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In Partnership with RSM

REAL ESTATE Investment Excellence 2016

A compendium of institutional real estate thought leadership

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The U.S. markets face several challenges today: volatility overseas, the threat of another recession, and a looming presidential election. But this fluidity, especially overseas, is creating investment opportunities in U.S. real estate.

Foreign investors looking for a safe haven are putting their capital to work via real estate funds and direct investments. They're finding good values in multifamily properties in metropolitan areas—as millennials move to city centers—and in secondary markets. And while there is plenty of capital available, the competition for assets is making good opportunities harder to find.

The opportunities that can be found are being driven by secular market and demographic shifts. The industrial sector is benefiting from the rise of e-commerce as businesses open more distribution centers; senior housing is growing to meet the needs of the baby boomer generation; and office investors are finding success by offering the amenities demanded by millennials.

Those changes also bring challenges. The hospitality sector is being impacted by demographics as Airbnb draws some younger people away from traditional hotels, and as hotels adapt to changing consumer appetites with new amenities.

All of these changes require proper due diligence and compliance—especially with foreign investors—as tax and reporting requirements get more and more complex each year, tripping up even the most sophisticated investors. Whether you are an institutional or a high-net-worth investor, the compliance expectations have been heightened for SEC and tax reporting, as well as for investor reporting.

The pages of this Investment Excellence Compendium address the challenges and demographic shifts impacting the real estate market through expert interviews and data. The interviews support the view that having the right professionals on your team to provide guidance and offer expertise is as crucial as ever.

Richard Edelheit **Tom Green**

RE Managers Must Strive to Be the Whole Package

Zoe Hughes
Editorial Advisor,
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Welcome to the second edition of the Investment Excellence Compendium.

When Privcap published its inaugural report in 2015, we highlighted how scrutiny—in every stage of a commercial real estate deal, from sourcing to underwriting and structuring—had increased dramatically in the wake of the financial crisis. Institutional real estate investors, faced with the challenges of investing in a lower-return era, were demanding investment excellence from all of their private real estate managers, beyond anything seen before.

That scrutiny continues unabated today. However, it's coming not just from investors, but also from operating partners, lenders, regulators, and peers.

As commercial real estate markets globally face slow growth, real estate managers are charged with not just delivering the best risk-adjusted returns they can find for their LPs, but being best-in-class managers as well.

That reality means that in every facet of the business, real estate managers have to sweat their assets like never before. And they have to excel at doing so.

This report, produced in partnership with RSM, provides insights into that undertaking by tapping Privcap's extensive network of real estate experts to provide comprehensive intelligence on how to drive investment excellence in maturing cycles.

Among the insights: Mike Fascitelli, former CEO of Vornado Realty Trust, says it's not time to sell the real estate asset class short; Frank Lively of Wafra Investment Advisory Group offers a "cautionary tale" of U.S. property markets amid concerns about overgrowth and pricing; and Chris Balestra of Taconic Investment Partners believes the pre-built office space could be a thing of the past.

We hope you enjoy the thought leadership in these pages, and stay tuned to Privcap's ongoing real estate coverage at privcap.com.

Enjoy the report,

Zoe Hughes

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STRATEGY

What Will the City of the Future Look Like?

Cities are in danger of suffocating from increased density unless real estate investors, developers, and politicians start thinking differently about how to improve quality of life

Joseph Brancato
Regional Managing Principal, Gensler

Privcap: When thinking about the future of real estate, people are not thinking about 3-D printing of our skyscrapers, having airports floating in the middle of rivers, or driverless cars everywhere, making parking garages obsolete. Is this science fiction for real estate?

Joseph Brancato, Gensler: If we think beyond next week or next year, this is all a reality. More than 54 percent of the world's population lives in cities. It's projected to go to 70 percent by 2050. These cities are going to increase in density, and… We have to think about how do we create places for people to live, work, and play that provide them with a quality of life. It's happening now. This is not a fairy tale.

How do we ensure that our cities thrive as they become more dense?

Brancato: We're going to create the verticality—have [super-tall] vertical cities and towers. But we have to focus on the horizontal plane to create that quality of life that's necessary to accommodate the increased density.

Over the last 15 or 20 years, we took underutilized infrastructure and spaces and reimagined what they could be. The trestle for trains [in Manhattan that's] no longer used—the High Line—has not only become a great [green space] for people to use, it's also helped connect the community. It's increased the value of the properties next to it.

Look at the west side of Manhattan, all those piers. They were relevant, but the ships stopped coming in; freight stopped coming here and started to go to Bayonne, N.J.; the cruise lines stopped coming in as much. What do we do with them? That's become green spaces, sports facilities, spaces for the performing arts.

We have to focus on the horizontal plane. There's infrastructure that's irrelevant now that can be repurposed and rethought.

I know one idea that you got is in London, reusing abandoned subway stations. How do we take unused, unloved public spaces and bring them back?

Brancato: There were a few metro tunnels that were vacated many years ago in London. We worked with the politicians to identify those. And there's a lot of street traffic, which is great.

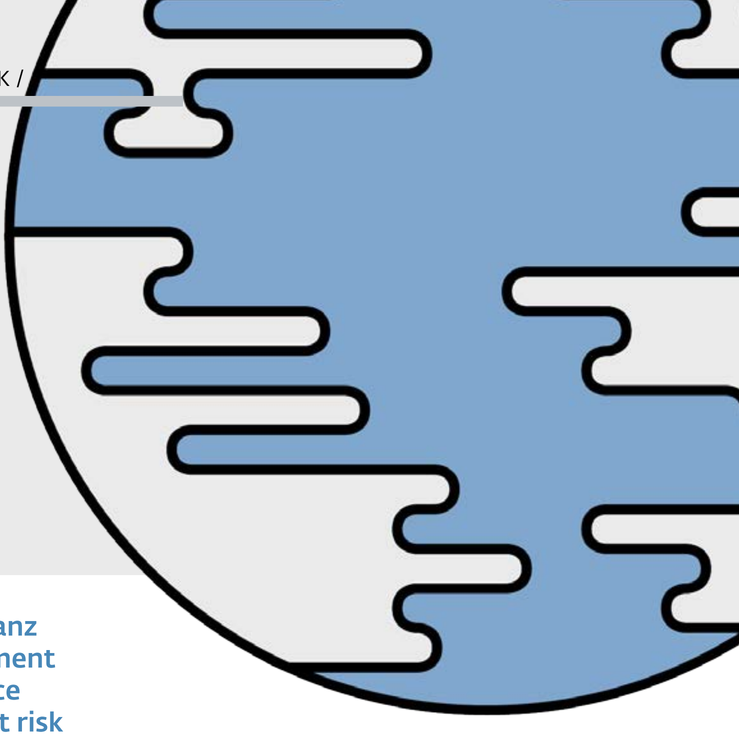
We organized it so we could have one tunnel for pedestrians, another tunnel for cycling. We've put some retail down there. They're taking some of the pressure off the street and the increased density. But it's not just a tunnel to circulate. It becomes a place to go. Just like the High Line, it's a place to go, and then things feed off of that.

One thing that's capturing people's imaginations: 3-D printing. Will we see drones with 3-D printers attached building our skyscrapers in the future?

Brancato: Someday maybe these 3-D printers will print buildings that are more than two stories [high]. We're partnered with an entrepreneur in China, and the Gensler team [is] working on how we can create 3-D-printed houses. It's really exciting, because you could do it for temporary housing.

And we've brought on a structural engineer to work with our team to think about how can we go vertical. We're working with the doers, the smart people, imagining how to build these printers, with structural engineers trying to help us figure out how we stack these modules. ■

Where to Look for Risk in Global Opportunities



Hauke Brede
Chief Risk Officer,
Allianz Real Estate

Hauke Brede, chief risk officer for Allianz Real Estate—the capital asset investment manager for Germany-based insurance company Allianz—discusses looking at risk profiles worldwide

Privcap: You are the chief risk officer. What do you spend most of your day doing?

Hauke Brede, Allianz: "Chief risk officer" means to look at all the risk dimensions of our investments, be it on the new business side when we underwrite new deals, and also on the ongoing portfolio monitoring that my team will look at the key risk dimensions.

You look at these investments and you say, what is the typical risk associated with the investment on a structural level? So that could be market risk. It could be also leverage risk through financing. But it goes all the way down to asset-specific risk, tenant risk. It also includes non-quantitative risk factors—let's say reputational risk. It puts the risk into perspective of the target return to say if there is really a balanced view on this investment.

How much time and energy can you put into geopolitical risk?

Brede: Some countries we basically exclude from our investment horizon because we don't get information on current performance, nor on the outlook.

What's an example of a country that has been excluded?

Brede: One country we looked at a couple of years ago was Turkey. And we had a couple of issues. From a financial standpoint it's just sometimes not attractive to find assets for our risk-return profile. But then you had a long [list] of issues around, for example, political risk, ethics risk.

We looked at other markets, let's say Brazil. And we found out that just to get the euro-denominated return that we need for our investments, we would actually incur a hedging cost of 900 basis points. So that really doesn't make sense for us.

How do you determine whether a market is simply too frothy for your target risk and return goals?

Brede: Overall, prices are very high. And our investment horizon [of 10 years] is typical for insurance companies and pension funds. We of course don't have a crystal ball, but at least we have a view on what could actually happen over the next couple of years and whether we believe where we are today could be, at the exit, still attractive.

There are some markets where we see a major recovery and we're back to 2007 figures.

Places like London and Munich?

Brede: Exactly. [In] Munich, we see price increases beyond what we've seen before. But London... We don't have a lot of liabilities in the British pound. So for us, that market is not very attractive.

Then you look at the broader U.K. market, and you say maybe there's something else on the retail side, but maybe it's not prime London.

How active has Allianz been in China, and where do you see the opportunity to invest?

Brede: China is, in terms of exposure, below 10 percent, so it's not the major part of our portfolio. But we looked at many different opportunities to invest in China. The issue that we found very often is it's a different legal environment. And you have a couple of things to keep in mind when you invest in this country, like whether you can actually repatriate your money at the end of the investment period.

You have to be careful about the existing stock. You don't want to buy an existing shopping center in China, because the setting is not what you could consider a top-notch, dominant shopping center. But we would certainly go into such a market with a local champion who actually knows the market locally. ■

How Millennials Are Disrupting Real Estate

Millennial spending and household-formation preferences, retail disruptions, and global capital flows are top trends shaping the investment outlook for U.S. real estate, say two expert observers of the global economy

Privcap: Millennials are moving to major cities, seeking work, and having different expectations about what their workplace should be like. What kind of effect is that having on the office market?

Joe Brusuelas, RSM: [Since] those 25-to-34-year-olds have entered the market, it's been, on the margin, very positive for commercial real estate. What you're seeing is a little bit of a renaissance in many of these buildings as demand for the integration of advanced technology in the workplace accelerates.

Lee Menifee, PGIM: Twenty, 30 years ago, the best [office properties] were in the suburbs, because that's where the employees wanted to work. And now they're in cities, because that's where the employees want to work. It's just a different set of employees.

Joe, how is the trend of millennials and family formation affecting multifamily assets?

