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Real Estate Investment Excellence 2019

Insights for institutional real estate investing

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About Privcap
Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap offers communications services to market participants.

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Richard Edelheit
Partner,
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Micro-Markets, Macro-Opportunities

Real estate markets are fickle—a desirable city, or even a street, can sit next to one that's well out of favor. Regional microeconomics, therefore, are a critical component of any investment analysis. So for this year's edition of our Real Estate Investment Excellence report, our partners at Privcap have taken a deep-dive into three critical Northeast markets—New York City, Boston and Philadelphia.

We have also focused on the current regulatory and risk environment, as well as in trends in real estate "food groups" that our experts believe present outsize opportunity for investments. The range of experience contained in these pages is considerable—our RSM experts are joined by leading investors from firms such as LaSalle, PGIM Real Estate, and GreenOak. We hope you find many actionable insights in these pages, and we look forward to working with you on "investment excellence" in real estate throughout the year.

Regards,

Richard Edelheit
RSM US LLP

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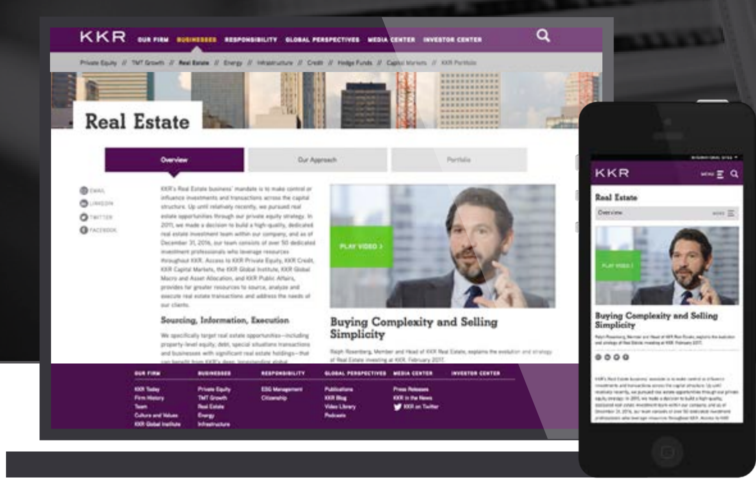

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REgional Impact

What's driving the opportunity in Northeast markets? An in-depth look at real estate dynamics in Boston, New York City, and Philadelphia.

BOSTON

NEW YORK CITY

PHILADELPHIA

Late in a Cycle, Real Estate Investors Work Harder

Peter Hayes, Global Head of Investment Research for PGIM Real Estate, shares his take on current property investment opportunities amid major challenges in the real estate space

Dr. Peter Hayes
Global Head of Investment Research, PGIM Real Estate

Privcap: U.S. interest rates are rising. Can you paint a picture for us of what that looks like and how it might affect real estate performance?

Peter Hayes, PGIM Real Estate: What's surprised the markets is perhaps the speed with which these rate rises are coming through, particularly in the U.S. But I would say that investing over time has deliberately created a more defensive, more cautious environment in which to operate. Today investors are realistic about the current state of the market and looking at ways to maintain values despite the rate rises.

Does that mean investors are looking for managers that simply need to work harder to add value to the properties in which they invest?

Hayes: Coming out of the financial crisis, the value theme has been a big driver of how investors have behaved. They're now taking a bit more location risk. But what they have done in this context of looking at the major gateway markets—the big cities, Hong Kong, Tokyo, London, Paris, or New York—is start to look more at the operating income businesses.

This behavior is leading to the growth of more sectors to be investable for investors themselves. Examples of that growth are data centers, student housing, and manufacturing housing as well.

You mentioned location risk as investors are looking outside the traditional gateway cities for value. What are those risks, and how can you get your hands around them?

Hayes: We're talking about 40 percent of transaction volume in about eight cities, not a hundred. The narrative was always that investors were looking for transparency and liquidity. They want to be in the big cities. This is where you saw the most aggressive pricing and good performance. What's now happened is, in this slow, long economic cycle of recovery, you've had more occupiers moving into submarkets, outside the major downtowns and central districts, with smaller cities now seeing a better rental-growth story.

Investors, in our mind, have been slow to take advantage of moving to these later markets because the risk to some of these markets is: how sustainable are they over a cycle?

Today investors are in a long-term buy and hold mindset and looking at smaller cities to take advantage of what they call an "illiquidity" premium. The cap rates are higher because of their illiquidity. But a long-term mindset means investors are happy to be paid for that risk.

Investors are increasingly interested in trying to understand how the real estate dynamics will work with regard to distribution centers and logistics facilities. How do you understand the growth of rent in places like that?

Hayes: Investors should have a lot more logistics property in their portfolios than they can actually get a hold of. By value, only 10 percent of the investable stock, globally, is logistics. Investors want more than 10 percent, because of rental growth. However, shortage in supply is causing investors to look at secondary or older, even light industrial buildings for conversions. We can see a rental-growth story there, because they're fulfilling a need. We also see a demand for the 1-million-plus-square-feet distribution warehouses, which feeds into this delivery system due to the growth of e-commerce.

Speaking of supply and demand, is development around the world at levels that you would expect, given pricing trends?

Hayes: No. We've used history as an example. Historically, when rent goes up, so does development. Today we are not seeing the development pick up. For example, in the U.S., there's definitely less appetite for lenders to provide especially speculative development finance. That's really the big issue.

Then you look at the developers and there is still an issue about rising cost of materials and a shortage of labor. London has had a pronounced development cycle, as has Tokyo, but on balance it is still a lot weaker than history. Again, it's harder to get development finance. The numbers don't stack up and both developers and lenders don't want to make the same mistakes of the past. ■

CRE's Biggest Technological **Disruptors**

Which technology will cause the greatest disruption in commercial real estate, and why should the private real estate business pay attention? We asked experts from across the U.S.

"**Blockchain technology.** What are the long-term applications in real estate? Fast and accurate deed recordings, leading to accurate title reports. In development, full transparency over plans and sign-offs. And in leasing, record-keeping, which is currently in the hands of multiple teams of owners, brokers, users, architects, and attorneys, will be streamlined. It will take time, but blockchain appears to be the answer."

—Alice DiMarzio, BSD Realty Worldwide

"**3D printing.** When labor costs as a part of construction shrink, the supply-side dynamic should shift dramatically."

—Ezra Dweck, CIO, The Oved Group

"**Blockchain technology.** It has the ability to eliminate the title insurance business."

—Stephen DeNardo, CEO, RiverOak Investment

"**The rise of shared spaces.** The untethering of place and user due to the interconnectivity allowed through new communication technology. This paradigm shift has decreased our expectation of private ownership or private use of space, a shift that will be felt at different paces for different types of CRE [as demand for shared spaces rises]. Historically, the risk attributed to functional obsolescence [in CRE] from technological disruption was small and incremental. Our challenge now is to design and build assets that can adapt and remain useful."

—David Castilla, President, GenCap Partners

"**Renewable energy.** The energy market in the U.S. [and globally] will move over time to greater independence from fossil fuels [with] geothermal, solar, and wind energy production—combined with significant improvements in insulation and air circulation technologies—will become the market and regulatory norm over the coming years. This change will have far-reaching impacts on planning, design, construction, and financing of all new real estate projects and projects, not built to these standards will become obsolete and decline in value."

—Peter Merrigan, CEO, Taurus Investment Holdings

"**Digital manufacturing** will fundamentally transform the world as we know it over the next 20 to 30 years, enabling items to be produced in a variety of ways never before known and without the need for mass production. In the U.S., this will mean a move away from large factories to smaller assembly shops and, combined with 3D printing, allow small businesses to effectively compete with larger corporations. As a result, low labor/production-cost countries like China and India will need to reinvent themselves to live through this major disruption of their economic model."

—Malte Stoeckhert, Managing Director, Cambridge Wilkinson

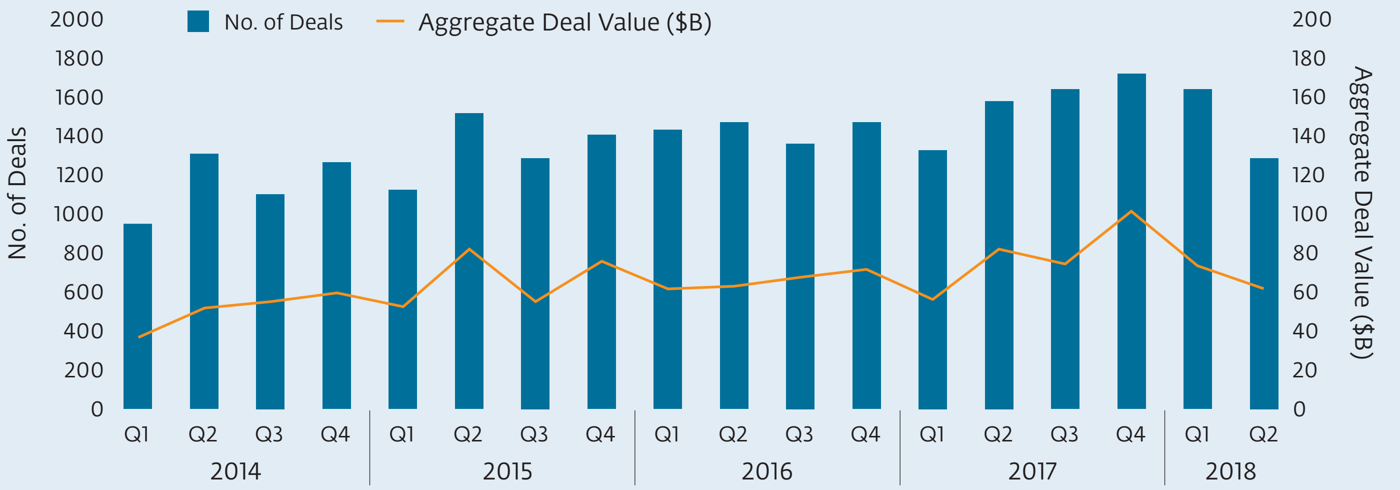
"The biggest technological disruption to CRE, and what keeps me up at night, is the potential devaluation of assets, not from market fluctuations but from **technology-enabled platforms.**"

—Daniel Farber, Principal, HLC Equity

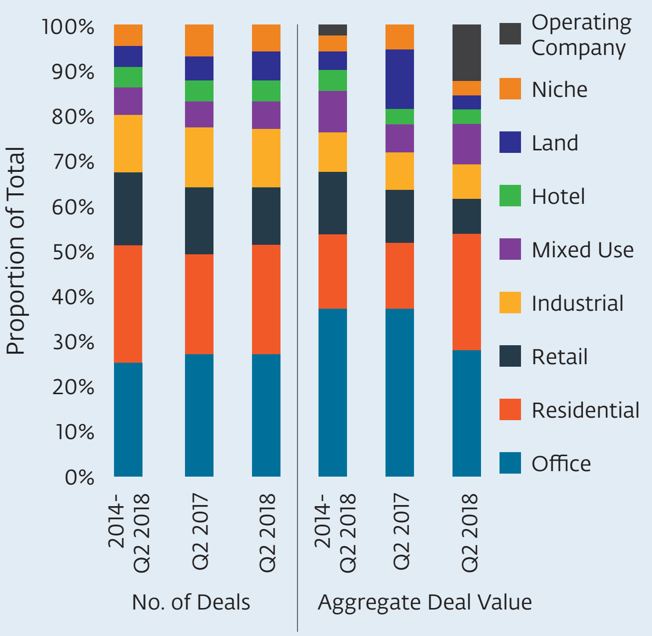
REAL ESTATE DEALS IN REVIEW

Deal activity continued apace in 2018.
What will 2019 bring?

