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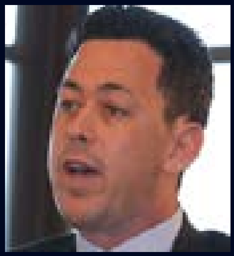
In Conversation with GreenOak, Andell, GTIS, Lowe *and* Mesa West

An Executive Summary of the Privcap Real Estate Forum in Los Angeles



Theodore Karatz
GTIS Partners

Jeff Friedman
Mesa West Capital

Russell Munn
Lowe Enterprises Investors

Mark Tronstein
Andell Inc.

Jonathan Epstein
GreenOak Real Estate

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Real Estate's *Long-Term Challenges*

Few people would consider self-driving cars and water rights as factors that could fundamentally change commercial real estate investment. Yet GreenOak managing director Jonathan Epstein said at Privcap's Real Estate Forum in L.A. that these are just a couple of the game-changers facing investors in the asset class.

Jonathan Epstein
Managing Director,
GreenOak

David Snow, Privcap: Most of us have never seen self-driving cars, yet they are looming on the horizon. What does that mean for cities and for real estate investing?

Jonathan Epstein, GreenOak: Depending upon the city and the landscape, they'll have different impacts. San Francisco, for example, has reduced parking requirements for new developments in an effort to promote mass transit and reduce traffic. L.A. is considering that, as well. That's the first impact you'll see it. From a real estate perspective, it means you're not going to have or need spaces to garage as many vehicles longer term.

It will probably have further implications for industrial real estate as well. If you do have fleets of autonomous cars, and there's a greater use in the shared economy of those cars, you're probably going to wind up with conversions of industrial assets into mass-automated parking facilities.

Will this spell the end of trucking-related jobs?

Epstein: At a recent conference I attended, the keynote speaker said that 27 percent of all jobs in the U.S. employ someone who drives a truck, a bus, or a car. It's a lower-educated workforce and it's certainly a lower-salaried workforce, so the political and social ramifications of potentially having that many people automated out of a job is a little scary.

This is not something GreenOak invests in on the industrial side, but this technology could have tremendous ramifications for the logistics [sector] and how you move things from ship to rail to truck, and for last-mile delivery.

Online sales accounted for 7.3 percent of total retail sales in the U.S. in 2015 and 60 percent of total retail sales growth. How do you have to change your investment strategy for retail given the growing importance of e-commerce?

Epstein: Let's take it from the mall perspective. Several hundred malls are projected to close in the next few years. Here in L.A., at Century City [mall owner Westfield Corpo-

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ration is] investing $800M into the project and bringing much more food and beverage outlets to the space. It's radically shifting the traditional thought of a mall to a gathering place.

You're also seeing a lot of malls that are on the cusp that maybe are not going to die. We looked at a recent portfolio sale where probably half of the real estate needed to be converted to multifamily because the mall had been built in the 1960s or 1970s, and everything else around it was 30 or 40 years old. Some of that [retail] real estate will have to be recycled, which is a good thing, but it's requiring enormous amounts of capital.

What about water rights as a challenge to real estate investing?

Epstein: This goes back to civic planning, as you need to prove that you have a 100-year water supply in order to get development rights in a lot of areas.

If we get comprehensive immigration [reform] and we get more people owning and renting homes, it will put more pressure on development. And in the West and the Southwest you're going to see greater fights over water.

Are people really paying attention to ESG systems in buildings and factoring that into the total cost of occupancy?

Epstein: We tend to focus much more on energy efficiency now and [for one building we had in downtown L.A.] we were charging a premium for the work we were putting in. One tenant [prior to signing] had an interesting observation. They said, and I'll use an example, "Look, the building we're in currently is $2 a foot and you guys are charging $3.50, a massive premium. So we're really not that interested."

But we heard from one of the team's people that they were paying 100 percent of their rent in off-hours air conditioning costs. Their cost of occupancy was a lot higher than what we were charging but their brokers hadn't focused on it and their CFO hadn't focused on it.

GreenOak is investing in Oakland, Calif. Is that the new San Francisco?

Epstein: We've been investing in San Francisco since we started the firm in 2011. We always try to invest ahead of gentrification, and one of the things we saw was people starting to move to the East Bay.