Brusuelas: What we've seen is a real shift away from single-family residences in the suburbs. We saw, at least with the last two generations, more of a demand for multifamily dwellings, condos and coops.

Boston's the [metro area] where it's most telling, where they have a very low unemployment rate. There's an intense competition for workers, and the millennials who are arriving have different forms of demands. So you see lots of multifamily units being built, adjacent to highly clustered, dense workplaces where many of these young people ride their bikes or take public transportation to work rather than own a car.

Menifee: We were looking at the household-formations data with trepidation for many years. It was incredibly low and really put off by what was a really severe recession for everybody, but particularly for young people, who had an extremely hard time getting a job and coming into the workforce. But now the fastest pace of hiring is going on in that age cohort—25-34.

Let's talk about another real estate area that is undergoing tremendous disruption, and that's retail. How can an investor find a place to invest?

Menifee: Looking at the disruption that's going on in bricks-and-mortar retail, you see a whole sector like office supply in trouble, consolidating; electronics, which is almost going away; even the grocery segment, which is a sort of an ongoing consolidation trend. And then you get to the threat from e-commerce, and there's a lot of reasons to be very negative about retail.

Our basic view is that in 10 years we don't know whether or not the tenants in any particular center are going to be there.

Joe, what do investors need to understand about some macro trends that are affecting retail?

Brusuelas: We're undergoing a pervasive disintermediating and disruption in the overall retail space. What we're seeing is a profound behavioral shift by the new emerging demographic majority, not only in how they shop, where they spend money, why they spend money, and what they're likely to spend money on. I think the motto of that emerging demographic majority is to own memories, not stuff.

And so with a migration into preferences on spending with travel accommodations, entertainment, and not just buying 12 pairs of jeans, you're going to see a pretty thorough shakeout in the commercial real estate environment.

Lee, how can you even quantify the effect that something like e-commerce would have on retail real estate?

Menifee: The growing share of e-commerce is having a profound [negative] impact on retail real estate, but also [a big positive] for industrial real estate, and we expect that positive to continue this year, particularly for industrial real estate that's located somewhere where you can deliver to the consumer within a day, [and] sometimes within hours. ■

Joe Brusuelas
Chief Economist,
RSM

Lee Menifee
Head of Americas
Investment Research,
PGIM Real Estate

Griffis' Hyperfocused Multifamily Strategy

Griffis Residential invests in 15-year-old multifamily assets, with deals in just four markets in the U.S.

David Birnbaum
Co-founder, Co-CEO,
Griffis Residential

Privcap: What can you tell me about Griffis Residential's very specific, highly focused strategy?

David Birnbaum, Griffis Residential: We acquire recent-vintage near-core multifamily properties, most of them 2001-2002 construction, and we currently operate in four markets: Denver, Austin, Seattle, and Las Vegas. All of our target markets are... hubs of innovation and entrepreneurship. [The strategy is to] invest in cosmetic enhancements to make the properties more competitive with newly constructed product in their markets. We have followed the same strategy for decades; we don't chase yield or explore new asset classes. We focus on what we do well, and that's creating value.

Is asset management a fundamental component to your process?

Birnbaum: Because we buy newer near-core assets, we use asset management to create value, and a lot of effort goes into that process. Our first two funds are both reasonably mature; about half the value created in each was generated through hands-on asset management and property-level improvements and initiatives. We have to sweat our assets, so both the asset management and the property management functions are critical. We take advantage of every revenue opportunity, both apartment rent and smaller, less obvious revenue streams, like garage rent, that can be maximized even if market rents are slowing.

Which improvements give you the best return?

Birnbaum: We're not developers, and we don't take construction risk. The properties we buy are competitive with newer product in terms of floor plans and amenities, so our enhancements are designed to make them more contemporary. We do this by improving finishes, upgrading appliances and technology, and creating common areas that support collaboration by replacing walls with glass to add light and increase the interaction [that] millennials prize. We create a home and a place where our residents want to live.

How cost-effective is handling the asset and property management functions in-house?

Birnbaum: Excellence in property management is vital to our business, so we've deliberately tied asset and property management together. [By doing] both in-house, [we feel] it creates a virtuous circle. In practice, asset management is often pushed down to the property level, since it is such an important part of our model. Operationally, we focus on our residents and survey residents continuously to measure performance and identify areas for improvement. We're very proud of the fact that 100 percent of the assets held for more than a year were top-rated by their residents. We are owners for the longer term, so we have to focus on the value of our brand.

What makes a great asset manager?

Birnbaum: The best asset managers put residents first; they're problem solvers, analytical, smart, and persistent. We put a lot of effort into increasing the financial literacy of our property managers, since budgeting and performance relative to budget are integral to the value-creation process. ■

Malls Aren't Dead, Even in L.A.

Laurus Corporation is investing $30M in equity to renovate a mall in Los Angeles next to the Playa Vista neighborhood, the massive redevelopment of Howard Hughes' former aviation empire that's fast becoming known as SoCal's own Silicon Valley

Online retail is hitting its brick-and-mortar rivals hard. In November 2015, online shoppers outnumbered in-store visitors during the Thanksgiving and Black Friday sales period for the first time in U.S. history. Just weeks earlier Alibaba, the online shopping giant, broke world records with $14.3B of sales in 24 hours during China's Singles Day.

Retail has been transformed. But that isn't stopping private equity real estate managers from investing in the mall sector and underwriting growing sales in the coming years—especially in gateway markets such as Los Angeles.

Indeed, Laurus Corporation, with financing from Torchlight Investors, has acquired the 250,000-square-foot Promenade at the Howard Hughes Center close to LA's Playa Vista submarket, betting precisely on such growth. That growth, however, won't come from the stores that traditionally lined U.S. malls—it's now all about lifestyle choices and experiences, says Laurus' chief investment officer, Austin Khan.

"At a fundamental level we see a lot of opportunities in retail," says Khan. "We are already seeing a healthy amount of recovery and growth in household and discretionary income.

"When buying a new television, most people are likely to shop online to do their research and then get it delivered to their home," concedes Khan, but adds: "What you cannot replace is going to a center to visit that new specialist retailer but also trying the great restaurant that's next door to it. That's what malls need to be today."

And that's the thesis behind the Promenade deal at Howard Hughes Center, acquired in June 2015 for $111M by Laurus—the real estate investment and development affiliate of real estate private equity firm Ethika Investments. Ethika provided a majority of the common equity for the transaction, while Torchlight provided subordinated financing via a $37M preferred equity facility, according to data provider Real Capital Analytics.

Brought to the market two years previously by the prior tenant-in-common owner, Passco Companies, the mall failed to sell. The subsequent loss of tenant Nordstrom, however, pushed vacancy at the center from 7 percent to 27 percent and enabled Laurus to re-approach Passco to renegotiate pricing.

"Nordstrom giving notice to leave changed the dynamic of the discussion," says Khan. "The pricing began to make more sense, not just because the owners faced this large vacancy, but they also faced a maturing CMBS loan against the mall. They were caught between a rock and a hard place, and it helped bring pricing down to a value-add opportunity."

The mall is currently anchored by the cinema chain Cinemark with tenants such as Buffalo Wild Wings, Dave & Buster's, and Starbucks. Laurus plans a $30M renovation, half of which will be spent on changes to the common areas, outdoor space, access points, and on installing digital media stations. The remainder will be spent on tenant spaces.

The renovation is expected to increase rents from an average of $29 per square foot to as high as $70 per square foot.

Khan says such rental growth will also be fueled by the continuing development at neighboring Playa Vista—Brookfield Residential's master-planned office, residential, and retail community that once was home to the aviation empire of business mogul Howard Hughes.

"In the next two to three years, there will be between 3,000 and 5,000 residents moving to this area, and given the rents being paid for apartments in Playa Vista, those average household incomes will be around $200,000 a year," says Khan.

"That purchasing power is going to change retail in the area. That's why we're re-energizing the space at Howard Hughes." ■

The New Real Estate? Shipping Containers

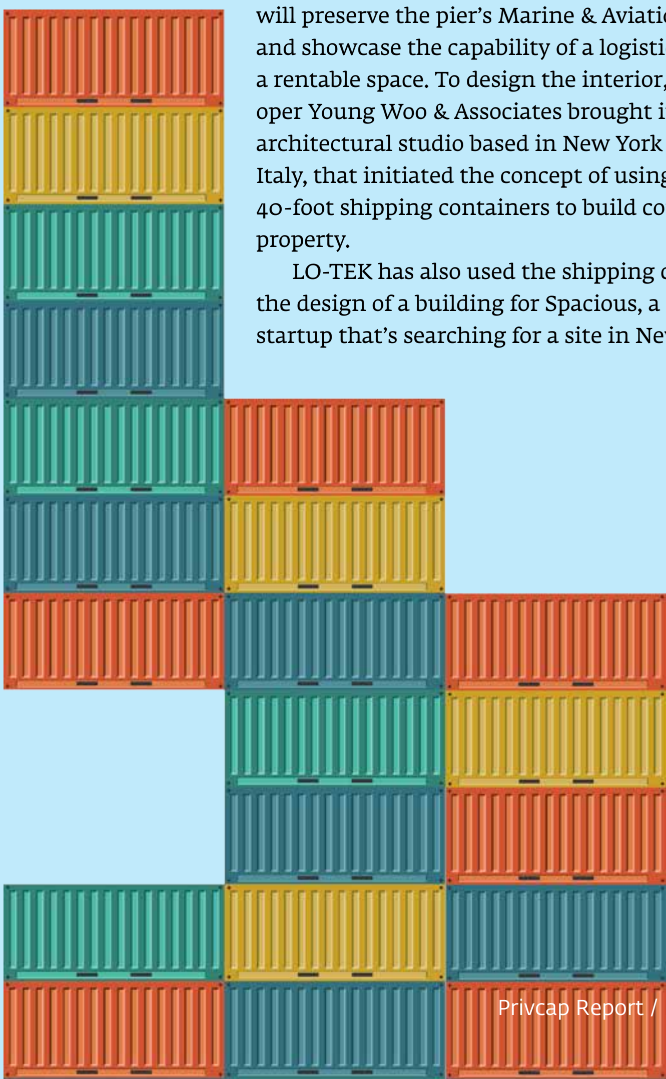
Startups in the U.S. and other countries are turning to unconventional spaces to provide lower-cost, mixed-use, and student housing

Shipping containers are essential for transporting everything from smartphones to appliances around the world. But the once lowly container is now emerging as a game changer, disrupting several sectors of the real estate investment market, not least housing, retail, and hospitality.

Indeed, as the global economy continues its slower growth, many of the world's 17M shipping containers are proving ideal solutions for real estate developers wanting efficiency and flexibility.

The $210M redevelopment of New York's historic Pier 57 will use more than 450 shipping containers to house retail stores and food stands, a design that will preserve the pier's Marine & Aviation building and showcase the capability of a logistics solution as a rentable space. To design the interior, Pier 57 developer Young Woo & Associates brought in LO-TEK, an architectural studio based in New York and Naples, Italy, that initiated the concept of using standard 40-foot shipping containers to build commercial property.