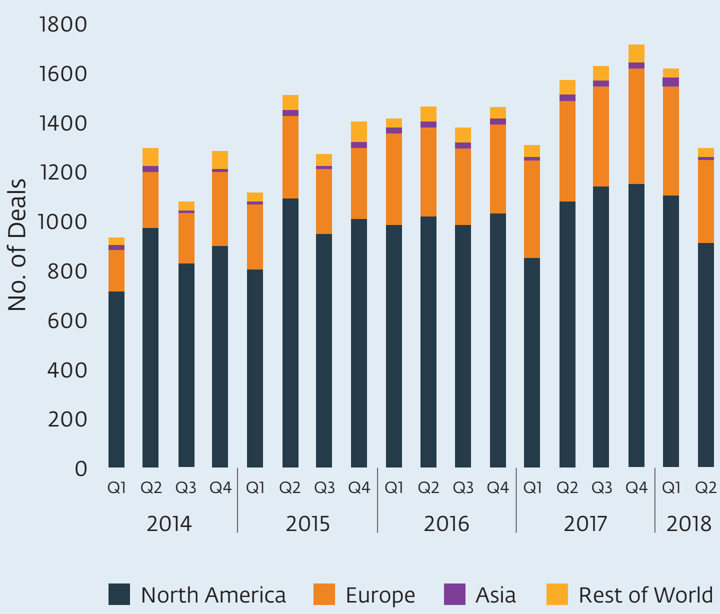
PRIVATE EQUITY REAL ESTATE DEALS



PRIVATE EQUITY REAL ESTATE DEALS, BY PRIMARY ASSET TYPE



QUARTERLY PRIVATE EQUITY REAL ESTATE DEAL FLOW BY REGION



SOURCE: preqin

REgional Impact

What's driving the opportunity in Northeast markets? An in-depth look at real estate dynamics in Boston, New York City, and Philadelphia.

REgional Impact: **Boston**

Education's Driving Force in Boston CRE

Boston's highly educated talent pool is increasingly attracting businesses to the city, contributing to significant rental growth, rising occupancy rates, and demand for suburban housing. But will affordability, infrastructure, and a concentration in technology dampen the growth prospects?

Boston real estate is hot.

Fueled by its high concentration of research universities and colleges and a highly educated, technically inclined workforce, Boston real estate has drawn growing institutional interest that has resulted in significant absorption across property types. In fact, in some submarkets, vacancy rates are essentially zero.

For GreenOak Real Estate, such talent concentration means Boston has continued to outperform other U.S. major markets post-crisis. Human capital, recruitment, and retention needs have become critical components of corporate growth strategies.

Mark Van Zandt, head of East Coast for GreenOak, says Boston has been one of the firm's most profitable markets in the current cycle, and the near-term outlook remains strong.

"Education and the city's educational institutions have always been a driver for Boston's commercial real estate market," says Van Zandt. "But particularly this cycle, with technology and creative industries helping drive the U.S. economy, companies want to be where the talent is. There is no better city in the world to access highly educated, highly motivated young people than Boston."

Dan Cummings, head of Bain Capital Real Estate, concurs: "[Talent] is a huge strategic advantage for Boston." That advantage is evident in Greater Boston's unemployment rate, which stands at 3.3 percent compared to 4.1 percent nationally. That trend has helped office vacancy rates fall more than 100 basis points below the historical average.

Constrained Supply

And it's not just talent and education that are driving Boston's commercial real estate fundamentals. Boston is a supply-constrained market, with limited new inventory coming online and long-term holders controlling an ever-increasing share of the commercial real estate market.

"There's probably two more years until meaningful new supply comes to the Boston market," says Van Zandt, whose firm has acquired 11 assets in Boston since 2012, most of them Class B offices. In 2017, the firm bought the 741,200-square-foot, three-building Center Plaza, along Boston's Cambridge Street.

The $365M deal highlights Boston's supply dynamic at work. "There were only 15 large blocks of office space with over 50,000-square-feet available in Boston's CBD at that time," says Van Zandt. "Those 15 blocks of space totaled 1.6M square feet, but there were more than 20 tenants looking for around 2.2M square feet of space. It was a pretty powerful statistic for us."

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> **"There is no better city in the world to access highly educated, highly motivated young people than Boston."**
>
> —Mark Van Zandt, GreenOak Real Estate

Those same supply constraints are being seen in submarkets such as Cambridge, which attract professional services, technology, and biotechnology firms looking to hire from Harvard University and MIT. In the first quarter of 2018, office vacancy in Cambridge was 2.1 percent, while lab space vacancy was 0.9 percent. The submarket also experienced the second-largest increase in rent growth among U.S. tech submarkets, according to CBRE, increasing more than 25 percent between 2015 and 2017.

The lack of new supply, coupled with heightened demand, means rental growth has been strong in Boston, with central Boston office rates increasing from around $48psf in 2009 to more than $56psf today.

The Suburban Shift

The trends extend well beyond the central business district.

"Boston is getting more and more expensive for everybody, and it's driving people to higher-end suburban markets with direct access into the city," says Taurus Investment Holdings' CEO Peter Merrigan. "It's where people want to be and need to be."

Taurus, which over the past two years has acquired more than 2,000 apartments in the Boston suburbs of Everett, Malden, Beverly, Lowell, Chelmsford, and Fall River, recently disposed of a land parcel in Wakefield and saw "extraordinary" demand.

"There are significant demand drivers at play in Boston today…and it's creating some compelling opportunities to invest in transit-orientated suburban and inner-suburban markets close to Boston as people look for greater value," says Merrigan.

"Lack of affordable housing options is something already high on the agenda of state and city politicians," says RSM partner Robert Langley.

"Boston needs to retain its highly educated workforce, and to do that they need affordable housing options, including workforce housing," Langley says.

The suburban spread means infrastructure needs are paramount.

"Boston is well-positioned to grow," says Cummings. "The challenge for Boston is to be able to respond with infrastructure that respects the heritage of the market, makes it easier to move around, and that is responsive to the opportunities in the market."

For Merrigan, infrastructure is all about transit and connectivity: "I think transit is critically important to Boston. Traffic is difficult but we need to ensure we connect people with the job centers, with the urban core."

> **"There are significant demand drivers at play in Boston… and it's creating some compelling opportunities to invest in transit-orientated suburban and inner-suburban markets."**
>
> —Peter Merrigan, Taurus Investment Holdings

Should GPs Refinance Deals Today?

Macroeconomic issues such as increasing interest rates and employment growth are key to the performance of commercial real estate investments and projected returns—and managers need to be increasingly mindful of both as the U.S. property cycle matures.

The commercial real estate industry is carefully watching the uptick in interest rates, not least amid concerns about the potential impact on cap rates, NOI, and property valuations.

However, RSM partner Troy Merkel says real estate investment managers should also pay attention to rising rates for one other reason—the potential need to refinance 2015- and 2016-originated debt earlier than the maturity dates of 2020 to 2023.

"Many investors refinanced properties when cap rates and interest rates were at their lowest, in 2015 and 2016," says Merkel. "When a lot of that five- and seven-year debt comes due there could be some real challenges for investors, particularly in the office space, with valuations lower than when they originally refinanced and interest rates much higher."

CBD office values in the U.S. posted a 0.3 percent year-over-year decline in value to May 2018, according to the Real Capital Analytics CPPI valuation indices.

The decline stands in contrast to the performance of almost every property type which saw increases in valuations, some by more than 11 percent year-over-year. Even retail, significantly impacted by e-commerce, remained away from negative territory, posting zero growth in May 2018.

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"Transportation is one issue that could truly choke growth in Boston," says RSM partner Troy Merkel. "If Boston wants to grow from a small older city to a larger international market, it needs to unlock infrastructure around the Seaport area, and it needs to connect with the suburban communities with public transportation."

Cycle Risk and Resilience

Despite the challenges presented by affordability and infrastructure, Cummings, Merrigan, and Van Zandt all see room for growth in Boston's commercial real estate market. "We are believers in Boston, we are actively looking for opportunities for investment, and we are excited about the near term," says Van Zandt.

He cautions that Boston's concentration on high-tech jobs this cycle could pose issues during the next economic downturn—even given the U.S. economy's shift from financial services to technology based industries. "That may provide some additional resiliency to Boston [in the short term], but the technology sector also feels very heated," he says.

"Also, Boston has historically been a volatile market. You can make a lot of money on the way up, but the opposite is true on the way down, which means you have to be more conservative on a going-forward basis," says Van Zandt.

> **"The challenge for Boston is to be able to respond with infrastructure that respects the heritage of the market, makes it easier to move around, and that is responsive to the opportunities in the market."**
>
> —Dan Cummings, Bain Capital Real Estate

Merrigan, though, feels that Boston's enduring edge in higher education and intellectual capital gives the market greater resiliency.

"I'm from Boston, I grew up here, I was educated here, and I've been through a number of different cycles at this point," says Merrigan. "What's always quite compelling is how strongly Boston bounces back and how it usually enjoys a V-shaped recovery. That's heavily driven entirely by the universities, which create huge demand drivers for a large number of corporations and industries." ■

"The key is returns," says Merkel. "Investors need to carefully understand what their returns from a potential refinancing or exit could be at that future date. They may need to evaluate their projections and their future valuations, given the maturity of the real estate cycle, and give serious thought to what their debt situation could be in five to seven years."

Another macro trend that real estate investment managers need to be mindful of is the war on talent—and the impact that weak growth in the working-age adult population could have on economic and job growth.