One of the data points we always look at is bar and restaurant openings. A unique factor for Oakland was the opening of 200 bars and restaurants in the past three years. Newspapers articles were talking about "the Brooklynization of Oakland." Uber bought the building above the 19th Street BART (Bay Area Rapid Transit) Station, which really validated Oakland for tech firms.

We've bought several buildings in Oakland now and are buying at a significantly lower basis than buildings in San Francisco.

Is downtown L.A. the next Oakland?

Epstein: I'm a huge believer in downtown L.A. You had 30,000 residents in 2006; 60,000 at the end of 2015 and you'll have 150,000 projected within eight years. I actually think that will happen sooner. [The area has] had $27B of public-private infrastructure invested in it. So if you have a longerterm view and longer-term patient capital it's an amazing place to invest. ■

"If you have a longer-term view and longer-term patient capital, [downtown L.A.] is an amazing place to invest."

–Jonathan Epstein, GreenOak

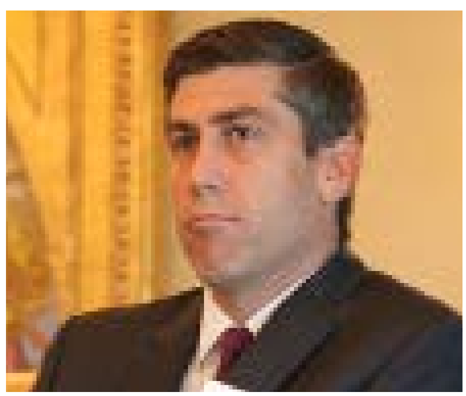
Testing Real Estate's Entrepreneurial Spirit

The Panelists

Jeff Friedman
Co-founder, Principal,
Mesa West Capital

Theodore Karatz
Director, Acquisitions,
GTIS Partners

Russell Munn
Senior Vice President— Hospitality,
Lowe Enterprises Investors



Mark Tronstein
Managing Director—Real Estate,
Andell Inc.

Traditional real estate concepts are undergoing dramatic change, from the shared office and shared accommodation. But, the growth of new, entrepreneurial products, investors and lenders in the asset class remain cautious—not least in a world where returns are expected to be low for longer.

Theodore Karatz, GTIS Partners: The real estate sector appears to be going through an evolution of innovation, driven by a strong entrepreneurial spirit, which is changing the way properties are developed, utilized and valued. Some examples of this can be found in newly conceived product types such as micro apartments or creative office. As a lender, how do you view these types of assets, given the lack of institutional performance track record and largely that they haven't been tested through down cycles?

Jeff Friedman, Mesa West: I think it's brutal. We make first mortgage loans on commercial real estate so, as a lender, if things go really well, we just get our money back. If things don't go well, then we're out of business. It's not a great dynamic, as a lender, to be involved in some of these emerging areas of commercial real estate. The question is, if it doesn't work, how do we think about it? We saw a $200M loan package for a property in Times Square in New York and WeWork was 100 percent of the office space. [To offset the impact of WeWork failing] the sponsor was saying 'Assume there's retail, that there's signage opportunity, what do you make the loan?' It's challenging.

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Karatz: There have been are some significant shifts in demand within hospitality. Russell, where is the opportunity in that sector today?

Russell Munn, Lowe Enterprises: The lodging market has evolved and the lodging customer has gotten more sophisticated and likes to have a differentiated experience, to some degree. Historically, you made almost as much money on your food and beverage operations as you did on your rooms and that has changed dramatically just with the proliferation of offerings. People no longer want to stay at their hotel and have dinner at their hotel. They want to get out, so we, as an industry, are trying to respond with demand-driven offerings, like communal tables in the lobby, smaller plate offerings, not really offering dinner, but really focused on beverages and small food offerings.

Friedman and Munn in discussion at the forum

Karatz: How is Airbnb and offerings like that impacting our business?

Munn: We've been renting rooms for 19 hours at a time for a very long time and while Airbnb is consolidating the home vacation rental business, they don't have a meaningful impact on the lodging industry and I don't think they're going to have one.

Karatz: Mark, as a family office you can be more entrepreneurial. How has your role evolved at the family office versus a role at a real estate fund?

Mark Tronstein, Andell: Prior to my joining a little over five years ago, the family's exposure to real estate was exclusively as an LP invested in large closed-end funds. But following the Great Recession they decided, not unlike some other family offices, endowments and foundations that they still wanted exposure to real estate, but wanted to be more active, and wanted more control and discretion. So we were very, very active early on and, as things got marginally better, we turned into net sellers and we've since sold a lot of our portfolio.