LO-TEK has also used the shipping container in the design of a building for Spacious, a real estate startup that's searching for a site in New York City to erect a prototype structure combining a coffee shop, hotel rooms, and co-working space. Spacious co-founder and CEO Preston Pesek says in an email interview that the plan is to lease "a site where we can erect and operate with a minimum duration of 10 years, then disassemble and return a vacant site to the landlord."



The concept is all about the maximum utilization of space. Spacious, for instance, offers hotel guests a discount rate if they allow their rooms to be rented as conference space when they're out and about. "It's wasteful to design single-purpose spaces that are productive for only 50 percent of every day, in locations where demand for space exists 100 percent of the time," according to Spacious' website.

That underutilization of space also extends to affordable housing. Kasita, a real estate startup producing mobile micro units, has leased land in Austin, Texas, for a rack that will hold nine 208-square-foot studio apartments built in shipping containers. It's the brainchild of Jeff Wilson, a professor and dean at Huston-Tillotson University, who earned the moniker "Professor Dumpster" for living in a 33-foot converted trash container for a year to explore affordable housing concepts.

With help from industrial design agency Frog, Kasita has developed a patent-pending tile system that allows for virtually infinite combinations of shelving, storage, and functional items such as clocks and a sound system—with a subwoofer in the floor—plus spa-like amenities like an in-wall fireplace and live plants.

The economic rationale is to unlock value by building on small tracts of land previously deemed unusable. Kasita aims to rent at just half the market rate of a traditional urban studio apartment.

It may not be long before shipping containers also appear in student-housing portfolios. The largest container city in the world, Keetwonen, is a student-housing complex in space-constrained, rent-controlled Amsterdam. Started in 2006 with just 60 units built in China by Dutch manufacturer Tempohousing, the project now includes more than 1,000 units on 4.5 acres.

Tempohousing founder Quinten de Gooijer hatched the plan after two of his cousins came to study in Amsterdam but were unable to find housing. Dutch rent controls did not allow for charging the amount needed to support development costs, so De Gooijer, a real estate developer, converted containers to housing units at a low enough cost to stay below rent ceilings. ■

Five Factors Driving the Hospitality Sector

1

CAPITAL IS FLOWING INTO HOSPITALITY

The robust growth in the hospitality sector has sparked interest from investors, both domestic and international. "It's attracting capital from sources who may have shied away from the asset class in the past," says John McCourt, an audit partner at RSM US LLP. "Even [from] as far [away] as China, where they've eased restrictions on outward investing. And from what we're seeing from our own client base, there are several hospitality transactions happening at the moment."

Cheryl Boyer, the chief operating officer at Fulcrum Hospitality LLC, agrees with McCourt. However, she thinks the kinds of transactions driving the market are focused on ultra-luxury properties. "In New York City alone we've seen iconic brands change hands, like the Waldorf-Astoria and the New York Palace," she says. She believes that investors are looking at a long-term hold on those properties, indicating continued growth in the asset class.

McCourt also expects demand to be driven by macro-level sources. "The amount of debt that needs to be refinanced is a key driver, and over the next three years there are a lot of leveraged assets out there that will need to be refinanced, and that can be a catalyst for transactions," he says.

2

THERE ARE THREE KEY FUNDAMENTALS TO LOOK OUT FOR

Investors, first and foremost, want to know the underlying drivers pushing a real estate food group before committing to one—and in hospitality, fundamentals matter the most.

While the Average Daily Rate and Revenue per Available Room (RevPAR) are the industry standards when it comes to indicators of performance, Fulcrum Hospitality's Boyer says it's imperative to dig deeper than just the indices. "One of the things we look at are operating fundamentals," she says. "How [fully] are the hotels occupied? What rates are they able to charge, and what is driving the growth in RevPAR? The economic recovery has been moving very well, and we're having another great year of top-line performance and, hopefully, profit."

RSM's McCourt says there's reason to remain optimistic for the next three years. "RevPAR in 2014 was up 3 percent from 2013, but in 2015 it's expected to grow between 5 and 8 percent, and the outlook on supply is anticipated to meet the demand for rooms through 2017," he says.

But Noble Investment Group CEO Mit Shah says just riding the wave of good times is not enough to be successful. "In times like today, where the fundamentals are outstanding, you could argue that just buying an asset and being focused on the rising tide is enough," says Shah. "But the most successful lodging real estate owners today are the ones that have a real operating acumen for revenue management and operational management."

Shah believes that the hospitality industry as a whole has not been growing great operating leaders at the rate that it did in the past, and he terms this lack of leaders "the most critical that it's ever been."

3

PREMIUM AND SELECT-SERVICE PROPERTIES PROVIDE LONG-TERM INVESTMENT PERFORMANCE

Although fancy brand names do not guarantee superior performance, Shah is confident that the long-term performance of upscale properties belies their ability to produce results through down cycles. "The thing that we like most about the select-service and upscale categories is that we think it's secular, not cyclical," he says. "If you look at the majority of well-located top brands in the upscale, select-service, and extended-stay categories, they have been cash-flowing through the energy crisis of 1998, [through] the dot-com bust of 2000, after 9/11, and through the

John McCourt
Audit Partner,
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Mit Shah
Senior Managing Principal, CEO,
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Experts from Noble Investment Group, Fulcrum Hospitality, and RSM discuss capital flow, what fundamentals are impacting the hospitality industry, what kind of properties provide long-term performance, why data should be in your strategy, and why an asset's facelift should be done early

Great Recession because of their strong operating models. We've been through a lot of cycles over 22 years, and we've always seen this sector perform and generate cash flow, even in the worst of times."

Offering insights into the drivers for premium brands, Boyer says that "the mid-tier corporate travelers tend to fill rooms midweek. We're seeing that segment of the business is very strong right now. We observe it in air-traffic trends. Across the board, there is strong demand on the corporate side. Then the leisure segments and local business comes in on the weekends."

Boyer adds that, from an investor perspective, "this segment had a great ramp-up post-downturn. It's also the relatively young age of the product and the good level of upkeep that attracts consumers."

4

DATA IS THE BEST DEFENSE AGAINST HOSPITALITY DISRUPTERS

The rise of the sharing economy has made Airbnb a force for the hospitality industry to contend with in just a few short years. However, as Airbnb grabs headlines, it's the companies with big data that might be best positioned to be game changers.

"I don't think that it's going to have quite the disruption effect that a lot of people are anticipating," says McCourt, who argues that many seasoned travelers don't have the appetite to switch from more traditional lodging. "Airbnb is a very successful company. However, I don't think the hotel industry is going after the same customer."

Boyer believes Airbnb's greatest opportunity is in big markets where hotels get filled to capacity and travelers have to look for alternative lodging. "But that's less of an issue in the secondary markets that only get [filled] to capacity during local events," she says.

As demand for new services and amenities increases, companies that are able to gain superior customer insight might be the true disrupters to the traditional hospitality business. Shah sees the true power in big data. "The [online travel agencies] such as Expedia, Orbitz, and Travelocity have been threats," he says. "However, the sleeping giants are actually Google and Amazon. Their collection of data gives them the potential of truly getting to know consumer behavior."

Both Shah and McCourt point out how smart operators are already keen on a data-driven mentality, gathering customer insights that help drive engagement and improve amenities. McCourt shares an anecdote that shows how social media can shape customer interaction. "Operators are using social insights from Facebook and Twitter or Instagram to find little tidbits about their guests' preferences and working to fulfill them," he says. "For instance, if a customer expresses on social media that they're a wine connoisseur, the operators might instruct staff to stock a bottle of wine as the guest checks in."

5

REBRANDING AND RENOVATION SHOULD BE CONSIDERED BEFORE A DEAL IS DONE

After the global financial crisis, investors have focused on due diligence. But hospitality may require unique insights when compared to food groups such as office or residential.

"A lot of investors and lenders are doing a lot better job of going through due diligence," RSM's McCourt says. "They're taking it very seriously, and there is no longer a reliance on the fact that they think somebody else has done the diligence."

Understanding where the property is and where you think you can take it over the time of your investment is also one of the keys of due diligence, says Fulcrum's Boyer. "Are there opportunities to develop a business plan whereby you're changing the brand or the management company?" she asks. "Maybe you're investing capital to renovate and reposition the hotel. What's the thesis that's going to take the asset from where it is to grow the revenues, profit, and value of that hotel over your whole horizon? The most important thing—at least fundamentally—on the due diligence side is trying to figure out how you are going to do that."

Shah says looking at the asset's income stream, and figuring out how to move it from X to Y, is a good starting point. "You have to be able to do it without relying on market growth," he says. "Even though most of the pundits will say that we have 5 percent of RevPAR growth on the horizon, you can't go into an asset assuming that will be the case." ■

Are U.S. Data Centers at a Saturation Point?

Google's former director of global infrastructure acquisitions, Erikas Napjus, warns that the U.S. and London data center markets could be on the cusp of a bubble

The U.S. data center market could be close to saturation, with investors urged to consider "getting out of the sector" within the next five to 10 years.

Erikas Napjus, managing partner of the data center consultancy firm Zenzu and Google's former director of global infrastructure acquisition, says the retail data center space—where tenants sign shorter-term leases for a rack, space within a rack, or a caged-off area within a facility—is suffering the most.

"There's been so much incremental growth in the enterprise area [retail data centers], but as people in the U.S. and internationally go to the cloud, this is where things will suffer," says Napjus.

Internet giants such as Amazon, Facebook, and Microsoft are investing heavily in mega data centers, which research firm International Data Corporation estimates will account for more than 72 percent of all service provider data center construction by 2018. Napjus also argues that increasing competition from wholesale data center providers that typically lease entire data centers to a single tenant, who is then responsible for all IT operations, would drive consolidation in the sector as wholesale providers move into the retail space in search of growth.

"After the financial crisis, investors realized that data centers were one part of the market that was pretty solid and sustainable," says Napjus. "That was around the time that the smart private equity money was flowing into the market." Napjus advises public and private investors and firms on sourcing data center sites, infrastructure, entering new markets, and evaluating data center management teams. "In the past five years, we've seen a lot of growth and are now seeing that early private equity money starting to back out of the sector and sell their assets," he adds.

As capital continues to flow into the sector, Napjus says, "this second wave of investors entering the data center space may not realize they are entering on the cusp of the next bubble. In some cases they might be creating the next bubble."

The issue isn't just restricted to the U.S. market, however. Napjus says London and Amsterdam are also on the verge of potential saturation. "The shoe is about to fall in some of these developed markets. London definitely feels that way."

Instead, data centers in emerging and frontier markets—as well as on the edges of core gateway markets in developed countries—can offer much better risk-adjusted returns, Napjus says. "The real opportunity I see is in markets where there are not the existing players, such as Latin America and South Africa. The risk profile of these markets has kept the established REIT players away, but if you are willing to notch up on the risk side and create a good company, you can be rewarded well for it."

He also says edge data centers—located in the top 40 to 80 markets of countries such as the U.S. and regions such as Europe, rather than the biggest four or eight cities—are gaining traction and "possibly over time may end up edging some of the wholesale and highly connected data centers out.

