evaluating the success of a real estate asset, owners and operators look to the internal rate of return—the discount rate that's associated with receiving your capital back as well as a return on your capital and waiting for distributions of cash could depress those returns.

**Will the new HVCRE rules ultimately affect returns?**

**Newburn:** It's possible especially to the extent underwriting is negatively affected. Borrowers certainly want to avoid having NOI trapped at the asset for a particular time period.

**Will this impact construction lending volume?**

**Newburn:** The effect of the HVCRE rules—just like the effect of widening spreads or the effect of lenders asking for additional recourse—is just one more element to the underwriting decision for owners and operators in particular and their investors. So it certainly could have an impact. ■