Now, we're still active in real estate, but that being said, we're a risk-adjusted investor. So we're not going to accept the same or an increased amount of risk in today's market for a lower return. We're actually going down the risk spectrum to get an appropriate risk-adjusted return. As such we've been active in the debt space recently.

Karatz: Mark, as it relates to being more entrepreneurial, can you share some examples where you've been able to pursue more alternative real estate endeavors?

Tronstein: The answer is yes, but we try not to be speculators. We really target deals based on what the demand drivers are and what needs are being served by it.

So we haven't pursued any deals like longer-term leases to WeWork, but we have done a smaller, micro unit deal. The reason we did that was because it was located in a very strong, infill, supply-constrained market with a lot of tech demand drivers.

"While Airbnb is consolidating the home vacation rental business, they don't have a meaningful impact on the lodging industry and I don't think they're going to have one."

– Russell Munn, Lowe Enterprises Investors

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"We're not going to accept the same or an increased amount of risk in today's market for a lower return."

– Mark Tronstein, Andell Holdings

Karatz: Regarding the micro apartment project you invested in, what was the average square footage for each unit?

Tronstein: Studios and one bedrooms, across the building, probably about 450 square feet.

Karatz: Russell, how do you view the real estate market currently? Is there a story around deep value investing or are you subscribing to a growth story thesis?

Munn: It's fourth and long in the bottom of the seventh and we've got two more out bats to make a wicket. I think we've been in a period of very long, slow growth and we all recognize we're late in the cycle, but we don't see anything very specific that causes us a lot of concern.

We see the growth rate slowing and we're trying to be reactive to that in different ways. We have more investors today looking at cash flow and what's in place, with not a very huge pop on the exit. So we don't see a huge opportunity set of big value-add investments today. But there are still some very attractive cash flow plays with the average cap rate in the limited service hotel space, for example, still a massive spread to the 10-year Treasury.

Karatz: But Lowe Enterprises has a fair amount of extensive and long-dated development projects in several gateway markets across the US. How do weigh that against current cash flow performing assets?

Munn: Those are difficult because they're very long cycles and they very long lead-time projects. You don't always control how long it takes you to get from start to finish, so our focus has been on projects that are sustainable, focused on transit-oriented development projects, things that can survive through a cycle, as long as you capitalize them right. And I think that's the lesson a lot of folks learned last time around is making sure capital structure has the ability to survive a dip.

Karatz: Jeff, we currently have historically low cap rates which has pushed asset values higher, however there feels to be a large amount of equity in the system with lower traditional leverage which is inconsistent with the characteristics of a traditional "bubble". What are your thoughts on the current market? Will it last?

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RSM's Michael Schwartz and Mesa West's Friedman in discussion with other attendees.

A networking break at the forum.

Friedman: So we're in this environment where rates are crazy low and it's hard to see an impetus for them to go up. Personally, I think, that cap rates aren't artificially low—they're low for a reason and you could definitely make the case that even though there was a volatility and disruption [to markets] in the first quarter, we're going into a period of time where low cap rates will persist.

Karatz: Should investment return expectations be lower?

Friedman: For sure. As the world continues to become more global, I think we're going to be in this low rate, low growth environment. We're all mandated to invest and make a 12 percent to 15 percent return. And it's realistic when the Treasury is at 5 percent. When the Treasury is at 1 percent or 2 percent, it's just not realistic.

Munn: If you look at the list of funds that have been raised in the market today, they still are saying their target returns are almost identical to every other point in the cycle. We have investors that we've been working with for 20-plus years and we're still targeting the same rates. On some newer capital, you can tell the story of the market we're in today and the expectations are slightly lower, but it's a dramatic change.

Karatz: We tend to agree. Since September 2009, GTIS has been very active in the residential space investing across the spectrum within the housing strategy including land, homebuilding, multi-family and condo development as well as investing in single-family rentals which, the latter has a strong appeal among investors seeking yield. While rates are low, our homebuilding and land portfolio employs very little to no leverage while our single-family rental strategy is financed with institutional debt.

"Part of the challenge today is, even though debt appears to be cheap or inexpensive, there's truly [a case of] the haves and have nots."