"There is a great opportunity to become a leading data center provider in these markets, if just 20 percent to 30 percent of the market moves to Class B–type markets. That may happen over the next five years." ■

Berkshire's View on Multifamily Growth

The firm has its eye on increasing its core multifamily portfolio, with development and debt in the cards, says CEO Chuck Leitner

Privcap: When it comes to cycles in commercial real estate, multifamily is frequently cited as being ahead of the pack, and Berkshire owns, manages, and has in development more than 28,000 units. Are we at the top of the cycle?

Chuck Leitner, Berkshire Group: It depends upon how and where you're investing. Certain parts of multi[family] are...pretty well into the later cycle. Value-added multifamily, as an example, has gotten pretty competitive in terms of getting appropriate risk-adjusted returns for buying, repositioning, redeveloping, raising rents along with that strategy, and then, ultimately, selling a property for more than you put in it. That part of the market is pretty long in the tooth right now, but there are other parts of the market that we think have quite a bit of running room.

Value-add is a significant part of the Berkshire portfolio—almost 50 percent. Are you pulling back from that?

Leitner: We've been generally doing more selling out of our value-added positions and have been very careful about buying. We're doing a little bit of it here and there, but generally the risk-adjusted returns are getting thin.

How much will you sell?

Leitner: In 2014 we sold about $1B worth of what I would call value-added multifamily real estate in the U.S. We have some 10,000 units. And we'll sell more.

Our value-added multifamily assets are not just in individual repositioning properties. We also do a significant amount of debt investing. We have an active program where we're buying the first-loss CME position from Freddie Mac-issued multi-family-backed portfolio pools. And actually buying mortgage positions.

So you'll actually be ramping up the strategy?

Leitner: Correct. We've been doing it for a while, and I think we'll continue to do it. And in select markets we're still pretty active on the ground-up development side and doing that in our value-added strategy.

Is that development for sale, or for holding?

Leitner: For the most part it's development to lease and sell with either a local or regional partner that is incented to do the same. And as those assets sit in our value-added funds, which tend to be closed-end vehicles, that formula works pretty well. We are starting to do some more development in very high-quality major-market locations that are more build-to-hold and are fitting into more of our long-term core investment strategies.

Is core an area where you would see an increase, even given pricing?

Leitner: There's a lot of talk about low cap rates and high prices per unit. But quality locations are really the key. Not necessarily brand-new product, but really high-quality locations where there are barriers to entry in terms of new competition. Where there are strong demand drivers, job creation, and markets where there still is some really healthy job activity. We've bought a couple of properties in Boston, for example. Right now the supply-demand fundamentals are quite attractive.

Do you see the rents continuing to grow?

Leitner: We definitely, in certain markets, have seen the effects of competition. So rent increases are getting smaller. They're not going away, but they're not the high-single-digit numbers you were seeing a couple of years ago. ■

Death of the 10-Year Office Lease?

Sonny Kalsi
Founder and Partner,
GreenOak Real Estate

Will Silverman
Managing Director,
Group Head of Investment Sales,
Hodges Ward Elliott

Rising demand for creative space is pressuring landlords to deliver more to tenants. But while demand for amenities and the accompanying tenant improvement costs are increasing, landlords are holding the line on lease duration.

Privcap: Let's cut to the heart of the issue: Is the 10-year lease in jeopardy thanks to the growth of smaller, newer firms and co-working spaces?

Sonny Kalsi, GreenOak Real Estate: I really don't think so. Clearly, some trends in the last several years—I'll call it the WeWork effect—have been creating options for tenants. But by and large, in major markets in which we operate, there's still a strong preference on the part of tenants, and surely on the part of landlords, to have some duration to their leases.

Will Silverman, Hodges Ward Elliott: I think it's still very much alive. If tenants were to express an overwhelming preference for the shorter lease term, which many do, lenders would have to be on board. Otherwise there would be a substantial correction in property values, because you wouldn't be able to finance as aggressively.

Why is there such a focus on the lease being 10 years? Will, you talked about lender requirements, but is it also down to rising tenant improvement [TI] costs being incurred by landlords?

Kalsi: When you think about the capital costs involved with [many office buildouts for tenants], what's required in a B+ or better building, they're pretty significant. So as the landlord, I sure want to have some duration there to offset some of those costs.

Silverman: I would liken it to $200 ripped jeans. In order to achieve the true aesthetic that people are really looking for, it's really hard to get that patina organically. With respect to co-working and creative space, those buildouts can look a little bit raw, but there are a lot of materials there. There is a lot of glass involved in that. And the amenity spaces they have in the centers of each of those floors are actually pretty rich.

So how do landlords even underwrite some of these newer, smaller firms, given they haven't been in business for long?

Silverman: Investors are feeling like they're sort of walking a tightrope, because a lot of them are fearful. A lot of these tenants haven't existed for the amount of time that's equal to the forward commitment in their lease. You have three-year-old tenants signing 10-year deals. As a landlord, that's got to give you a little bit of pause.

Kalsi: That's why something like WeWork has been so well received. It's an aggregator, and it is helping disperse, if you will, the credit risk of those underlying tenants by pulling them together and providing, certainly, better credit. Now, you can have a whole debate about WeWork's credit, but it's clearly better credit than any of the underlying tenants beneath them. And so that disintermediation, they've addressed a big need.

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Are investors conceding a significant part of the technology, advertising, media, and information leasing market to co-working spaces like WeWork?

Kalsi: We've thought about it, and at the end of the day, we're not sure it's worth it. You're on a treadmill with shorter-term leases. Your net operating income, yield on cost, might look somewhat attractive, but your net cash flow, yield on cost, between paying the brokers and then paying for your tenant improvements, you're always on a treadmill.

Silverman: There's an arbitrage here. There's an old trope in the retail business: Whenever there's a super expensive store on Fifth Avenue with a really, really high rent, people always say, "Well, I suppose that maybe they're not making as much money on the store, but some of the rent is in their advertising budget." These types of tenants, they're using their real estate space, albeit rented space, as a recruiting tool.

Tenants are willing to pay up if the landlord is deemed to be delivering the style of experience that they want, with a building that has outdoor spaces available to tenants, a gym, etc. Workers are actually willing to, in many cases, accept a little bit less money or work slightly longer hours to work in these well-amenitized spaces. To the extent you can get people to take less money by paying more rent, you're not paying payroll tax on the additional rent. So you've accomplished recruiting without having to spend more money, which is terrific.

In terms of office buildouts, what are tenants asking you for?

Kalsi: We're seeing more tenant requests for what I'll call a complete buildout. A lot of them are in a position to do it themselves, but they don't want to deal with it. They'd rather see it amortize into their lease. Partly it's because if they are in an industry where their cost of capital is perceived to be high, they view this as something that's going to be more easily provided by a landlord. In a lot of our buildings, we will be able to borrow the TIs that we put into something. And clearly our cost of capital for that is going to be lower than some tech firm's venture capital is going to cost them. If that means we can get a higher base rent and we're comfortable with the credit, it's a good trade-off.

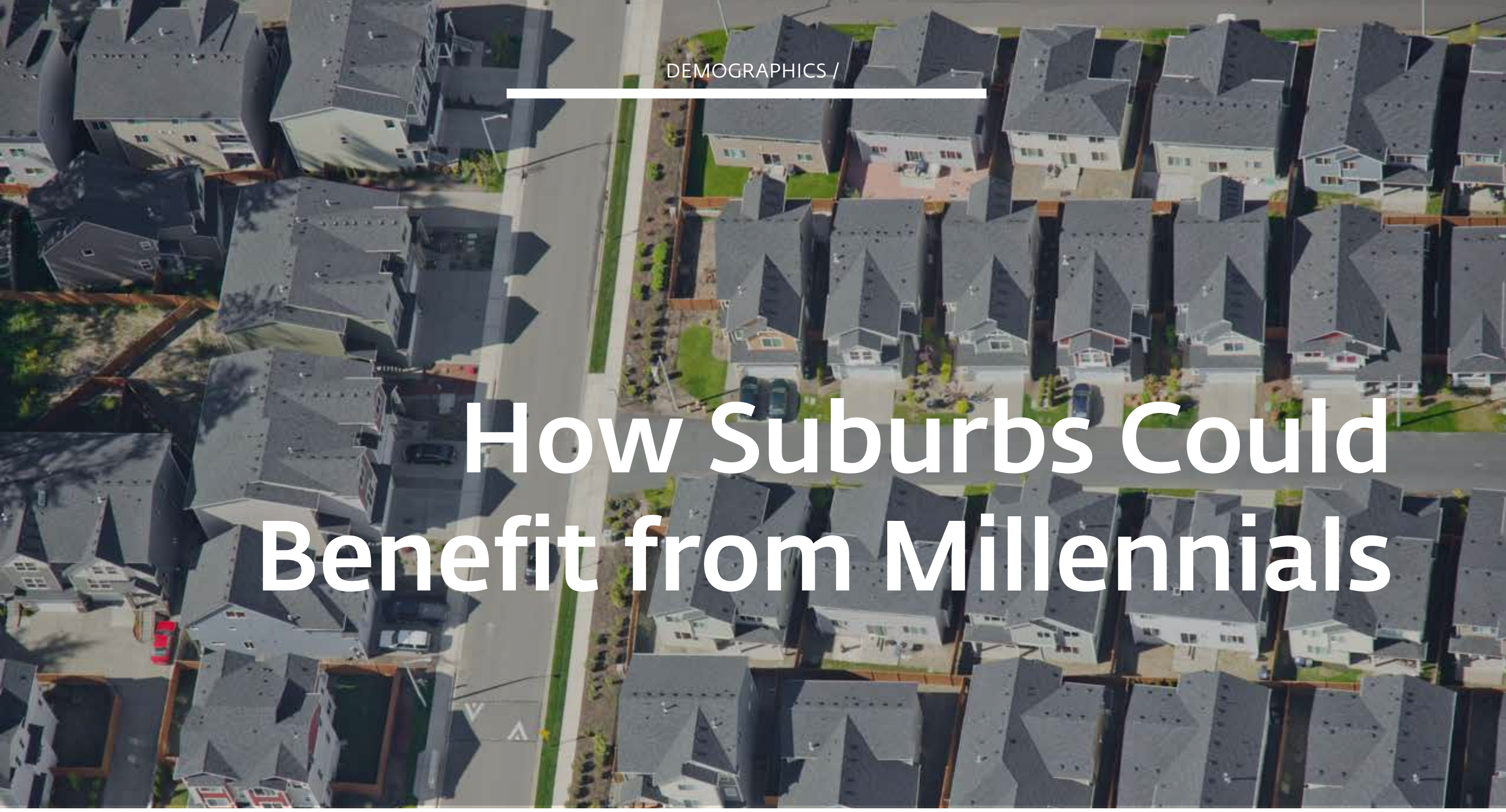
What's the minimum amenities package that you think you can actually offer today to attract tenants?

Silverman: Anything that you would find in a modern apartment building or a hotel as an amenity is probably something that you will get a nice response to in an office building—things like gyms, bike rooms, outdoor space. I don't think it's indispensable, but it's a very important thing to have. There's a convergence of uses, and people are spending more and more time at the office.

