NAREIM

National Association
of Real Estate Investment Managers

Dallas

NAREIM WINTER A&A - ACQUISITIONS & ASSET MANAGEMENT

WINTER 2014

NAREIM

National Association
of Real Estate Investment Managers

NAREIM Winter A&A
January 15th and 16th, 2014

UNCERTAINTY, INNOVATION, AND THE FUTURE OF REAL ESTATE INVESTING

In times of disruptive change, new winners and new losers are often revealed. The question often becomes, how can I make sure I'm in the first category but not the second? Anticipating, understanding and responding to change was a passionate core of the discussion at NAREIM's Asset Management & Acquisitions Winter Meeting in Dallas on January 15 and 16.

Evolving Strategies

Everything in commercial real estate seems to be changing—investor needs, employee values, capital markets expectations, and real estate market demands—and the pressure on leaders in this business is not letting up. The need to learn, evolve and connect with others in the business is greater than ever.

In today's real estate, leaders need to understand the emerging and evolving social, financial, geopolitical, and environmental trends are affecting risk and return. Changes in the past were often slow enough for forward-looking real estate investment managers (REIMs) to mitigate risks and seize opportunities. But to many, the pace of change is allowing far less lead-time.

So what can be done? How can someone be strong enough or smart enough to thrive in this environment? According to Charles Darwin "It is not the strongest of the species that survive, nor the most intelligent, but the most responsive to change," Perhaps in today's environment, as NAREIM President Gunnar Branson pointed out, "The ability to change is more important than being the smartest or strongest. Perhaps we need to approach our challenges in a different way than many did in the past."

What are we facing, exactly?

Tenants may need less space. For example, law firm lease renewals are typically for one-third less space than the leases they replace, due to electronic file storage, the elimination of law libraries, and other efficiencies brought on by technology. Internet sales are expanding faster than store sales, and as this trend continues, malls and shopping centers may need to re-think their approach to space. Are we ready for higher density of use and perhaps a lower gross demand for space on a per person basis?

People are acting different than before. Social and demographic shifts are in high gear. Millennials, which make up the 18-to-34 age cohort that drives apartment and retail markets, have tended to make different life choices than preceding generations—living in cities, renting apartments and putting off marriage and children longer, driving less, and acquiring fewer physical assets. Business people of all ages work outside the traditional office more, and consumers are buying more and more online. All these fairly recent shifts have a direct impact on office, retail, industrial and multifamily residential markets. Are the assets in our portfolio flexible enough to allow for the changing uses of space?

Capital is changing. It's not just about the defined benefit pension plans anymore. Global capital, defined contribution plans, family offices and other investors of capital are looking for different things from private real estate. Are we providing the right kinds of structures, risks and returns for a changing client base?

Fig. 24.—Skulls of Pigeons viewed laterally, of natural size. A. Wild Rock-pigeon, Columba livia. B. Short-faced Tumbler. C. English Carrier. D. Bagadotten Carrier.

"It is not the strongest of the species that survive, nor the most intelligent, but the most responsive to change"
– CHARLES DARWIN

At the NAREIM meeting, the insights were abundant during the table discussions. One table, for example considered the dilemma of a CFO who wants to attract young people but must also retain more experienced professionals. Committing to a unique location or open-workplace design may commit a firm for 10 years, during which time the young urban dwellers hired today may moved on, gotten married, and moved on to a more competitive market. In the meantime, the company could lose older workers who don't adapt well to open plans or prefer to work in convenient downtown areas rather than trendy areas favored by tech start-ups. The way these considerations play out in the minds of business leaders today and tomorrow can affect real estate investment yields.

Another trend examined by the small-group discussions was the rapid increase in home schooling. Currently, 4 percent of students are homeschooled, but this group is growing at seven times the pace of public school enrollment. As homeschooling becomes viable for more and more people, one of the biggest motivations for families to move from cities to suburbs could be eliminated. "Technology is changing education dramatically," one participant said. "Are we even going to have schools in 10 or 15 years?"

"It may not seem like it, but we're in a sweet spot right now"

Doug Poutasse
Bentall Kennedy

REIMs are well aware of the impact that rising Internet sales volume is having on retailers and distribution systems, but the NAREIM discussion was the first time many heard about potential changes to apartment properties. New multifamily residential developments are being designed with "package rooms," similar to mail boxes but larger to accommodate deliveries from online retailers. These rooms are increasingly being considered necessary because the volume of deliveries is too much for lobby staff to handle and delivery people often can't leave packages unattended in lobbies or hallways. For apartment buildings that can't accommodate individual package lockers for residents, NAREIM attendees theorized that "Amazon locker stores" could crop up in many retail locations.