Robert Langley, audit partner at RSM, says clients are exceptionally focused on the issues of recruiting and retaining talent, whether internally in their own organizations or in providing highly-amenitized space for tenants to support HR strategies. However, Langley asks, with the large Baby Boomer generation heading into retirement and immigration policies in transition, "will the U.S. have enough workers to sustain the recent economic growth we've had?"

The U.S. total working-age adult population is expected to increase just 0.3 percent a year in the decades between 2015 and 2035, according to Pew Research Center compared to peak growth of 2 percent between 1975 and 1985 when the Baby Boomers came of age. Without future immigrants, the total U.S. workforce is projected to decline by more than 17 million people by 2035 to 165.6 million.

"It will be telling in the years to come how manpower and immigration not only impacts the growth of the economy, but also how it shapes demand for commercial real estate space on a going-forward basis. It's something we all need to be thinking about."

Creating Opportunities from *Disruption*

Technology continues to impact every facet of commercial real estate, according to LaSalle Investment Management's David Schreiber—requiring LPs and GPs to stay aware of technological advances to make more informed investment decisions

David Schreiber
Managing Director, Acquisitions,
LaSalle Investment Management

Privcap: Commercial real estate has been undergoing a significant transformation in the past decade. What demand drivers will have the greatest impact on CRE in the next decade?

David Schreiber, LaSalle: Demographics, technology, and urbanization are shaping everything that we're looking at [within commercial real estate]. One way we're seeing that within the office and multifamily space is through the greater need for building amenities. Prior to the last five to seven years most office buildings didn't offer or require conference facilities, fitness centers, cafés, tenant lounges, and/or roof decks. But this has become a strong demand driver for today's tenants. And that's now a common investment strategy within the office space—finding opportunities to activate buildings by introducing full-scale amenities and making them more relevant to today's users, thereby driving tenant demand, rental rates, and ultimately, building value.

CRE has been notoriously slow to adopt new technologies. Is the industry finally changing?

Schreiber: You're seeing [technology being adopted] in a very pervasive way across all property types, and I think you're going to continue to see adoption impact the way the built environment is used. For today's tenants and users, technology is a daily part of their lives, and real estate will have to change to meet their needs.

That means, as an investor, it's critical to stay ahead of new technology. I spend more time than ever before focused on disruptive technologies that are impacting real estate to evaluate how we can potentially integrate them in the properties we own and pursue.

But technology is also hurting some CRE property types, not least in retail. What property types are out of favor with investors today—and does that create opportunities?

Schreiber: Investor demand for commodity suburban office and big box retail has never been at more of a low—and that creates compelling opportunities for contrarian investors. If you look at the cap rate spread between high-quality urban and suburban office, or high-quality grocery-anchored retail and generic big box retail, there's a lot of opportunity for higher-risk strategy investors to capitalize on that real estate being out of favor.

Not all real estate is created equal, of course. But there are a lot of very sophisticated investors taking advantage of price dislocation in the current market by buying well-located suburban office and high-quality big box retail centers at a very attractive cost basis.

The suburbs aren't dead, people still live there, and there certainly are a lot of companies that prefer suburban locations and will continue to prefer suburban locations in the future. But many of those tenants still want all the same amenities that users in a downtown office want. By activating higher-quality buildings with locational advantages that are close to transit, and by putting amenities in the building, significant value is being created.

What is happening in the urban core, the CBD, not least in Boston?

Schreiber: Urban migration has been an important trend nationally and that's been a particularly huge driver in Boston. Companies such as GE, Amazon, and Reebok are a few of many examples of companies migrating from suburban locations or other markets to Boston's urban core for their employee recruitment and retention strategies.

Boston CBD office fundamentals have rarely been stronger than they are today. Urban demand is outpacing supply, and it's put significant upward pressure on office rental rates, particularly Class B office rents [as tenants search for greater rent value]. The market has demonstrated robust rent growth in recent years, and it's now very difficult to find office space of any quality in downtown Boston for less than $50 per square foot gross.

Where are the greatest challenges, given the U.S. CRE industry is so mature in the cycle?

Schreiber: The biggest headwind is rising interest rates. That will, at some point, put upward pressure on required returns and cap rates, and in turn could put downward pressure on real estate valuations. The counterbalance is that rising interest rates should eventually put upward pressure on rents and net operating income.

It means that current investing requires us to be increasingly thoughtful about where we are in the cycle and potential recessionary events. We address the potential risk of a softening economy in our pro forma underwriting assumptions, as well as by approaching certain opportunities with more caution, such as investments with binary outcomes, like office buildings with outsized near-term lease expiration exposure. ■

What's the Real Fallout of **Rising Construction Costs** on CRE?

Construction costs have increased 25 percent since 2013, with Boston reporting construction costs of up to $650psf, according to a 2018 report by Rider Levett Bucknall. But what impact are rising costs having on the commercial real estate sector, on returns and on the supply of new inventory? Four experts provided their views on the fallout of ever-increasing construction costs, including the lack of financial incentives to build affordable housing product, the challenges of budgeting amid construction labor shortages and the impact on new supply to the commercial real estate market.

$187.58psf

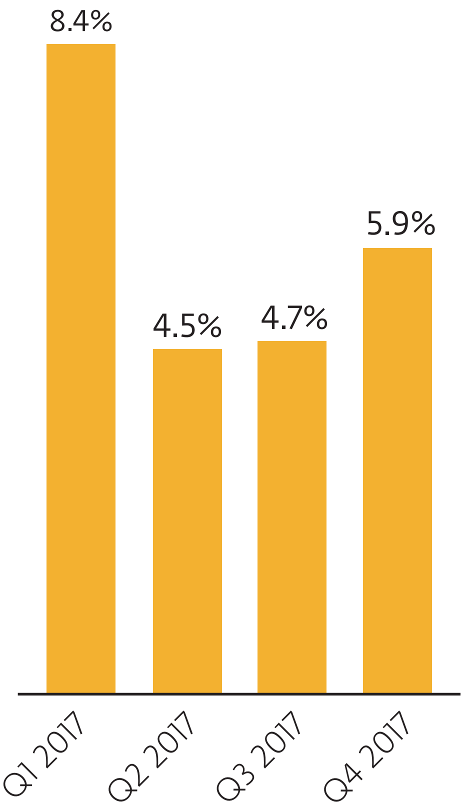
Average cost per square foot of gross floor space to build commercial real estate properties in the U.S. in the first quarter of 2018—up from $149.19 in 2013.

$475psf

Prime office in Boston cost up to $475 per square foot of gross floor area to build in the first quarter of 2018, the third highest cost behind New York and Honolulu.

Construction Unemployment

Experiencing a 2.5 percent drop in 2017, construction unemployment started out the year at 8.4 percent and closed it at 5.9 percent.



Source: Rider Levett Bucknall

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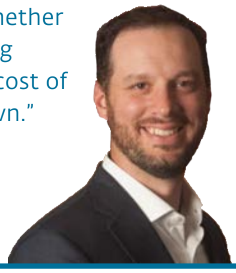
Expert Takeaways

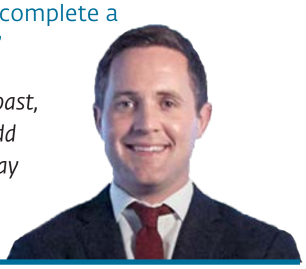
"While many people are talking about tariffs on steel, aluminum and lumber, challenges with construction labor are driving up the cost of buildouts and new developments more dramatically. Whether it's finding their own people or finding enough labor for projects, the rising cost of labor is actually slowing projects down."

—Troy Merkel, Partner, RSM US LLP



"Construction costs have been a big challenge, and I don't see any relief on the horizon. It impacts your ability to budget properly and make sure you have available labor when you go to complete a meaningful renovation project."

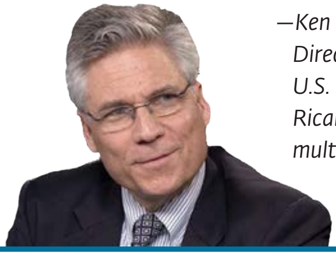
—Mark Van Zandt, Head of East Coast, GreenOak Real Estate, a value-add platform focused on major gateway markets globally



"Higher construction costs have increased construction replacement rents to levels that are above most market-clearing prices. Both labor and materials have been inflating well above the level of the Consumer Price Index since 2013. While many markets demand [and need] the construction of new buildings, most cannot afford it, or if they can, for a relatively few number of buildings. This has put a damper on significant supply in most markets around the country, maintaining favorable supply and demand levels."

—David Lynn, Chief Executive Officer, Everest Healthcare Properties, a core and core-plus medical office platform investing primarily in net-lease assets

"Rising construction costs mean that developers in most major markets can only make a 5.5-to-6.25 percent return on cost, and to generate even this initial yield, developers are forced to build upper-end rental product. The U.S. is congenitally unable to build affordable middle-income housing. Rising land and construction costs are one reason, but lack of political willpower and financing are also causalities. Without land or financing subsidies, the market simply cannot build affordable rental units."



—Ken Munkacy, Senior Managing Director, Kingbird Properties, the U.S. real estate arm of a Puerto Rican family office focused on multifamily investments

REgional Impact: **New York City**

New York, New Markets

New York City is the biggest collection of villages in the world, but investors are increasingly turning to the outer boroughs of Brooklyn, Queens, the Bronx—and even northern New Jersey

New York City itself is one of the largest investable commercial real estate markets in the world, yet there are many opportunities to be found in outer boroughs.

"Places such as Williamsburg are no longer just about price and affordability, they are about lifestyle," says Marc Warren, principal of the capital advisory firm Ackman-Ziff.

With an office market alone valued at $107 billion and measuring 450msf in size, Manhattan will, of course, always capture a significant portion of the global institutional equity targeting the metropolitan area of New York.

What has changed in the wake of the financial crisis, however, is the growth of New York's four other boroughs. With local economies that would each rank as the U.S.' fourth-largest city if judged individually, Brooklyn and Queens have become increasingly competitive as private equity real estate managers and investors target the growth in these two submarkets, Warren says.

"The new joke is that kids are still living with their parents on the Upper East Side in order to save money for Brooklyn," Warren says, highlighting increased migration to areas such as Williamsburg, Park Slope, Cobble Hill, Astoria, and Long Island City, and increased prices as a result.

"A recent luxury multifamily project we financed in Brooklyn is achieving rents competitive with Class A Manhattan rents," adds Warren.