Kalsi: For tenants in New York City, as an example, cool has become much more important than it used to be. If you think about those factors, which ultimately come down to cost, for sure tenants are asking for more. If you want to build out space with a concrete polished floor and exposed ceilings, that's more expensive than dropping down carpet and dropping a ceiling. So base rents are moving up and have consistently moved up for the last few years. Tenant improvement allowances are moving up as well, and that's very much driven by tenant expectations. ■

"Tenants are willing to pay up if the landlord is deemed to be delivering the style of experience that they want."

– Will Silverman, Hodges Ward Elliott



How Suburbs Could Benefit from Millennials

The urbanization trend isn't killing U.S. cities—it could, in fact, create more opportunities as an increasing number of millennials and Gen X-ers opt to move away from city centers, says RSM US LLP partner Jason Sevier

Privcap: 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 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.

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 [you] 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. The way millennials interact [with other people] and the way they conduct themselves on a daily basis is [driven by] technology. ■

Don't Sell Commercial RE Short

Mike Fascitelli
Co-founder and Managing Partner, Imperial Companies

The former CEO of office and retail REIT Vornado Realty Trust, Mike Fascitelli, says it's time to be selective in buying U.S. assets, but believes fundamentals are strong

Privcap: What's driving the foreign capital flows into the U.S.?

Mike Fascitelli, Imperial Companies: I think it's both an absolute and relative objective for that capital. They want to get good long-term returns. New York has shown [that] over time it can deliver those. And the other alternatives to do that around the world are not quite as attractive. And [in a] flight to safety, the U.S. always wins.

Outside of New York, what type of impact is the inflow of foreign capital having?

Fascitelli: We've seen a big increase in prices in the gateway cities, not just New York and San Francisco but also Chicago, Boston. It isn't all over the country, but it's broader than New York. Foreign capital has come from the Middle East, from Europe, from China and Asia. Each of those territories may have a preferred city—New York's probably number one—but people like Washington, D.C., they like Boston and San Francisco. So we've definitely seen an impact in pricing across the country.

Do you have any concerns that the market is peaking in certain property types?

Fascitelli: In the high-end condo market we've seen a pullback [of capital flows] with many people calling it the peak. That market was particularly influenced by the flow of foreign capital, as well as [by] domestic wealth creation. So we've got some unsold condos that are piling up at the luxury end, and I think it will be a challenge to keep pricing at [its high] level.

What's your view on office?

Fascitelli: Foreign capital has been an impact in terms of pricing, but office fundamentals are decent and steady, and even showing some growth in rents. But pricing may have gotten ahead of itself, thanks to the wall of capital coming in from both foreign and U.S. investors.

What does that mean for cap rates?

Fascitelli: When I first got to Vornado, we were buying things at 8 percent to 10 percent cap rates. [You have to] look at the absolute cap rate. As they spread against the 10-year Treasury, which is around 2 percent, they're pretty consistent with history. They may have not much room to go down, but they're not overly wacky at the moment.

How will interest rates impact real estate investment going forward?

Fascitelli: One of the biggest risks is that interest rates spike up or go up more quickly than people think. There's a lot of debate about whether cash flows will win the race against interest rates going up. If interest rates go up without cash flows going up as high, that's going to be a problem.

What parts of the real estate market should be avoided today?

Fascitelli: One of the great things about real estate—and one of the tough things about it—is it's really market by market, asset by asset, product type by product type, brick by brick. But one of the greatest problems or red flags to worry about in real estate is oversupply. Overbuilding is starting to pick up in certain cities, and oversupply is coming in certain areas. I wouldn't sell short the market [or say] it's time to back up the truck and buy. It's very selective right now. ■

The Realities of Repositioning Real Estate

A panel of experts from Taconic, TIAA, and RSM highlight five realities of value-add real estate investing in the U.S. today, including tenant improvements, keeping existing tenants happy, and redefining lease terms

The Panelists

Chris Balestra
Senior Vice President,
Taconic Investment Partners

Jason Sevier
Partner,
RSM US LLP

Kevin Smith
Senior Director,
TIAA Global Asset Management

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.

For Kevin Smith, senior director at the investment-management firm TIAA Global Asset 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." Landlords trying to attract technology, advertising, media, and information (TAMI) firms also "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. You have to know who your audience is."

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

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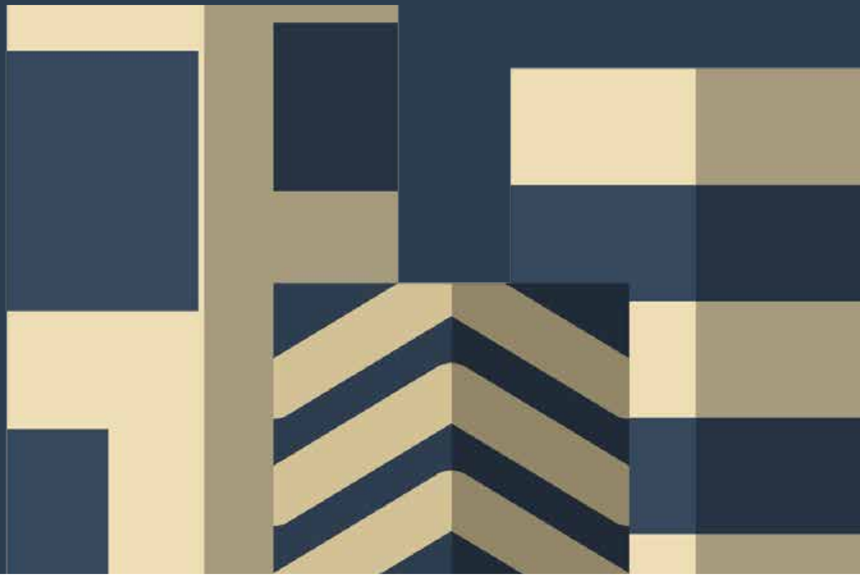


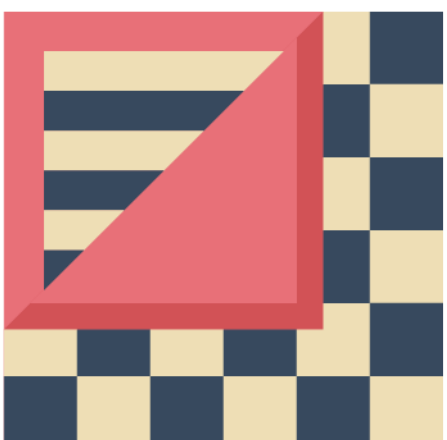
things. They like open space," says Balestra, whose firm previously owned and now manages Google's 3-million-square-foot headquarters in New York at 111 Eighth Avenue. "That's been a huge driver of tenant demand in some buildings these days, whereas 10 years ago you didn't really think of a rooftop as 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.

3. WEWORK AND CO-SHARING SPACES 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 abbreviated track records but that are also demanding shorter leases. "I would call this the WeWork effect," says Smith. "It's definitely having an impact on how we look at [spending on] pre-built spaces."



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 says, and warns that in the future "you're going to see different versions of the lease agreement."

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.

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.

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.

"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," Balestra 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 time frame 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." ■

Extended RE Cycle Seen on the Horizon

Marty Connor
CFO,
Toll Brothers

Marty Connor, the chief financial officer of U.S. luxury homebuilder Toll Brothers, weighs in on the real estate cycle for residential for-sale homes

Privcap: Where are we in the real estate cycle?

Marty Connor, Toll Brothers: The cycle has been much more extended in terms of the recovery than we, and most people, thought. We went down to 250,000 to 300,000 units a year from a long-term average of 105 million. Right now we're about at 1 million, so we have a long way to go. Most cycles have been seven or eight years, but the last one was 15 good years, four really rough years. I don't know that we'll get to 14 or 15 years again, but it's not going to be the normal seven or eight… It's going to be pretty extended.

Toll Brothers isn't just about homebuilding. You're also expanding into multifamily and condos in New York City. How have the strategies developed?

Connor: We're thrilled with our results in the condo product that we're building in New York City and Hoboken, N.J. We'd love to take that business to certain other markets around the country; we've just struggled to find the right opportunity. But we're in our 24th or 25th building here, and we learned some lessons along the way.

What are your expectations for continued growth in the condo sector?

Connor: We have seen rapid appreciation in condo prices in New York over the previous three years, and we're benefiting from that now as we deliver units. But we don't project that to continue. So for these buildings, because they are higher risk, because you can't stop in the middle, we demand a higher return. We underwrite to roughly a mid-30s gross margin, and the buildings we're delivering now are mid-40s gross margin.

Where are you focused on the multifamily side?

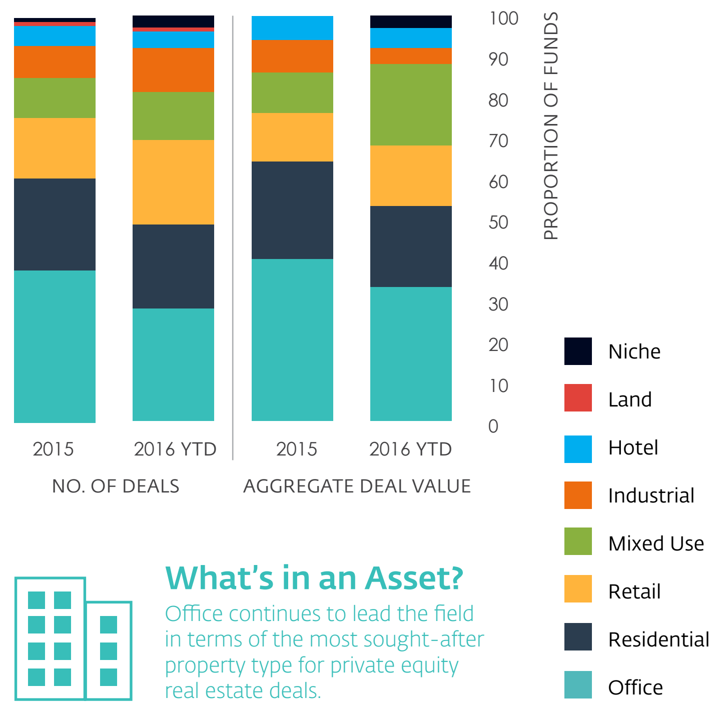
Connor: Our sweet spot is Boston to Washington, D.C. We are looking to get this expanded beyond that, but we want to get a few things completed with the team we have in place. We have a great team, but when you start diluting them on a plane to California or Texas, you run some risks that we're not willing to do right now.

Has your understanding of risk actually changed?

Connor: We want to make sure that our balance sheet is positioned to take advantage of opportunities, both going up the cycle and down the cycle. [Because] when things get tough, if you have a lot of cash, you can pick up some opportunities at a significant discount. In addition to the amount of land we have, we got hurt in some pretty complicated big partnerships as things went down. A partner or two, two or three banks, that's fine. But we had some deals with five or six different partners and 10 to 12 different banks, and it's tough to get everybody thinking the same way. ■

In Search of Deals

Real estate fund managers have been net sellers in recent years, distributing more capital back to investors than was called up. Yet the amount of capital ready for investment in closed-end funds remains at historic levels, hitting $236B in June 2016—a record, according to data provider Preqin.



$236B
The record amount of dry powder currently in closed-end private equity real estate funds—up from $210B at the end of 2015.