– Theodore Karatz, GTIS Partners

Friedman: How does the single-family homes for rent model work from an operating perspective?

Karatz: Our view is that the sector is in its early stages of being a recognized real estate investment product. There is considerable demand from the consumer to rent homes and while its institutional performance track record is relatively new, the larger more established owners are able to access institutional level debt which has been a positive development and provides for good cashflow. We were disciplined in selecting our target investment markets and have been pleased with the performance of our portfolio from a management and oversight perspective. ■

Has CRE Overestimated the Impact of Millennials?

As investors and managers face increasingly volatile investing conditions, it's essential they question assumptions underlying their portfolio construction strategies. Privcap used its Real Estate Forum in Los Angeles to convene a roundtable discussion with delegates to challenge traditional assumptions about the impact that millennials will have on commercial real estate.

Sources: Pew Research Center; Census Bureau; Citizens Bank Millennials in Debt Survey, April 2016; New York Times

The millennial generation may be the largest age cohort in U.S. history, but attendees of Privcap's Real Estate Forum in L.A. agree there's a lot of hype around the group.

While few of these investors in commercial real estate are ignoring millennials as a group, owing to the sheer size of the generation, delegates say investors need to understand what millennials will want in their 40s and 50s—when they have children and need larger homes and good schools—in order to make better portfolio decisions.

Affordability is also a critical factor for many millennials, forcing many in the generation to move to outer submarkets of gateway cities. However, delegates at the forum also believe differentiation is a key to keeping millennials living in the major markets as the bulk of new real estate product—including multifamily, office, and retail—is too similar.

But some companies, not least technology firms, are trying to overcome these issues themselves, according to forum attendees, by developing, or leasing, apartments near their offices specifically for employees to rent.

In 2013, millennials earned $3,472 a year less than any previous generation

45 percent of millennials do not know what portion of their salary goes to paying off their loans, while 15 percent do not know how much they owe

In 2015, the portion of those under 35 purchasing homes hit its lowest level since records began, while average rents in the 50 largest metro areas is approaching its 2000 peak

Millennials—those 18 to 34 years old in 2015—number 75.4 million, surpassing the baby boomers as the largest generation in U.S. history

The average student debt for a 2014 graduate was $28,950

Expert Q&A

Markets Where Smart Investors Are Focusing

As society adapts to new technology in the workplace and in personal lives, fewer people will want to spend hours commuting to an office in the city, argues RSM partner Tom Leyden

Tom Leyden
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As real estate cycles become shorter and faster, investors are eager to find a way to invest in commercial real estate that avoids much of the lumpiness, and illiquidity, inherent in the asset class. For many, the answer is a focus on global gateway markets.

Tom Leyden, a partner at RSM US LLP, agrees that the city and the urban market is essential to any institutional investor's portfolio, but believes cycle risk isn't the only reason to focus on cities.

The city is increasingly becoming a place to live, as people reject the traditional commute from the suburbs, Leyden says.

"It's all about how people want to work, how they want to live, and how they want to play," he says. "And in my mind, what people are finally questioning is why they need to sit on a train for an hour or sit in traffic for one and a half hours, commuting."

But rather than people using remote-access technology to allow them to work and live in the suburbs, Leyden says people are increasingly opting to move to city centers to be closer to the office, and closer to the entertainment and diversity of downtowns across the U.S.

"When you look to demographics and how people want to live, and how that's being translated into commercial real estate investment, it's much more an urban market strategy versus a suburban one."

And while that doesn't mean the death of the suburb, for Leyden, it means the continued outward expansion of cities as people search for affordable residential, office, and retail on the edges of expensive of metro and downtown areas.

Citing Oakland as an example of San Francisco's expansion, Leyden says: "People are being pushed into the East Bay because of the expense of San Francisco and that, in turn, is leading a really interesting push, a gentrification of that area."

Uber is set to open a 330,000-square-foot office in Oakland in 2017, a move that many brokers have argued will transform the local office market. According to broker Colliers International, asking rents for all office types in the Oakland metropolitan area rose more than 10 percent to $2.61-per-square-foot in the first quarter of 2016 as low supply and high demand drove rents higher.

"San Francisco's Mission District is another area that's seeing high-rise multifamily and condo developments," Leyden says. "These are areas that had once been protected from development or you would never have thought would be developed. There's a real expansion of our urban markets taking place." ■