It's a sentiment shared by Brodie Ruland, senior vice president and Northeast region head of investments for ASB Real Estate Investments, who says the shift to New York's outer boroughs is not just a trend for the multifamily sector, but across all property types as corporations follow the customer.

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> **“Places such as Williamsburg are no longer just about price and affordability, they are about lifestyle.”**
>
> —Marc Warren, Ackman-Ziff

Between 2014 and 2016, ASB, in partnership with L3 Capital, paid $104M to acquire 15 buildings and four land parcels, mostly fronting Williamsburg’s North Sixth Street, on behalf of its $7B core Allegiance Fund. In 2017, the firm invested another $30M to acquire three buildings in the neighborhood from its $174.5M value-add Meridian Fund II. Since closing, ASB has invested more than $45M to redevelop the properties, including one that was fully leased to Estée Lauder’s Le Labo brand as its U.S. headquarters and NYC flagship store.

“From a retail perspective, Williamsburg is very exciting, and it’s not about an affordability issue. Retailers are being driven there by a need to serve their customers or because they see it as the coolest location,” says Ruland.

The same is true in the office sector.

“Corporations need to attract and retain the best talent that’s out there, and depending on the company, that may take them to neighborhoods such as Williamsburg and Long Island City,” says Ruland.

All About Location

That’s certainly been the case for Long Wharf Capital, which leased 77,000sf of office space to WeWork in 2015 at its 195 Montague Street property, the co-working firm’s first location in downtown Brooklyn.

“I was a developer at the very beginning of my career, and it was all about the classic question, ‘Where is it located?’” says Long Wharf founding partner Michael Elizondo.

“If you’ve got a great location today, that location should be great in 10 years’ time. You may not know who’s occupying it, particularly when it comes to retail, but you’re always looking at location and the quality of the asset,” he says.

Staying Put

While residents may have initially moved out to Brooklyn, Queens, and the Bronx in search of affordability, price is not the primary reason they are staying in the neighborhood, says RSM partner Michael Mastruzzo. Lifestyle is just as important.

Despite the spread between median rent in Manhattan and Brooklyn shrinking 53 percent in the decade to 2018, “people are not moving out of the boroughs and back into Manhattan as they may have traditionally done in the past when the city became cheaper,” says Mastruzzo. “People are staying, because these areas in Brooklyn, Queens, and the Bronx have become highly sought after.”

The Sixth Borough

For Warren and Mastruzzo, any conversation about New York’s boroughs also should include northern New Jersey, particularly Jersey City.

“It’s effectively the sixth borough now,” says Warren, while Mastruzzo points to the 33,000 residential units that were expected to break ground in northern New Jersey suburbs in 2018.

Infrastructure, though, is critical to the continued growth of New York and its outer boroughs.

“All the important development that is taking place in New York today [in Manhattan and in the boroughs] is around subway and transit nodes,” says Warren.

“They are our biggest asset and sometimes our biggest liability, and it’s incumbent on officials to make sure they keep investing in them and try to keep up with other global major city transportation systems if they want to maintain quality growth.”

> **“Corporations need to attract and retain the best talent that’s out there, and depending on the company, that may take them to neighborhoods such as Williamsburg and Long Island City.”**
>
> —Brodie Ruland, ASB Real Estate Investments

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Regional Highlights

$1.65T

NYC has the largest economy in the U.S., with nominal GDP of $1.65 trillion, $600 billion more than second-place L.A.

*Source: Bureau of Economic Analysis**

64%

Technology and information service jobs have grown rapidly since 2008, while financial and legal services have remained static or retrenched.

Source: JLL

38.8%

More than a third of average NYC household budgets go to housing, compared with 32.9 percent nationally.

Source: Bureau of Labor Statistics

$22.5B

Value of property transactions in H1 2018, **up 34 percent YOY**.

Sources: Cushman & Wakefield, Bloomberg

15.4msf

Manhattan leasing activity in H1 2018 increased 12 percent YOY and was the **third-highest half-year total since 2009**.

Source: CBRE

* *BEA and BLS analysis covers the New York, Newark, and Jersey City metropolitan area.*

> **"If you've got a great location today, that location should be great in 10 years' time. You may not know who's occupying it, particularly when it comes to retail, but you're always looking at location and the quality of the asset."**
>
> —Michael Elizondo, Long Wharf Capital

Location Through Cycles

The growth of new submarkets isn't restricted to the outer boroughs, of course. Within Manhattan, new submarkets have emerged to challenge traditional retail and office centers such as Fifth Avenue and Midtown East, and have attracted some of the world's leading brand names as a result.

For ASB, the Midtown South office market is one such submarket, with the bulk of its office portfolio in the neighborhood. In H1 2018, average asking rents in Midtown South rose above $74psf, up 12 percent on the prior year and the first time the rate has been above the overall Manhattan office average.

"Midtown South is still perceived to be the most desirable office location in New York City for a lot of people, particularly companies who need significantly smaller space," says Ruland, adding that rental comps for new Class A product in the area are around $150psf—with anecdotal reports of asking rents hitting $175psf.

"What's helping bolster rents and keep supply in check is the continued conversion of properties into residential or hotels," Ruland says. "But it's also where employees and employers want to be."

For Ruland, that's the key to navigating commercial real estate markets across the U.S. and not just in New York City—paying close attention to location and to asset quality.

"Over the long term, through up and down cycles, we focus on buying assets in the best locations that have the best physical characteristics and that we believe are always going to be desirable to people. It's about being tenant-centric to ensure you can deliver great long-term net operating income growth. For us, that's about targeting dynamic submarkets across the country." ■

Peripheries in Focus

Insights from RSM's Michael Mastruzzo

As millennials leave urban cores in search of space and value, is "suburbia" being redefined?

Across the U.S., urban areas are experiencing rapid growth as people increasingly choose downtown over suburbia. But it's not just the urban core that's witnessing growth; so too are submarkets on the periphery of urban downtowns.

These urban-lite areas are heavily transit-oriented and mimic much of the urban core in terms of housing, retail, and commercial opportunities—but without the price tag.

In New York City, it's not just headline areas such as Williamsburg, Brooklyn, or Queens that are experiencing dramatic levels of construction and investment, but New Jersey towns such as Edgewater, Englewood, and Fort Lee.

RSM senior manager Michael Mastruzzo says that while pricing can sometimes be "commensurate" with downtown valuations, these areas are becoming more "desirable for young people and newer families looking to settle down, because of their proximity to the city and the need for more space."

Michael Mastruzzo
Senior Manager,
RSM US LLP

Yet infrastructure, particularly transportation linking those communities to New York City, will always be a cause for concern, says Mastruzzo.

In its latest report, the American Society of Civil Engineers gave New Jersey's infrastructure, including bridges, roads, rail, and transit, an average rating of D+. Delays in the planned $20-billion-plus Gateway Project tunnel to connect New Jersey and New York—and effectively the Northeast Corridor—could hamper growth of the peripheries, adds Mastruzzo. "It's a huge challenge for New Jersey and New York. When you have a growing population, you have to make transportation links more efficient, or otherwise undertake some newer projects to reduce some of the volume that's going to be coming in and out of the city."

It's not just employees who need robust infrastructure investment. So too do corporations, as many look outside the urban core to set up operations and be more closely connected to the consumer.

Mastruzzo notes that companies are becoming more strategic in terms of their location. While that has seen mega corporations such as GE move downtown, others are looking for value in peripheral markets.

"Key markets like New York have been through their ups and downs, and these are cities that will adapt over time to what's needed to make their industries successful," says Mastruzzo. ■

REgional Impact: **Philadelphia**

The Millennial Moment

Institutional appetite for the City of Brotherly Love is rising 'exponentially' as LPs and GPs target the city not just for its education and medical industries, but also for its appeal to millennials, culture, and affordability

In Philly, they call them "eds and meds."

Modern-day Philadelphia is a city built on education and health services. Today these two industries represent a third of all jobs in Philadelphia, with nine out of 10 of the largest private employers either universities or medical institutions.[1]

Indeed, 80 percent of U.S. pharmaceutical and biotechnology companies have a presence in the Greater Philadelphia region.[2]

The rising prominence of education, health, and life science as major growth industries has spurred increased appetite for Philadelphia commercial real estate transactions as institutional investors and fund managers look for greater value in secondary markets across the U.S. and away from gateway cities.

"Over the past five to eight years, institutional capital coming into Philadelphia from outside the region has grown exponentially," says Daniel Killinger, managing director of development at National Real Estate Development. "Traditionally, a small pool of institutional capital traded almost all the Philadelphia assets. Now there is a world of investors eager to invest."

The May 2018 acquisition of GlaxoSmithKline's U.S. headquarters by the South Korean sovereign wealth fund Korea Investment Corporation is one example of the heightened cross-border appeal of Philadelphia. The deal marks KIC's second deal in the city and set a record per square foot (psf) price of $628.

But while eds and meds continue to be at the heart of Philadelphia's growth story, the City of Brotherly Love's renaissance in the wake of the 2008 financial crisis is not just about job growth in two industries.

Private real estate LPs and GPs have increasingly turned to Philadelphia, thanks also to its demographics, culture, and

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affordability—factors that have helped the Greater Philadelphia region retain young, highly educated talent and help it rank top for growth of millennials.[3]

"People don't give the city the credit it is due," says Christian Dalzell, managing partner of Dalzell Capital Partners, which targets Class A boutique multifamily assets located in urban centers along the East Coast.

"Philadelphia is one of the most livable cities in the U.S. Anyone who spends time in Philadelphia will notice how enjoyable it is to walk around and/or to live here," Dalzell says.

While Philadelphia's economy has traditionally been, and continues to be, driven by the eds and meds industries, Killinger says growth in the technology sector is also contributing to the city's rising status. For example, Comcast Corporation is building a $1.5B technology hub in Center City alongside its global headquarters.

The growth of the technology, education, and health service industries is "encouraging a population of educated young students to stay in Philadelphia rather than move elsewhere after school," says Killinger. "Philadelphia today is a dynamic urban environment."

Indeed, the retention of higher-education students has been dramatic, with 67 percent of students in 2017 saying they would be very or somewhat likely to stay in Philadelphia—up from 58 percent in 2010.[4] It's part of the reason why Philadelphia today boasts a young population, with 51 percent of residents aged 34 years or younger and the median age of a Philadelphian just 34 years, compared with the U.S. average of 37.8 years.[5]

It's a significant change from the gritty Philadelphia depicted in the 1993 Tom Hanks movie of the same name. The city was on the brink of insolvency after years of poor fiscal management, and was so plagued by the heroin and crack epidemics that parts of the city were nicknamed "the badlands." The city suffered some of the highest rates of poverty in the country.