27%
Proportion, by value, of deals completed in New York, despite the state representing only 11 percent of all actual deals.

What's in an Asset?

Office continues to lead the field in terms of the most sought-after property type for private equity real estate deals.

38%
The amount of European deals overall captured by the U.K., which also netted 42 percent of deals, by value—twice as much as Germany.

€1.3B
The amount of the AEW Europe close on the largest portfolio deal in Europe in 2015 and 2016—the 10-shopping-center Celsius Portfolio acquired in partnership with sovereign wealth fund CIC.

67%
The amount of deals globally that were single-asset transactions, with 33 percent of them portfolio deals.

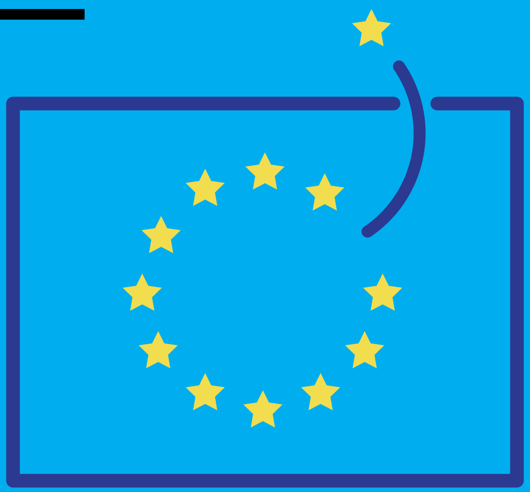
57%
The proportion of deals done by Australia, the largest number for any country in the Asia Pacific region.

¥140B
Acquisition of Tokyo's mixed-use complex Meguro Gajoen by LaSalle Investment Management and CIC, making it the largest single-asset deal in the Asia Pacific region.

$2.2B
Sale of the office tower 3 Bryant Park in New York—the largest single-asset deal in North America. Sold by Blackstone Group to Callahan Capital and Ivanhoe Cambridge.

preqin

Source: Preqin Real Estate Deals report, June 2016. Data for 2016 is YTD to June 6, 2016. Data for the largest single-asset and portfolio transactions is for the period 2015 to June 6, 2016.



What Brexit?

In the Long Run, Europe Demand Remains Strong

Four out of 10 private capital LPs admit they'll invest less in the U.K. in the next year, thanks to the Brexit vote, but when it comes to long-term investment intentions for the U.K. and Europe, it's a much different story

David Skinner
Global Head of Strategy and Portfolio Management, Aviva Investors

Ric Lewis
Chief Executive, Tristan Capital Partners

Brexit be damned—for some investors, the U.K. and Europe still represent the best value in global real estate.

It's true that some institutional investors have adopted a wait-and-see approach following the U.K.'s vote to leave the European Union. Within two weeks of the June 23 vote, a Preqin survey revealed that 43 percent of private capital LPs were likely to invest less in the U.K. over the next 12 months, with 25 percent saying the same of EU investments.

But long-term appetite for the real estate in the region remains. On a longer-term basis, the number of firms saying they'd "invest less" fell to 31 percent—with 62 percent of private capital LPs saying they expected no change to their U.K. allocations in the long run. When it came to EU investments in the long term, 74 percent of LPs said they expected no change.

The data was backed up by U.K. brokerage Peel Hunt, which—despite predicting significant declines of up to 11 percent in capital values for retail and City of London and West End offices in 2016—says valuations could turn positive again by 2018.

For Aviva Investors' global head of strategy and portfolio management, David Skinner, Europe is still the most attractive global real estate market.

"We have a sense that Europe, in a global context, offers better value than other parts of the global real estate market," he says. "First, other parts of the global real estate market have recovered earlier and much stronger. They are much more mature in the phase of the recovery cycle.

"Second, the extent of recovery in other parts of the world has meant that the relative-pricing argument attractions to real estate are less strong in other parts of the world than they are in Europe. Third, the prospect of further quantitative easing within the Eurozone suggests that the relative-pricing argument will last for longer in European markets than it does in much of the rest of the world."

Ric Lewis, chief executive of Tristan Capital Partners, agrees that Continental Europe presents some compelling opportunities.

"The smart money and smart investors coming to Europe now are those who want to place themselves in the pathway of growth—those places, economies, and strategies that are going to benefit from above-trend growth in a stumbling but growing euro," he says.

For Tristan, that translates into being in a disciplined hurry to invest in Europe in the near term.

"I like where the European economy is," says Lewis. "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 and that, effectively, 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...I want our portfolio to be in a position where we can be a net seller." ■

FIRPTA Reforms Put Foreign LPs 'On Notice'

Jim Fetgatter
Chief Executive,
AFIRE

Frank Lively
Executive Vice President of Real Estate,
Wafra Investment Advisory Group

Reforms to the act will impact those interested in investing in REITs

When reforms came to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), they came fast, catching many foreign investors unawares.

However, the changes—which will make it easier for certain foreign pension funds to invest in real estate and REITs in the U.S.—could pave the way for a long-term increase in allocations to the asset class, say Frank Lively of Wafra Investment Advisory Group and Jim Fetgatter of AFIRE.

Privcap: How do you view the impact of FIRPTA reforms?

Jim Fetgatter, AFIRE: I think it's going to be a big deal. However, I don't think it's the biggest thing that's happened to commercial real estate since sliced bread. It will impact people who want to invest in REITs, and it will impact qualified pension funds. So it's not going to affect everybody. We were very happy to see the reform. We think it's a good first step.

Did the speed with which this happened take you by surprise?

Frank Lively, Wafra: They've been talking about change to this for 30-plus years, [so] I think the speed and acceleration with which this thing got done probably did surprise some people.

Given that surprise, have foreign pensions had a chance to digest the changes?

Lively: It [puts them] on notice that they have to rethink maybe some of their allocation issues. I would say [for] any of the large investor pension funds, that's an ongoing process regardless. I know our own parent does this on a continuing basis. So they'll look at it in the context of what this potentially offers them, but I think the devil is still in the details to be hashed out. But everybody has been, hopefully, put on notice in the sense that this may encourage more investment into the U.S.

AFIRE just released its 2016 annual survey of investors. Do you see appetite for commercial real estate within the U.S. decreasing at any point this year?

Fetgatter: Every time we ask to survey [investors], there are a number of them who say, "Well, we're going to decrease some of our portfolio a great deal or a little bit." Nobody said that this time. It's the first time that there's never been anybody to say, "We're not going to do a measured decrease in our portfolio."

The U.S. is a favored destination for many foreign investors. How is Wafra looking at the U.S. going forward?

Lively: We're looking at the U.S. economy. We're trying to gauge whether or not it's really going to continue with the momentum that it's had. Is that momentum going to accelerate or is it going to decline?

More importantly, is the U.S. economy really going to be able to sustain the kind of pricing that we've seen, commensurate with what real estate has done over the last few years? How low can cap rates go on acquisitions? ■

Rethinking Opportunities in Asia

Commercial real estate deal flow in Asia fell dramatically last year, prompting many investors to rethink their strategies in the region. For PGIM Real Estate and Townsend Group, that translates to plenty of short-term and long-term opportunities.

Asia's commercial real estate markets had become increasingly volatile long before China's equity markets wobbled in late summer 2015.

Indeed, deal flow in 2014 was down 24 percent compared to a year earlier, while in the first half of 2015, transaction volume fell $159B, or 41 percent, according to data provider Real Capital Analytics, the latter driven by a two-thirds fall in development site acquisitions as well as 30-percent-plus declines in office, industrial, and hotel deals.

As value recovery took hold in the U.S. and Europe, it seemed many investors turned their attention away from Asia.

Yet in the wake of rising volatility and falling transaction volume, managers and institutional investors are beginning to refocus their attention on Asia as short-term opportunities re-emerge alongside the longer-term growth stories of the region.

"Asia is going through a transitional process," says PGIM Real Estate's head of Asia Pacific, Benett Theseira. "It's had many years of strong growth, [but] it's actually good that there is some element of correction or headwind in the markets, because it creates opportunities. It brings values to a much more rational level."

And those opportunities are coming across the risk spectrum, he adds, as well as across different countries. "Asia offers both long-term and short-term opportunities," says Theseira, who leads PGIM Real Estate's $4.7B Asia portfolio, which is invested in six countries, predominantly in the core and value-added space and across all the property food groups.

"In general, based on the long-term fundamentals of the region, we advocate a long-term hold—particularly for core assets. But apart from that, because of the growth of the markets, which creates some volatility, there are great opportunities for short-term [investments]."

Seeing a plethora of opportunities is a view shared, in part, by Townsend Group principal Prashant Tewari, who leads global investment strategy for the Cleveland, Ohio-based investment manager.

"There is growing interest in our client base in Asia real estate," says Tewari, who believes that in "years to come, Asian real estate is going to gain increasing prominence in our client portfolio."

Townsend is focused on value-added, repositioning opportunities in the region, not least in India, where the firm—alongside a sovereign wealth fund—recently invested in a senior secured lending platform for condo developments.

However, Tewari thinks that, before investing, it's important to understand the unique elements of each country's economy and how uncorrelated the Asia region is as a whole.

> "Asia offers both long-term and short-term opportunities"
>
> –Benett Theseira, PGIM Real Estate

CONTINUES ON NEXT PAGE

"In the developed markets of Japan and Australia, Japan has a stagnant growth outlook, while Australia has a healthy growth outlook," says Tewari. "On the contrary, when you look at the emerging economies of China and India, in India you have a high growth rate that is accelerating, and China, up until now, had an even higher growth rate. This lack of correlation among the economies in one given region is a little unprecedented."

For Theseira, such a lack of correlation among Asian economies and real estate markets means execution is key to the success of any investment strategy.

"Asia is a complex market," says Theseira, who argues that boots on the ground is part of any successful deal execution. "There are different markets and different cultures, and relationships are important. In order to be successful you need to have a local presence. You need to have people that are either local or have a great understanding of the local culture."

But just being able to read a market or pick a good asset isn't enough, Theseira continues. "Execution is key. In many cases, the level of asset management execution in the Asian markets is fairly weak, and so our ability to work with development partners or joint venture partners, bring in quality standards or a much more developed approach to real estate asset management—I think that adds a lot of value."

Tewari agrees, noting that it's not just boots on the ground that ensures success, but also a robust investment strategy and asset selection. "I wouldn't want to say one is more important than the other, but if you have a stack of cards and you pull one out, the rest of the tower falls down," Tewari says.

And when it comes to location and assets, both Theseira and Tewari agree there are plenty to choose from in Asia, depending on the investor's risk appetite.

On a short-term basis, Theseira says the next six to 12 months will generate good buying opportunities in China, thanks to the recent equity market volatility and government attempts to cool down property markets—particularly when set against the country's long-term growth story. Theseira also sees retail as one of the most attractive food groups across Asia today, fueled by strong consumption and demographic trends.

Australia is on the radar of both Theseira and Tewari, with the Townsend principal saying people often lose sight of the country's high rate of population growth. But even countries with slower population growth, such as Japan, offer opportunities for investors. "We're doing a lot of work in senior housing in Japan," says Tewari. "We're looking at student housing in Australia. We've made a recent investment in self-storage in Singapore. So even within developed Asia, there are emerging [property sectors] that provide outsized returns to investors."

A build-to-core strategy is another part of the equation in developed countries, with Tewari noting that while Townsend currently doesn't like core income properties, "we like to build to core in these [developed] markets." Theseira echoes Tewari's comments: "The reason for going to development is all about the long-term opportunity in Asia and the growth of core real estate... And over time, we do see a lot of potential in the region's markets, thanks to their long-term growth." ■

Around the World With Aviva Investors

The firm's global real estate CEO, Ed Casal, describes the platform that includes Continental Europe and Asia, and explains what sectors the firm sees as particularly frothy

Privcap: Let's take a bit of a tour of the world, starting in Europe, where you're a major direct investor. Where do you see interesting ways to capture value?

Ed Casal, Aviva: We've done very well on the long-income side of the business. Aviva has an insurance company parent and affiliate, and so we do a lot of asset-liability matching for them and for other pension plans. And by long-income I mean acquiring assets that may have 25-to-35-year leases on them, so you're not valuing the residual value very highly. We also have another pool of capital where we're buying properties with 12-, 15-, 20-year income. We'll be rolling out a platform like that in Continental Europe as well.

Continental Europe has some issues, and so it doesn't mean we don't see pockets of opportunity, but it's been harder.

We're owners of office assets in central Paris. There's a lot of demand, even if leasing isn't as great as you'd love it to be, but we've been very careful. In Germany, there have been some pockets of opportunity, but you have to be selective, because it's an overpicked market.

"We think about investing in the types of properties that we'd want to own in the downturn." Ed Casal, Aviva Investors

You've backed management teams in your indirect investments in the U.S. How did the best managers perform through the downturn?

Casal: The characteristic that the survivors had was clarity and honesty. When things started to turn down, they dealt with issues right away. They communicated extremely well with their investors, told them what was happening, started writing properties down, refinanced quickly, re-equitized what they needed to quickly. That was an important characteristic.

How do you view the U.S. today?

Casal: We love the gateway cities in the long term, even though they're expensive right now and you're starting to see the supply cycle kick in. We also like those markets outside the gateway cities, like Buckhead in Atlanta. Atlanta's a difficult city sometimes, but Buckhead is particularly strong. It's where people are gathering, where you can buy quality assets, where you're seeing more mixed-use activity day and night. We think about investing in the types of properties that we'd want to own in the downturn.

What property types are of interest to you today?

Casal: We've been overweight on logistics since probably before the global financial crisis. We were very concerned about the housing market. That made us concerned about retail, so we've been underallocated to retail for quite some time. Apartments we like overall, but again only in places that are walking distance to public transportation or a short distance to a university, to a hospital system, to something that's a good demand generator.

What are some of the best stories coming out of Asia recently?

Casal: We did well in China, having invested early and exited fairly early. We've done some industrial development in Japan and in the Tokyo Bay area. Being an investor in 225 different funds and joint ventures around the world, things percolate out [of those investments] that are sometimes very interesting. Australia is being hurt by the commodity cycle and the slowdown in China, but in the long run, you have to be in Australia. ■

EXECUTION

The CFO: A COO in Disguise

Financial chiefs are so involved in the strategic and operational needs of GPs today that the CFO role could often take over the tasks done by chief operating officers

The job of the real estate CFO has expanded far beyond its original number-crunching role—to the point that CFOs could ultimately take over the job of chief operating officers.

With financial chiefs now deeply involved in the strategic vision of investment management firms, operational needs and risk management, as well as internal controls and financial reporting, it's easy to see a future where separate CFO and COO positions are not needed.

"I continue to see the CFO role taking on some of the traditional COO role,"says Jeffrey Herrmann, CFO of Los Angeles-based Resmark Companies. "The CFO today is about strategic vision, new business, dealing with investors and their expectations upfront, not just reporting to them after the fact. It's about data and technology. It's about much more than it was just a decade ago."

The transformation has been due, in part, to the growing emphasis on financial engineering and balance sheet management among Wall Street firms and among Fortune 500 companies, says Herrmann—a move that has led CFOs to take on greater corporate responsibility. "I see that continuing," he adds.

At Resmark, Herrmann will see his role as CFO increasingly take on more of the strategic and operational needs of the business as the firm—which, since 1995, is reported to have invested in land, housing, and multifamily across the U.S. on behalf of the California Public Employees Retirement System and the California State Teachers' Retirement System—expands beyond its two investors.

"Our goal is to…continue to be a successful company through growth and, for that, we need to broaden our investor base," he says.

Herrmann will be deeply involved in investor meetings, talking to LPs about how Resmark expects to deliver risk-adjusted returns in today's commercial real estate markets. "Risk adjustment is key to LPs. They don't want to just go out there and invest in the most risky tranche of real estate debt or equity or stocks. They want to go out there and get a solid return that's not going to be subject to a big decrease if the market burps."

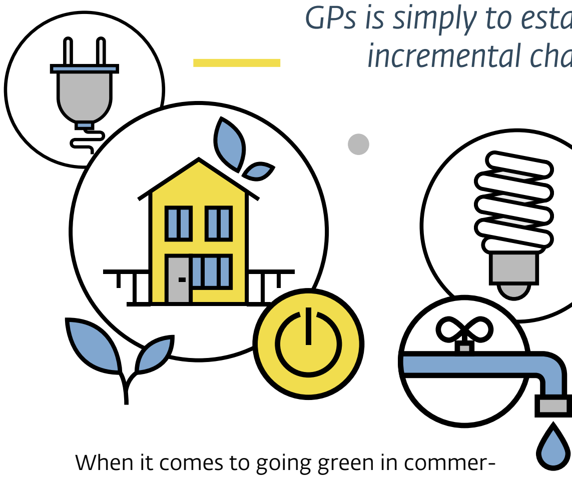
And it's the CFO, Herrmann argues, that can really help deliver that deep-dive explanation into how GPs balance risk and returns. "It's talking about the way we structure things financially; how we maximize our downside protection; how we're happy to generate mid-range returns because we invest money for institutional investors that want a consistent return."

Resmark's efforts to expand its investor base has already seen the firm hire Caroline Gibson, the former head of real estate at recruiter Alderbrooke, as director of U.S. and international investor relations. Herrmann says the expansion will also have a significant impact on Resmark's reporting infrastructure as it moves from customized reports for several large institutional investors.

"Our reporting is completely customized for our two investors so as we grow we'll need to move to a position where it's Resmark deciding what information to give to investors, rather than the other way around," he says. "Unfortunately, no GP can customize reports for 100 different investors so it's about giving investors what they want without overloading them and them having big stacks of documents on desks or in their emails. It's a challenge, but one we're excited about." ■

The Secret to Green RE

The first step towards better ESG strategies for smaller real estate GPs is simply to establish incremental changes



When it comes to going green in commercial real estate, taking incremental baby steps is a proven strategy.

While green initiatives and strategies have gained significant momentum over the past five years thanks to rising tenant demand, investor mandates, and the success of numerous large-scale, portfolio-wide projects involving ESG—environmental, social, and corporate governance—many real estate GPs privately express difficulty in demonstrating measurable impacts.

Indeed, smaller GPs can see the implementation of an ESG program, together with the need for dedicated staff, technology, and research, as more a cost than an additive element to the bottom line.

However, for Kate Brown, group director of sustainability for Grosvenor Group, and Jeannie Renné-Malone, vice president of sustainability at Prologis, there are many simple yet effective high-level approaches that smaller firms can take.

"Work out your biggest impacts. This can be very high-level. Even if you need a consultant to help you take this first step, it will be money well spent," says Brown. "Initially [Grosvenor] undertook a high-level carbon footprint of our assets, legacy, [and] supply chain to ensure we were addressing the big stuff first."

For Renné-Malone, it's all about focusing on the "E" in ESG. "Look at low-hanging fruit such as changing lightbulbs and meters. You have to start somewhere. Start with a framework and track progress."

Simple steps also include drafting a mission statement or basic sustainability policy, slowly increasing the depth of the program and its reporting over time, says Renné-Malone. Such communication helps garner C-suite support and works through the entire organization, creating a collective vision on ESG.

Helen Gurfel, executive director for the Urban Land Institute's Greenprint Center for Building Performance, adds that much of the demand for greater sustainability measures within commercial real estate is coming from tenants themselves, who see ESG programs as critical to their brand identities as well as smart resource management.

"Leading tenants—the Googles of the world—want to attract the best employees and the most talented individuals" to their offices, says Gurfel, which are designed to modern standards and are resource efficient.

Renné-Malone explains how Prologis engages its more than 4,000 tenants globally in ESG initiatives, with some tenants taking ownership of retrofits with the knowledge "they will pay less over the long term."

But Gurfel accepts that not every GP can implement a scheme on the scale of Prologis or Grosvenor. While voluntary programs and mandatory programs and codes have a strong impact on ESG implementation, she says that for many building owners and tenants, financial benefits help drive action.

And the first step for many smaller GPs is to simply establish goals and key performance indicators and balance them against operating budgets. That, she says, can begin a process that eventually leads to much bigger program success down the line. ■

Helen Gurfel
Executive Director,
ULI Greenprint Center for Building Performance

Kate Brown
Group Director of Sustainability,
Grosvenor Group

Jeannie Renné-Malone
Vice President of Sustainability,
Prologis

THE DATA YOU'RE MISSING IN DUE DILIGENCE

Investors need to look to new data sources—including taxi and Citi Bike data—to buy their next property in New York, rather than just relying on historical leasing and sales comp data

Privcap: What type of new data sources are you using to support the acquisition of real estate deals in New York?

Will Silverman, Hodges Ward Elliott: The city of New York makes available the latitude, longitude, and time of every single taxi ride that occurs in New York City, going back six years. And you say, "What can we possibly do with that information?" One example would be a portfolio we were looking at in south and eastern Williamsburg. [And] the question investors have when they look at a neighborhood like south Williamsburg or east Williamsburg is "What's the credit quality of that tenancy? Is it a bunch of 22-year-old kids subsidized by their parents, or do they have real jobs and are they paying real rent?" So we were able to show that over the last five years the average drop-off time on Saturday nights in front of the buildings that we're looking at moved from 3 a.m. to 1 a.m. So what is that telling us? I can't pinpoint the correlation, but I'm comfortable suggesting that the person who goes out and comes home at 1 a.m. on Saturday night is probably a little bit older, probably a little bit further along in their career than the person who goes out until 3 a.m.

What other data sets are there?

Silverman: Citi Bikes is a very exciting one. We were presenting on a building in Brooklyn, and it's…a little bit remote from traditional transportation, but there is a Citi Bike station in front of it. We discovered that the places that people took Citi Bikes to from that building were all of the places that everybody would love to invest in. But they probably didn't realize that the kind of people who hang out in or work in those neighborhoods live in this location. And so what it enables us to do is change the pitch from "Do you want to buy a building at X location?" or "Do you want to buy a building in which the tenants' favorite destinations are Williamsburg, Dumbo, the Navy Yard, Downtown Brooklyn, and Fort Greene?" When you layer that in with the taxi data and look at where those people come home from at night and where they work, you're then telling a very different story. You're telling a story about the other markets to which you're getting exposure by making this specific bet.