Philadelphia still experiences chronic levels of deep poverty, with the poverty rate in the city increasing more than 10 percent between 1970 and 2016—compared with a 0.1 percent increase nationally.[6] It's an issue that will take decades to solve, says Alex Dembitzer, CEO of Sky Management Services, but Philadelphia is continuing to change rapidly.

"I don't see Philadelphia as a secondary city anymore. It's a small primary market that feels good. It's where people want to be and which is going to succeed," says Dembitzer, who invested in Philadelphia more than 30 years ago in his company's first transaction outside of New York.

"[The growth of the technology, education, and health service industries is] encouraging a population of educated young students to stay in Philadelphia rather than move elsewhere after school. Philadelphia today is a dynamic urban environment."

—Daniel Killinger, National Real Estate Development

Regional Highlights

$628psf

Paid by Korea Investment Corporation for GlaxoSmithKline's North America headquarters in Philadelphia's Navy Yard. KIC acquired the 208,000sf office for $130.5M from Liberty Property Trust.

Source: The Philadelphia Inquirer (May 2018)

30%

Increase in the number of Philadelphia residents educated to degree level or more, more than any of the 10 largest U.S. cities. Today, 36 percent of Philadelphia residents are educated to degree level or higher.

Source: JLL U.S. Life Sciences Outlook 2017 and CBRE Tech 30 2017

500

Tech companies call Philadelphia home. The University City submarket was the most in-demand area for high-tech companies and experienced 10 percent rent growth between 2015 and 2017, compared with 4.3 percent for the Philadelphia market generally.

Source: CBRE Tech 30 2017

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Today, Sky Management is redeveloping a 1-million-square-foot public safety campus, The Quartermaster, on South 20th Street.

"There are significant challenges ahead… [but] we continue to see a lot of value and upside to Philadelphia," says Dembitzer, who also installs renewable energy projects, such as solar roof panels, at his assets.

Killinger also sees continued upside to Philadelphia, with National having grown its presence in the city from a 100-unit multifamily construction loan eight years ago to today leading a $780M redevelopment of a full-block site at the heart of Center City.

"I don't see Philadelphia as a secondary city anymore. It's a small primary market that feels good. It's where people want to be and which is going to succeed."

—Alex Dembitzer, Sky Management

The multiphase East Market redevelopment, which National is investing in through its $4 billion open-ended fund Indure, will ultimately deliver 800,000sf of Class A commercial space and 800 apartments.

"National slowly worked its way up the capital stack as they got to understand Philadelphia's fundamentals. We truly believe in the long-term growth of the city and the opportunities it presents," says Killinger. "We focus on neighborhood-making, transformational projects that have a huge impact on growing urban areas and that's happening here in Philadelphia."

The affordability of Philadelphia's downtown, for residents and businesses, has been a key factor in the city's growth over the past decade. "In cities such as New York, you need to make a significant amount of money in order to live there, but in Philadelphia someone could afford an apartment, have a decent job, and save money," says Dembitzer. "It has many positive quality-of-life attributes."

Dalzell agrees, saying Dalzell Capital, which has purchased three multifamily and mixed-used properties in Core Center City, has been spending the bulk of its time in Philadelphia "because you have the opportunity to buy good, solid cash-flowing assets that are in unbelievable locations. The first thing that drew us to Philadelphia was its affordability."

In Philadelphia, average asking rents for CBD offices are around $30psf, up from just over $25psf in 2013 but below Boston's $36psf and Chicago's $39psf, and significantly below New York and San Francisco's $72psf.[7] Killinger says average office rents surrounding the firm's East Market development prior to construction were in the mid-$20s. Today, the firm is leasing in the low-to-mid-$30s.

"Philadelphia is in the middle of transitioning from its manufacturing-based "old economy" to a new economy that is based on bio-med, life sciences, education, media, and technology. The resulting diversification of the local economy is pulling many firms and people back to the Center City," says Dalzell.

"It's an exciting time to be in Philadelphia," adds Killinger. "You watch the demographics, the millennials, and the empty-nester Baby Boomers, and you see the city's growth in technology as well as in education and health. You watch that together with Philadelphia's amazing museums, food, and cultural scenes, and this is a city that is growing. It's exciting to be a part of that." ■

Regional Highlights

14,100

New jobs added in the education and health sectors in the Philadelphia MSA in the year to Q2 2018.

Source: Cushman & Wakefield Philadelphia MarketBeat Office Q2 2018

1.9%

Vacancy rate for life science lab space in Philadelphia's CBD, significantly tighter than Boston's East Cambridge market, where vacancy is 6.8 percent.

Source: JLL U.S. Life Sciences Outlook 2017

67th

Rank out of 193 cities globally for its international retailer presence—ahead of Seattle; San Diego; São Paulo, Brazil; and Sydney, Australia. Philadelphia was ranked alongside Miami as the U.S. city luxury and mid-range retailers most targeted for expansion.

Source: CBRE, How Global is the Business of Retail (March 2018)

Sources

1, 5, 6:
Pew Charitable Trust, Philadelphia State of the City, 2017

2, 3:
Select Greater Philadelphia Council. SGPC classifies the Greater Philadelphia region as the Northern Delaware, Southern New Jersey and South Eastern Pennsylvania corridor

4:
Campus Philly, Ready to Launch 2017 report

7:
Cushman and Wakefield Philadelphia Office MarketBeat Q2 2018

Changing Spaces

Tenant demands for greater flexibility are changing the nature of traditional working spaces

The traditional 10-year office lease may be set for change as the very nature of work transforms. Technology and employee needs are paving the way for increased open spaces, co-working, and even shifts in working locations.

RSM partner John Rilling sees tenants requiring more open spaces and less space in general, for shorter lease durations.

At RSM, key offices have employed hoteling concepts whereby the majority of staff do not have assigned desks and where only partners have offices. Employees instead work at clients' offices or sit at shared spaces.

"You will still need space, but you don't need as much," says Rilling. "Instead of having six floors in a building, you may need two floors."

Two potential impacts of tenants' changing use of space could be lower tenant improvement (TI) allowances, and greater lease-term flexibility.

Rilling says offices spaces are becoming more functional, with only basic necessities provided, such as a clean, well-lit space, technology, and communal areas for dining and other activities, which could help lower final TI allowances provided by landlords. Another impact could be on the traditional 10-year office lease.

"Tenants are becoming much more efficient in terms of how they utilize their space, and that applies to the use of shorter-term leases," says Rilling. "I believe you will see a lot of space consolidation within the office sector."

Rilling also highlights the demographic shift back to the urban core. In the 1950s and 1960s, demographics led employers out to the suburbs, but today Philadelphia's central business district has almost 30 large-scale construction projects being built or due to deliver in 2018.

"Philadelphia is a vastly different place today than it was 30 or 40 years ago," says Rilling. "The neighborhoods around Center City have gentrified and developed, and many people want to live there. They want to live where they work."

Philadelphia's status as an education and medicine hub is helping attract highly skilled workers to the city at a rate faster than Boston, Seattle, or San Jose, according to JLL.

Although Philadelphia's suburbs still hold an appeal for some large employers, the demographics are dictating the movement. RSM's own main office in Philadelphia is in the suburbs, but "80 percent of new hires want to be in our Center City location," says Rilling. "We're constantly taking more space downtown to satisfy that need." ■

Going Large in the Suburbs

Best-in-class office properties right outside the urban core can have a lot of asymmetrical upside, according to Philadelphia-based Rubenstein Partners' Stephen Card and Brandon Huffman

Privcap: Historically, your portfolio has been evenly distributed between suburban and urban assets. Why have you been buying more suburban properties recently?

Stephen Card, Rubenstein Partners: We have been buying large blocks of quality vacancy in suburban office buildings because that's where we're currently finding the largest pricing inefficiencies. It's not a function of us liking suburban more than urban assets—it's a function of us liking the pricing and the underlying fundamentals that are attractive relative to the financing and pricing. Quality vacancy in the suburbs can be priced as a high-risk asset, while the reality often is that this perceived risk is mitigated once we apply our strategy to update and amenitize them. Frequently our assets are in high demand post-renovation simply because there's nothing else as good in the local market.

How do you define large blocks? What are you doing with them?

Brandon Huffman, Rubenstein Partners: It depends which market you're in, but generally we would consider 50,000 square feet or more to be a large block. We're not buying commodity assets that we can't make truly unique. We're buying best-in-class assets at scale, which allows us to invest significant capital to take the amenities to a whole new level and further differentiate the assets from the competition. Buying at scale allows us to justify the cost, since it's amortized over a large investment. Conversely, in most cases, our competition cannot replicate our strategy, because they cannot justify the cost on a smaller deal. In terms of our approach to amenity improvements, it's the urban/suburban concept. We reposition the properties we buy into great blocks of large contiguous vacancy in markets where those blocks are fewer and farther between. We're often the only large-block player that's trophy or Class A quality in our markets.

It gives us a very real opportunity to transform vacancy into large, long-term stabilized-lease assets that price like bonds even in the traditional suburbs. There's considerable investor demand for the product we aim to create—modernized, stabilized properties with credit tenancy. That's where we've been tremendously successful, buying vacancy that's priced like it's risk but which has a lot of asymmetrical upside because, with the right execution, you can secure large or full-building-credit tenants and add tremendous value.

What kind of amenities are tenants asking for?

Huffman: It's having the state-of-the-art fitness center, concierge service, conference centers, and all-day healthy dining options. It's bringing in food trucks certain days of the week, having after-hours events and pop-up beer gardens on some of our campuses. These amenities are very different from what you would historically see in a standard suburban office campus.

Is demand for offices in suburban nodes increasing relative to the urban core?

Card: The [rent growth] gap [between the suburbs and CBD offices] has been closing. It mirrors demographic changes. If you look at the data, more millennials have moved out of the cities to the suburbs over the last three years than vice versa by a meaningful margin. We're also seeing that pickup on the office side, so office vacancies have decreased. They're still higher in the suburbs than they are in the cities throughout the country, but they've come down a lot more. And it's often the best-in-class properties around these nodes, often the first stop outside of the urban core, that are absorbing all that space.

We're starting to see pressure on rents in a lot of those markets. Construction costs are up across the board, which has made replacement cost very, very high in these markets. Before you see any meaningful new supply as competition, rents are going to have to run a long, long way. We can see the fundamentals strengthening; we don't see any new supply coming online, yet the suburban markets are still very out of favor. That's a trend we really like when it comes to supply and demand. ■

Stephen Card
Principal & Regional Director,
Mid-Atlantic,
Rubenstein Partners

Brandon Huffman
Managing Principal & Portfolio
Manager, Equity Investments,
Rubenstein Partners

Understanding the Wall of Dry Powder

More than $278B of dry powder is sitting on the sidelines of the private equity real estate industry globally, according to Preqin. Experts from across the world offer their insights into the potential impact of the wall of dry powder on commercial real estate transactions and how it will shape investment strategies in the years ahead.

Asaf Rosenheim
Head of Investments, Profimex

Focus on Small to Mid-cap Deals

"The levels of transactions as well as prices have already exceeded the pre-crisis period. Driving these record high prices is the demand for quality real estate and the pressure to invest in larger transactions, particularly from the commitments and dry powder of some of the largest institutional investors in the world and the mega funds that have been raised in the last few years. Their focus has and will continue to be on large-cap investments, providing an opportunity to invest in small and mid-cap transactions, where the competition has not driven prices to the levels of pre-crisis. The one thing that still helps me sleep at night is the fact that leverage across the board is much more conservative, and we can see that in the LTV, rate, and covenants."

Morag Beers
Director of Real Estate, IMMO Investment Technologies

Will the Patience to Deploy End?

"I do not see transaction volumes increasing in traditional sectors in core markets. I sense a real awareness of the risk of overpriced deals. That risk seems to be outweighing the need to deploy for now. To me, the interesting point in time to watch is: What happens when the patience to wait to deploy is exhausted? Could there be appetite to consider viable but nontraditional and less-core markets on the fringes?"

Samuel Landman
Capital Markets/ Investor Relations, Universe Holdings

CRE's Relative Value Drives Dry Powder

"We will continue to see an increase in dry powder as long as private equity views commercial real estate as an opportunity to generate higher yield in comparison to other asset classes. While there is concern that too much cash is chasing too few deals, putting pressure on pricing, we are definitely seeing an increase in transaction volume in the multifamily sector as sellers take advantage of the increased competition. Interestingly, we are also seeing larger funds investing their core/ core-plus capital into value-add deals where they believe they can receive better returns."

Giving New Life to the Suburbs

Value-add multifamily housing for the middle-market workforce is both an offensive and defensive play, according to Boston Capital Real Estate Partners' Mark Dunne

Mark Dunne
Managing Director,
Boston Capital
Real Estate Partners

Privcap: Many developers are targeting major metropolitan areas around the U.S. Why do you focus on the suburbs?

Mark Dunne, Boston Capital: There is resident demand and investor safety in buying and renovating Class B properties in suburbs with a high concentration of forward-looking businesses in tech and services, where workers have incomes at and above the U.S. median. We're specifically not constructing new luxury apartments in downtown locations dependent on incomes at, say, 200 percent of median. Instead, we typically buy a 1990s-era property and perform significant renovations, including new kitchens and bathrooms, flooring, fixtures, stainless steel appliances, smart technology within units, and renovate the clubhouse and fitness center. We also add sustainable measures such as electric car park stations, water saving, and electric usage efficiencies that reduce impacts and costs to the environment, our residents, and ownership.

We strive to offer an optimal mix of new living and community spaces in a less-dense, mature landscape with more open and green space than new construction. Our residents value the community atmosphere, locations close to employment hubs, good schools, and service amenities, and perhaps most important, a rental price affordable to middle- and upper-middle-income people.

What do you see as the demand drivers for these suburban properties?

Dunne: There's lifestyle advantages as millennials and other cohorts seek more space and lower costs as they plan for families, or simply want to try to build a financial nest egg after spending a high percentage of their incomes living downtown. That is, if they could afford downtown in the first place, which most people can't. It's natural for developing households to look for lower density, more open and green space without sacrificing a modern, fresh look and feel in their apartment homes.

We believe renovated apartment properties that are close to transportation and employment, are well-appointed and new on the inside, and yet have a more suburban feel and lower cost structure are a compelling investment opportunity. The strengths of our properties and locations include lifestyle advantages, convenience, and affordability. We believe it's defensive from an investment risk standpoint to appeal to a very large swath of the income band, but it's also opportunistic in that we're manufacturing value by taking something that's been underimproved and underoptimized and bringing it up to a standard that a broad spectrum of the renter market demands and can afford.

Are rising interest rates a challenge for the CRE industry going forward?

Dunne: Rising interest rates of course increase the cost of borrowing, but also typically follow improving economic activity. So far, much of the rate increases have been absorbed in the lender spreads. But that cannot go on forever. With apartments' annual lease structure, you have built-in inflation protection. It's more positive, within reason, than many people might expect on its face. For portfolio properties financed with fixed or capped interest, it can be favorable from a cash flow perspective and overall as well, to the extent that exit cap rates don't track interest rates in lockstep, which historically they have not.

How do you view risk, given the maturity of the CRE cycle?

Dunne: We've invested in apartments throughout every cycle. As we're now seemingly later in the cycle, we believe we're in the best position with our current strategy to weather any storm, and to take advantage of opportunity at the same time. We think the long-term outlook for apartments is very positive, and housing as a normal matter has been undersupplied, particularly at the more affordable end. I have invested during my career in other product types, including office and retail, and decided 18 years ago to focus exclusively on apartments, because I believe it is the best risk-adjusted place to be, whether the sun is shining or a storm is raging. ■

RSM

OPPORTUNITY ZONES: WHO PROFITS, WHEN AND HOW?

A Q&A with Troy Merkel, RSM US LLP

The rollout of new specially designated tax-saving districts slated for development across the United States was unveiled as part of the federal government's post-recessionary $1.5 trillion tax reform package announced in late 2017 as the Tax Cuts & Jobs Act.

These so-called "opportunity zones" were set up to attract investments and stimulate economic growth in urban, suburban and rural areas where development has been stagnant. The U.S. Treasury issued proposed regulations in October 2018 to provide guidance on how the zones would operate, the types of investors permitted to participate and the types of projects that may qualify.

In anticipation of the new rules, real estate investment firms, private equity firms, Silicon Valley and others have eagerly begun to raise capital for OZ investment funds designed to take advantage of investments in projects targeted for these tax-saving areas. Depending on the holding period, eligible capital gains from investments in a qualified OZ fund can avoid tax on up to 15 percent of the original gain and defer tax on the remaining original gain until the earlier of the sale of the fund or the end of 2026.

RSM's Troy Merkel, a real estate partner located in the firm's Boston office, provides a run-down on how OZs work.

Q: What qualifies as an OZ and who has the authority to designate an area?

OZs are low-income census tracts, which are areas with a poverty rate of 20 percent or more and a median family income of 80 percent or less of the areas' median income. In addition, up to 5 percent of census tracts that are contiguous to an OZ may qualify, provided the median family income does not exceed 125 percent of the median family income in the nearby OZ. The governor of each state was allowed to designate up to 25 percent of these census tracks as OZs. The governors have made their selections and all the OZs have been declared.

Q: What type of investors qualify?

The range of investors is quite broad. It may include individuals, C corporations, real estate investment trusts, partnerships and other pass-through entities, including common trust funds. It is important to note that in order to benefit from a qualified opportunity zone investment, these investors need to have recognized recent capital gains.

Q: How does the tax-savings work? Have you assessed what hold time is the best?

The overall concept is one of deferral and partial forgiveness of capital gains tax. In addition, there are potentially benefits upon the exit of the QOZ investment. Let's take an investor who recently sold some stock with a basis of $50,000 for $150,000, resulting in a capital gain of $100,000, which would normally be taxed that year. That investor has 180 days to decide to invest a portion or all of the $100,000 gain in a QOZ investment, either directly or through an investment vehicle like a fund. At that point, any taxes on the gain are deferred until the QOZ investment is sold or until 2026. Let's assume our investor elects to invest all of the $100,000 gain. Now if the investor were to hold onto the QOZ investment for five years, the gain would be reduced by 10 percent ($90,000). If the investor holds the QOZ investment for seven years, the gain is reduced an additional 5 percent ($85,000). If the investor holds the investment for 10 years, the basis of the QOZ investment would be automatically adjusted to the sales prices, resulting in no taxes paid on the sale of the QOZ investment. As such, the best hold time for the investment to fully realize the tax benefits is 10 years. For a real estate investor, five-, seven- and 10-year hold periods are the norm and an easy sell to investors.

Q: What type of risk is associated with these OZ districts and are there strategies to mitigate it?

The need for a 90 percent tangible asset and the 50 percent income to come from the OZ will be easy for real estate investors to meet. The initial risk is being able to make a qualified investment and required improvements, which means a dollar-for-dollar improvement in the tangible property, in time. Fortunately, the IRS recently released guidance that will make it easier for real estate companies to meet this requirement. The IRS has stated that land is not included when calculating the basis of the tangible asset needed to be improved, thereby reducing the total cost of improvements. Furthermore, there is a safe harbor that allows for the initial investment and substantial improvement to occur over a 31-month period.

Once you have made the investment and substantial improvements required to qualify for the OZ investment benefits, the next biggest risk is helping investors with tax planning. If investments are held past 2026, there will be a tax due on the original gain (as adjusted for any reductions). There is a high likelihood that this tax payment may not be aligned with when the investors receive cash from the investments. It is important that anyone investing in QOZs understands that this tax is coming and has a clear plan in place to handle this tax payment, likely through a financing or operating distribution.

Key Issues for Real Estate Investors Under New Tax Legislation

Leading tax experts from RSM break down what it means to your bottom line

Privcap: In your opinion, what is the main goal of this tax plan?

Don Susswein, RSM US LLP: Congress decided that this tax reform bill would stimulate business. Even though a lot of individuals got tax cuts, it wasn't primarily about the individual, it was primarily about the businesses. And the corporations got a major tax cut. They went from paying a 35 percent tax to a 21 percent tax rate. In addition, to be evenhanded, you don't want to have a skewed economic recovery, where only part of the economy benefits, so they also implemented a more favorable pass-through tax regime than under prior law.

To put it simply, this law is an incredible incentive for entrepreneurship. Let's assume that you're a vacuum cleaner repair person and you work for the Hoover Vacuum Cleaner Company Repair Center and you make, let's say, $100,000. You're going to pay tax on $100,000. But if you decide you've had it working for Hoover and you're going to set up your own little shop, either in your basement or in rented space, and you're going to start a vacuum cleaner sale and repair company, and it turns out in the first year you make the exact same $100,000, you only pay tax on $80,000.

How will the new tax plan impact real estate investors on the new tax legislation?