Doesn't it come down to vintage, though?

Silverman: There is no bigger predictive indicator of whether a deal will be successful or not than its vintage. However, making the right investment decisions is very, very important. Sometimes it isn't just about whether you make money, because, yes, vintage can crush you no matter how good your analysis is. But if you made smarter choices than your peers based on better information, then when the next opportunity presents itself, you'll be better positioned to raise capital. ■

Why Asset Managers Should Be In on Acquisitions

Asset managers are the unsung heroes of successful real estate investing, and they need a seat at the deal table for every acquisition

John Cornuke
Senior Director,
Global Real Estate,
and Head of Asset Management,
TIAA

Privcap: How do asset managers add value to real estate investing?

John Cornuke, TIAA: If you use the analogy of a football team, asset managers are the linemen; they are the guys in the trenches who actually make things happen. Our asset-management team is involved with an acquisition from the outset, beginning with the due diligence process. We are always asked, "What is your long-term plan for this asset?" My team has deep knowledge of the local markets; we understand local economic fundamentals and key trends that can impact each asset. After acquisition, we implement active strategies to stabilize the property, manage it efficiently, and generate the highest possible return.

How does having asset managers involved in the buy decision impact a deal?

Cornuke: Our team brings a different perspective to the ownership equation. For example, we evaluate basic metrics such as floor-plate dimensions, leasing opportunities, and which local industries are growing or weakening. Is there evidence of a shift in the business climate from one industry to another, such as from finance/insurance/real estate sectors to tech? If a property has upcoming vacancy, what strategies can we implement to retain tenants or to re-lease the space? Asset managers should always have a seat at the table.

So how is space being used differently today, and how does it affect tenant improvement costs versus a decade ago?

Cornuke: Technology firms started the trend of moving into legacy buildings and renovating the space to accommodate modern work-style preferences, but many conventional businesses are now following suit. Tenants are reconfiguring these traditional spaces to create open floor plans and exposed ceilings. The few private offices are in interior locations, while bench seating for most employees is around the periphery. Businesses are adding staff, yet taking less space; the old standard of 150-215 square feet per person is now 85-150 per person.

Employees today are encouraged to come to the office rather than working at home. And in the office, they find collaborative spaces and a range of support services, including Wi-Fi-enabled common areas, breakout rooms, workout facilities, and concierge services. Collaboration between employees is encouraged, while amassing paper is discouraged. Essentially, today's office space is designed for millennials, and aging baby boomers have to adapt. Because these trends are changing how space is built out, the feasibility of transforming older space affects the acquisition process.

What can asset managers do to help turn a troubled asset around?

Cornuke: Our bread-and-butter responsibilities are maintaining the stability of well-located, well-leased assets, but it's so rewarding to change the trajectory of a problem asset. We ask ourselves, "What drives tenants and their employees? How can we provide the services they want?" Often we can implement a number of positive changes, starting with the parking facility and working up through the property. Is there easy access to parking? How can we improve building safety? How can we update an obsolete, uninviting lobby? All of these factors can improve the property's performance over time. Conversely, it's also crucial to know when attributes beyond our control will limit success, so we want to be prudent, investing capital only when property returns will be significantly enhanced. ■

Five Keys to **Intelligent** Joint Ventures

As the flexibility of JVs makes them increasingly popular, there are some best practices that can aid in avoiding pitfalls. Christopher Mendez of Madison International Realty goes over five keys to a successful JV.

Joint ventures have become de rigueur in private real estate for their fee efficiency, transparency, and greater access to deals, all in a customizable format. However, despite the buzz surrounding JVs, they are simply not turnkey solutions and definitely not for everyone. "A joint venture structure often allows an investor more flexibility," says Christopher Mendez, a director with Madison International Realty. He also warns that "we've learned that without the right partner, it doesn't matter what you put in the documents." Given the pitfalls that follow structuring a JV, here are five best practices to keep in mind.

1 Tackle major decision rights

Among major stakeholders such as investors, sponsors, and operators, it is critical to establish clarity on who has what rights. "You want to know what can be done without your say and what you can weigh in on," says Mendez. He lands on four key elements of decision rights—sale, refinancing, operating and capital budgets, and major leases—that should be tackled at the outset.

2 Conduct the same due diligence as an investor buying a property outright

For Madison International, joint ventures play a key role in the firm's investment business. The flexibility of JVs allows for a number of designs to create points of access. Although the Madison team is generally allocating capital and not operating properties, the level of due diligence required is no lighter or easier. "We conduct the same level and thoroughness of due diligence as an investor buying a property outright would," Mendez says.

3 Have "the appropriate teeth" and default provisions

Mitigating default issues in the document stage requires a healthy amount of give and take. "No one enjoys negotiating the default provisions," Mendez comments. "However, as fiduciaries to our investors, it is important we protect our investment in the event of bad acts or negligence by the sponsor."

It is vital to ensure that default situations and their triggers are well thought out in the documentation process. "The provisions need to be clearly defined, and the document needs the appropriate teeth to provide protections and remedies, including the removal of the sponsor when necessary," he says.

4 Make sure exits are aligned

Often investment horizons become the biggest hurdle to stakeholder alignment. Some investors fall in love with an asset and never want to sell, while others need to realize their gains and move onward. In situations where Madison is stepping into existing structures and documents, a little more ingenuity is required. "In some deals, such as old syndications, we are limited in our ability to restructure the existing documents to create clean exit rights," says Mendez. "In these situations, we create a promote structure to the sponsor that economically incentivizes them to monetize our interest through a sale or recapitalization of the property."

5 Create an alignment of interests between partners

Connecting with partners on a level that cannot be captured in documentation alone is crucial. There is no amount of legal language that can account for every outcome. "At the end of the day, once the documents are negotiated and executed, you hope to never reference them again," says Mendez. "Business plans change, and actual performance will never match the underwriting. Creating an alignment of interests at the outset will ensure partners work through issues together and create value for all." ■

How Property Manager Scorecards Boost Returns

Scorecarding your property manager could add real basis points to your total return. However, the real estate industry is lagging when it comes to adopting a data-driven property manager scorecard, say experts from TIAA and RealFoundations.

As an industry, private real estate often seems antiquated in terms of process, metrics, and management solutions. That's why there is little surprise that managers have been slow to adopt a data-driven property manager scorecard approach, despite the impact it can have on asset performance.

Scorecarding property managers gives owners a better grasp on how operators are performing on their behalf and identifies how to attack the problem when they aren't performing well, says Chris Williams, director of the consulting firm RealFoundations.

Property manager scorecards measure asset-level operations based on a standardized set of key performance indicators (KPIs) that go hand in hand with comprehensive governance standards.

While the concept appears simple at a high level, it can be challenging to implement in an industry where most asset managers do not make use of the practice. This is further compounded by operating partners who often lack consistent reporting methodologies and often resort to simple Excel spreadsheets to capture a plethora of data.

"We are no longer just investing our own capital but growing into a world-class global asset manager," says Paul Rozelle, managing director of private and alternative operations services at TIAA, a firm that manages $89B in global real estate assets. "So we asked, what do we have to do to make that leap? We have 36 different property management firms and over 200 individuals handling our properties, so getting them to act in alignment to ensure consistent data and performance within our system was critical."

Williams advises that the first step in developing a scorecarding system is defining the universe of KPIs. "It's most important to understand the things you want to measure," says Williams, "asking what you want to hold your property managers accountable for and getting each definition assigned."

Providing further insight into the TIAA program, Craig Lord, director of property management governance at the firm, explains: "We score using 18 metrics. The main categories are financial, accounting, and operational."

The goal, he says, is to have data capture that runs the gamut from areas such as capital expenditure tracking and financial reporting to more specific examinations, such as sustainability practices and tenant satisfaction.

The team then bakes a comprehensive communications plan into the process. "The key is to have communications where asset managers, sustainable directors, accounting, Yardi support—all of these parties are [regularly] gathered, and we continue to give ongoing instruction and feedback," says Lord.

After seven years of running the program, the results appear compelling. "Although not causative, we have determined a strong direct correlation showing that, in a 100-point system, for every 1 percent score increase, it adds on average between 12 to 19 basis points to total return for investment, varying by property type," says Rozelle. "It also reduces operational, reputational, and insurance risks."

While the program is still in its formative stages industry-wide, Rozelle hopes for greater adoption of scorecarding. "As we sit across from investors who seek to put money with us, it's a differentiator. It adds credibility to [the asset class], and it would benefit the entire industry if it were more broadly applied." ■

Why Every PE Partnership Needs to Be Rewritten

Changes to U.S. tax law likely mean more audits of private equity and real estate partnerships. Don Susswein, principal in the Washington National Tax office of RSM US LLP, talks about the consequences.

Privcap: Partnership tax law has undergone significant changes. What's the background?

Don Susswein, RSM: Partnerships and LLCs, or what we call pass-through entities, have really gone through incredible transformation over the last 30 years. Back in the early 1980s, they were a backwater. The only people who were set up as partnerships were either professional service corporations—lawyers, accountants, because they had to be—or tax shelters.

And a very cumbersome set of audit rules existed primarily to attack tax shelters. However, tax shelters were virtually eliminated in 1986. So for the last 20 or 30 years, we were left with this vast, very complicated infrastructure of rules that actually made it very difficult for the IRS to audit partnerships or LLCs. Part of the problem is that partnerships have not only proliferated, but they have become multitiered entities.

It was almost impossible for the IRS to audit them—and those are words that Congress doesn't like to hear. Everybody knew they had to do something.

What is the biggest change, and when does it take effect?

Susswein: Beginning with the 2018 tax year, the cost and burden to the IRS of initiating an audit of a partnership has dropped precipitously.

Until the new law takes effect, the hurdles for the IRS to successfully and efficiently audit a partnership remain formidable. In theory, the partnership has always been subject to one set of tax rules, and there was only one right answer. But in practice, every partner could take a different position or could hire their own attorney or accountant to negotiate on their behalf.

Beginning with audits of the 2018 tax year, that is no longer the case. The partnership must speak with one voice. It must be represented by one party, and any settlements made with the IRS by that representative bind the partnership and every one of its partners.

The law will require simple technical changes to existing partnership agreements. But are there more fundamental changes that members of partnerships, particularly investors, should consider?

Susswein: There's a whole new set of business issues that are presented, because not only do you have a single representative of the partnership, but that representative may have different interests than you do as an investor.

Let's say you leave the partnership after a couple of years. [Looking at] the interest of current investors and the interest of former investors, it may be the former investors who are going to be hit with a tax bill if the partnership is audited today, because you're audited for past tax years.

So if there's an audit in 2020, they're looking at whether the 2018 tax return was done. You may no longer be a partner at that point, and yet somebody is there making decisions, cutting deals with the IRS as to what your ultimate tax liability is going to be.

Is this all bad news?

Susswein: In some respects, this legislation is a tremendous win for the private equity community, for the investment-management community.

This could have been way worse. The original bill imposed an entity-level tax on the partnership. So even if all the people whose tax liability was an issue were no longer in the partnership and we were only dealing with current partners who never got any benefit from the position that's challenged by the IRS, the current partners would still have to bear the cost. ■

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