Susswein: Many real estate transactions won't be affected at all. If your classic real estate transaction is buying a building, or building a building, and incurring tax losses, or at least not making a lot of money while you're renting up, and then once it gets to a certain level, selling the asset at a long-term capital gain, your life isn't affected very much. You still get your losses, for the most part. You still get your capital gains. The rates have neither gone up nor gone down on capital gains, so there isn't much of a difference.

What about those properties with an operating income?

Susswein: If you are the holder of some properties that will generate a lot of operating income and that's part of your business strategy, or perhaps they've been held in your family for generations and you aren't planning to sell them—you will keep on living off of the rent, so to speak—then there is a new provision, not just for real estate, but a new provision that will lower the effective tax rate on income earned through qualifying pass-through entities by 20 percent, so that if you had $100 of rental income, only $80 of that income would be taxed. So if you're ordinarily in the top tax rate of 37 percent, you'd be at a rate of around 29.6. So that's an attractive feature, but it won't affect you unless you're earning the operating income from the business, i.e., the rent.

Can you explain more about this 20 percent? Who is entitled to it, and why?

Susswein: This is a very important provision in the new tax law, and the real estate industry wanted to be sure that they were covered by it, that they were eligible for it, even though the majority of real estate transactions may not end up using it. This is important for all different types of businesses that are not your large major multinational publicly traded corporation, which would not only include real estate entities but millions of businesses. For example, somebody could own, in an S corporation, 20 television stations, or they could own 50 hardware stores or what have you. It could easily be a billion-dollar business, but it could also be the corner grocery.

Can you explain like-kind exchanges and why it matters?

Andrew Cohen, RSM US LLP: Like-kind exchanges are a way for taxpayers to defer gains on the sale of real estate assets by reinvesting proceeds in other real estate assets, assuming they meet specific requirements. These rules used to apply not just for real estate assets but also for exchanges of personal-property assets. The rules that were enacted as part of tax reform left the application of the like-kind exchange rules alone for real estate assets but eliminated it for personal property. In general, if I bought a building 10 years ago for $1 million and it has appreciated and now is worth $3 million, the $2 million of income I would have otherwise recognized 10 years later would go untaxed if I go and I reinvest in other real estate assets (assuming I meet certain conditions).

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Most real estate investments are heavily debt-financed. Can you talk more about deductions and what people can expect?

Susswein: Well, if you're in a real estate trade or business, your deductions of real-estate-related interest are unaffected if you elect a specific set of provisions.

Cohen: In general, for real estate, you have a trade-off where the deductibility of interest survives for many taxpayers. You can elect to continue to fully deduct interest, but the trade-off is a longer recovery period on your real property. For people that own nonresidential property, it's basically doing 40-year depreciation instead of 39 years; and for residential real property, it's 30 years instead of 27 and a half years. The depreciation-expense decrease from qualified improvement property may be more drastic, but the deductibility of interest expense continues for electing real estate trades or business taxpayers. And I think, for many of our real estate clients that I've been speaking with, this interest-limitation provision is not something as concerning to them, compared to other industries.

REITs seem to come out ahead in this bill. Do you believe this is a true statement?

Susswein: I wouldn't necessarily say that, because corporate business and noncorporate pass-through businesses have also gotten tremendous benefits. If you look at which industries benefited, real estate was in a pretty good position before and was theoretically vulnerable to any changes that might be considered. Just look at what could've been taken away. But I wouldn't say that they've been advantaged on a relative basis. In fact, the commercial industry didn't want any advantage. The leadership of the commercial real estate industry just wanted to be taxed economically, more or less, not with special benefits or special tax rates, unless other people are getting them—in which case they want to be treated fairly. In fact, in one early proposal, it was stated that people should able to buy buildings and immediately expense them, and major leaders of the real estate industry said that was too generous and would bring too much money into the industry, perhaps leading to overbuilding.

So speaking of coming out ahead…

Cohen: One type of REIT that we see coming out as a big winner might be mortgage REITs. If you're a lender and you're basically receiving interest income, if that interest income is earned through a traditional partnership structure, it may get taxed to the individual owners at a 37 percent rate. But if that same interest is earned through a REIT that's otherwise meeting the REIT tests, the income that's generated could be taxed to the shareholders of the REIT at a 29.6 percent rate.

Let's say you buy one apartment building and for some reason the government says you're not in a trade or business—you don't do enough, it's net lease. How would you handle this?

Cohen: If you don't get this automatic deductibility of interest, then you still could deduct at least a portion of it, based on an EBITDA calculation for the first few years the law is in effect.

Another note is that if you were to go and buy an apartment building or buy some other real estate asset that has some personal property attached to that asset, the value that's associated with that personal property, compared to prior law—where it was depreciated over five or seven years—now is 100 percent deductible upon acquisition. And that's regardless whether you're in these interest limitations or not for purposes of this personal property.

If you're going and buying something in 2018, you could be in a situation where if you're getting this 100 percent deduction on a portion of your asset in the year that you acquire it, you could have in 2018 a substantial tax loss, with or without the deduction

"The leadership of the commercial real estate industry just wanted to be taxed economically, more or less, not with special benefits or special tax rates, unless other people are getting them—in which case they want to be treated fairly."

–Don Susswein, RSM US LLP

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for interest. In future years, you could have more income, because you've basically accelerated a deduction. Because of this, I think we will see a lot of taxpayers that acquire real estate see larger losses than they're used to seeing over the next year.

So would that be a disincentive to any kind of improvements on a property?

Cohen: No. Let's say you want to upgrade the appliances that you have in your building, and you take out the old refrigerators and you put in new refrigerators. Those appliances, whether it's existing assets or brand-new refrigerators, would then become 100 percent deductible in the year that you placed those in service. So what we're seeing in the industry is the cost-segregation specialists getting a lot of calls from people who are trying to find more personal property in their property acquisition, and renovations that they can go and immediately deduct in the year that they spend the money.

Is there a recommendation that could help alleviate some of the pain points or the anxiety of the law?

Susswein: Outside of real estate, there's no question that every business in America needs to have a major fiscal exam, so to speak, to see how they should possibly be restructured. In real estate, it's less dramatic.

Cohen: Yeah, I agree. Fund managers and the property managers could be impacted differently from the tax legislation, so they should consult their tax advisors regarding their structure. If they're trying to figure out how they're going be taxed on the income, it could vary for those managers of assets or portfolios.

Where do you see this bill taking us in five years, either on the real estate side or in general?

Susswein: That is the fascinating question. It depends on whether we have a big budgetary crisis, or whether we have a major change on the political front. It could be that the law works and we get a tremendous continued uptick in economic development, and it's going to be hard to criticize the law. It could be the tax law for another 10 or 20 years. Of course, there are technical errors that need to be fixed.

Unfortunately, Congress seems to want to pass a tax law every two years or so. They could enact the perfect tax law, as many people think they did in 1986, but then they have to come to work the next day. What are they going to do for an encore? The only thing they can do is take it apart or modify it. It's ironic. Our founding fathers made it very difficult to get a change in the law passed. But our political system makes the politicians want to show their constituents that they're doing something in Washington—even if the best thing they could do is to leave well enough alone. ■

"If you're going and buying something in 2018, you could be in a situation where if you're getting this 100 percent deduction on a portion of your asset in the year that you acquire it, you could have in 2018 a substantial tax loss, with or without the deduction for interest."

–Andrew Cohen, RSM US LLP

Real Estate Fundraising Trends

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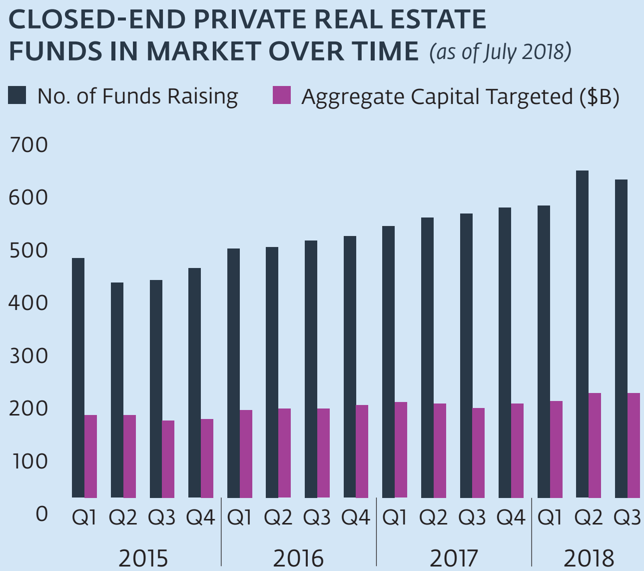

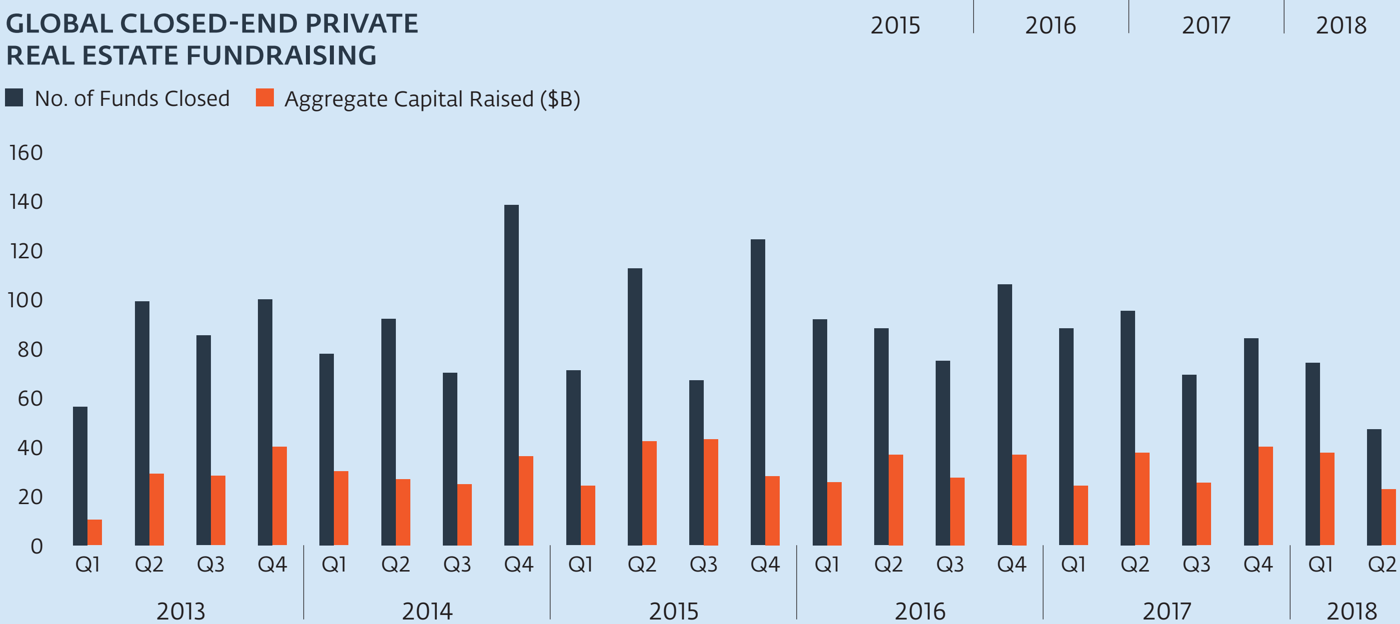

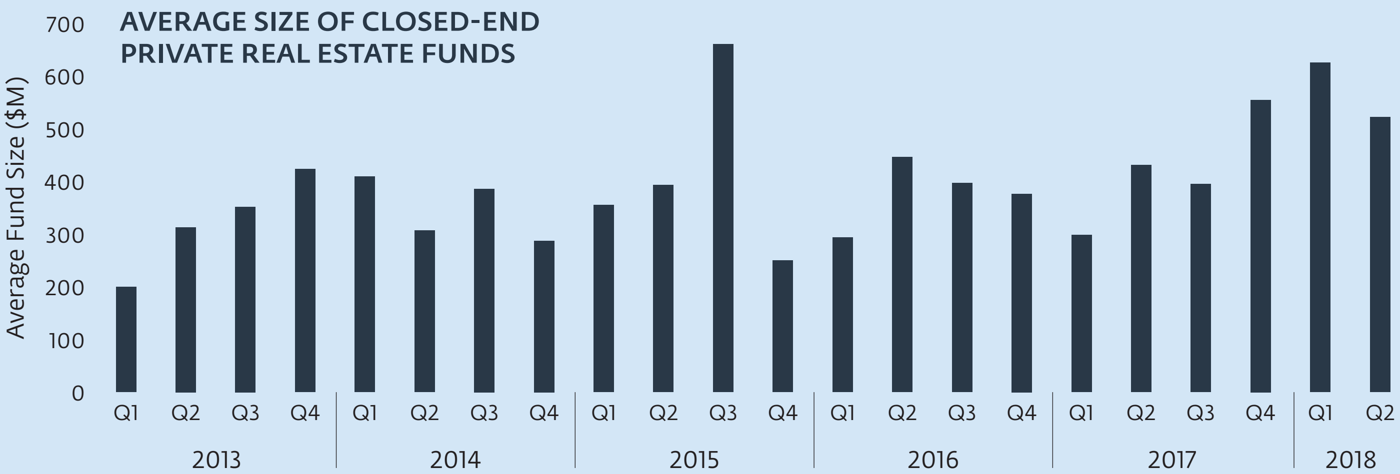

Emerging Risks in Real Estate Investing and Management

Experts from **StepStone Group**, **The Praedium Group**, and **RSM** survey the risks that real estate investors need to know in a market that grows more uncertain by the day

1 A firm with a disciplined, repeatable approach to underwriting is less exposed to risk

Real estate investment firms that thrive through multiple market cycles seldom adhere to the "trust your gut" approach to investing. A winner at one end of the cycle may make a losing bet at the other end, losing LP confidence in the process. The best firms trust a repeatable process that involves a painstaking assessment of all forms of risk.

StepStone's Jay Morgan, who annually vets hundreds of real estate GPs on behalf of institutional clients, says: "The repeatable process is important when we're doing the underwriting on a real estate investment manager, because we expect them to carry out their strategy through a changing market environment, through a changing capital-market environment where fundamentals may be changing. Gut feel can lead to incredible returns sometimes, but when you think about what's prudent for long-term liabilities, we think you really want to identify a team that has identified a process."

Adds Russ Appel of The Praedium Group: "A lot of risk is preparing for the unexpected. When a real estate investor comes up with pro formas, everything looks great. But reality never unfolds as you projected it. You need to put a plan in place so that when the unexpected happens, you're prepared. The hard thing for us to teach our young people isn't so much what goes behind the projections, but to really understand how one asset is going to perform differently than the next asset."

Question Assumptions

Jay Morgan
StepStone Group

As LPs seek to understand whether a GP has a repeatable approach to investing, they would be wise to understand how return projections are created, says StepStone's Jay Morgan: "Too often firms will just implement a model to solve for whatever their return target is. They may not really have a good understanding of what the rental expectations are, what the exit cap rate projections are, what the expected capital market environment may be at exit. They've come up with a number out of the air and don't have a foundation for it."

Real estate investors must take a systematic approach to assessing risks at the macro and enterprise level, says Nate Ruey of RSM. For example, an investor focused only on cap rates and deal-level uncertainties around interest rates as well as geographic risk might ultimately fail by overlooking weaknesses in the finance function, information technology, and cybersecurity at the firm level. "It's important to have checks and balances not only with back-office operations, but also through the management of the underlying assets and properties," he says.

2 Late in the cycle, development deals have many risks to manage

Investing in real estate developments has always carried additional unique risks compared with investing in existing real estate. But as a cycle matures, development deals carry greater risk, not only in the market but in the willingness of some investors to "swing for the fences."

Appel and Morgan both point to the tight labor market and how the added expense of labor can add risk to a project. "Clearly, construction costs are going up," says Appel. "Part of that is hard costs, part of that is labor costs."

"Employment is tight," says Morgan. "The other aspect of labor risk is the union side of it. When you go through a repositioning of an asset without union labor, you may have a strike in front of your building for an indefinite period of time, which blows the economics of the deal entirely."

Given the labor shortage, it is important to procure contractors and subs in a timely manner. The longer the duration between when the development's financial models and contracts are put in place and when groundbreaking actually occurs can significantly increase the risk for higher labor costs and misaligned cost expectations.

In an environment where investors are trying to squeeze out every basis point of return, Ruey warns that noncompliance with a contract is a major risk. "If you're working with a developer, you really need to make sure you are monitoring their compliance with the terms and conditions of the deal," he says. "You need to monitor things like the procurement process for contractors and subcontractors, as well as the reasonableness of reimbursable and pass-through costs, to really make sure you are on top of the books and records. One of our clients was recently doing construction of high-end university housing. It was supposed to be a $35M project, but it had $3M in cost overruns because there was poor oversight."

Another late-cycle risk lies in the mindset of the investor. With high valuations threatening to deliver weak long-term returns, an appetite to look for riskier projects increases. While prudent risk is appropriate in a competitive market, not every manager has the discipline or skill to execute on projects with greater development risks.

"Some people will be reaching for return," says Morgan. "There are a number of managers and investors who will come in behind those managers who are looking at 7.5 percent expected return, and they need to go find somebody who's going to deliver that for them. And they will look at the fundamentals where they see tight vacancy markets, and they'll go out there and underwrite to development yields, only to have those deals turn against them as the market goes through another cycle."

The '90s Are Over

Russell Appel
The Praedium Group

The bootstrapping, wildcatting roots of the private equity real estate industry have necessarily morphed into an institutional asset class, says Praedium's Appel. "In the 1990s you had a bunch of deal junkies—a bunch of people who were running around doing deals. They were highly entrepreneurial. But the industry has evolved, because things happen that you don't expect. No projection comes out exactly as you projected it, and so the focus on being a fiduciary and planning for the unexpected has just become more important. What investors want is durability of returns, and to do that you have to plan for the unexpected."

3 An institutional-quality back office demonstrates a broad commitment to risk management

A strong investor with a weak back office will eventually embarrass its LPs or, even worse, impair their capital accounts.

With this in mind, LPs are increasingly conducting on-site due diligence of their managers' back offices to ensure that an infrastructure of institutional quality is going to support the investment process.

"We've gotten to the point of having an ODD [operational due diligence] team go on site," says Morgan. "They're looking at

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the regulatory environment that the manager operates in and making sure that everything is consistent with the statutory requirements. They're looking at the cash controls. They're looking at the IT security. They're looking at stuff like compliance manuals, making sure that they exist and making sure that they're adhered to. They look at code of ethics to make sure that that exists and is demonstrable within the investment process within the firm."

Morgan adds that StepStone's assessment of the back office is independent of the assessment of the investment track record, and both need to be in place before a fund commitment can be approved.

Based on his own firm's experience on the receiving end of ODD, Appel confirms that "it's not only having the checklist of the processes, but it's actually making sure we're following them."

According to Ruey, operational due diligence can focus on governance, IT, the confidentiality of data, cybersecurity, cash controls, and fraud risk, among others. Investors are not only worried about losing money, but also, "if something went wrong in the back office, what would the impact be from a perception and reputation standpoint."

Employee Theft

Nate Ruey
RSM US LLP

RSM's Nate Ruey shares an example of what can happen at a firm with weak financial controls in the back office, in which a modest hit to the bank account nevertheless spelled a big hit to the firm's reputation: "The bookkeeper for one real estate client had access to the firm's checks and vendor master file. The employee was altering the file and cutting checks in their own name. The oversight and controls just weren't there—the fraud went undetected for months."

4 Cybersecurity needs to be pushed down to the asset level

Breaches of a company's IT security have become more common and more serious as bad actors have proliferated. In the real estate world, most professionals are focused on the security of electronic communications at the firm and between manager and investor.

Real estate firms are besieged by sophisticated hackers who know that the firms control the flow of large sums of money. "We see people who are constantly getting phishing emails sent to them," says Morgan. " We've actually seen rewritten wiring instructions come in. The controller sees what looks like a completely legitimate set of wiring instructions, and all of a sudden cash is moving in a way that you wouldn't expect. It can easily happen, and has happened in some of the smaller firms, or in firms with inexperienced controllers."

Ruey states: "It's becoming more and more sophisticated how hackers use social engineering with phishing emails, by creating messages which appear to come from a legitimate internal or external source, while knowing who the key stakeholders are and coming up with scenarios to transfer money."

But Ruey adds that managers need to know that hackers are also targeting their underlying buildings and assets: "Let's take building management systems, for example. Oversight of the systems, if it exists, would be at the GP's back office. However, if a building management system is hacked, the hacker could get into the tenant network. They could be able to take down the servers for the buildings, take down the fire suppressor systems, as well as have ability to take control of PA systems or elevators. You could really do some very malicious things."

"We want to protect our investors," says Appel. "But we also own all this real estate. We have responsibilities to our tenants, and we need to make sure they're safe. And, of course, we have employees that work for us, and make sure that we do the right thing by them, too. Part of what we're talking about is making sure that firms have processes in place to be prepared." ■

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