Technology and its impact on social trends isn't the only source of change in the real estate investment industry. NAREIM participants observed that institutional investment used to come mainly from defined benefit pension plans, but private-sector firms have largely shifted to defined contribution plans such as 401k programs, and many public-sector pension plans are under-funded.

Although U.S. pension funds aren't disappearing any time soon, they're not likely to grow as fast as other capital sources such as family offices, sovereign funds, and non-U.S. pension funds. Serving a greater variety of capital sources will require REIMs to develop new strategies and areas of expertise, and may also create opportunities for innovation. For example, some private-sector companies with DB plans have turned over administration of their plans to insurance companies, which may use third-party investment managers differently.

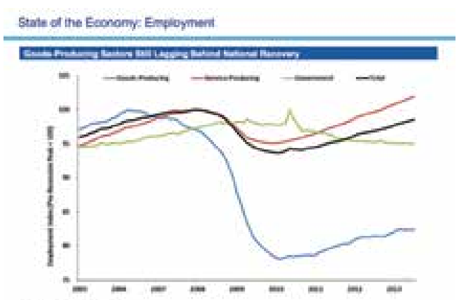
Changing Market Fundamentals

After the group discussion of emerging change factors, NAREIM members found themselves on more familiar ground: an overview of global capital markets and their impact on real estate investment. While change and uncertainty was still central to this discussion, at least the topic was one that REIMs are focused on for years, giving them time to develop adaptation strategies.

"It may not seem like it, but we're in a sweet spot right now," said Doug Poutasse of Bentall Kennedy. "Global growth was supposed to be slow in 2013, and it turned out to be better than expected," in part due to Federal Reserve policies, he said. "It's important to remember that, 18 months ago, it was not clear that the European Union was going to survive."

"Economic growth and rising stock prices helped trigger rise in long term rates"

Doug Poutasse,
Bentall Kennedy



"Producing sectors still lagging behind national recovery"

Doug Poutasse,
Bentall Kennedy

In 2010, as the world was coming out of the global financial crisis, there was almost no risk premium built into 10-year government bonds, Poutasse noted. As a result, investors had little incentive to move away from low-risk assets. The Fed's policy of quantitative easing—buying bonds at a pace of about $3 billion a day—raised the risk premium. "The Fed did exactly what they're accused of: they created an asset bubble. But it was the only thing they could do to drive people out of low risk into higher risk investments," he said. "They made it expensive to be risk-free and it worked."

Economic growth and rising stock prices helped trigger a rise in long-term interest rates, but the spread between cap rates and interest rates is still higher than the historical average, Poutasse noted. "We're in the middle of the fourth year of an economic recovery, which is fairly long upward cycle," but "people have good reason to feel that the economy is not doing well." The market for durable goods has recovered about 7 percent from its lowest point, but is still down 17 percent from its peak.

Federal, state, and local government employment is shrinking by 100,000 people per year, compared to average growth of nearly 300,000 government jobs prior to the recession. "When you look at the private sector by itself, the U.S. is adding the same number of jobs in this recovery as in the last recovery, but government is shrinking (or not growing) by 400,000 jobs a year," Poutasse said.

Private-sector growth is uneven as well. Some sectors—mainly education and healthcare—didn't decline much during the economic crisis and continue to see steady growth. The technology sector and other technical services are adding jobs rapidly. Several other sectors, such as banking and retail, still employ fewer people today than before the downturn, and a few sectors, like media and law, continue to shed jobs.

Job losses and gains have not been uniform across all geographies, either. Austin, for example, was not heavily impacted by the recession and has seen strong growth since 2008. San Diego and Seattle were hit hard by the downturn but have recovered quickly, while cities such as Las Vegas and Phoenix are still far below their pre-recession peak employment. With few exceptions, the level of job growth in a market correlates to occupancy levels of commercial real estate.

"Expanding markets are growing faster than recovering markets—that's an extraordinary situation," Poutasse said. Compared to past cycles, when cities could be counted on to make a comeback on a predictable schedule, the current economy is heavily tilted to "innovation cities" with high education rates and high numbers of patents per capita. That change in demand isn't reflected in historical real estate trends, so any REIM who clings to old methods for predicting market opportunities is likely to produce lower yields for clients going forward.

Another risk embedded in traditional demand forecasting involves vacancy statistics. If an industrial user needs a 30-foot clear ceiling and there are none available locally, the user will build one rather than settling for existing buildings, even if local vacancy rates are high. Similarly, a lot of office space may be deemed functionally obsolete by companies seeking space that improves employee well-being and productivity, so new development may be warranted even in areas of high vacancy.

Changing Space Demands and Changing Definitions of Suburbs

The question of whether new development is warranted, and in what situations, was also the topic of an interactive panel discussion at the NAREIM meeting. Since the developers on the panel were all focused on the Dallas market, their perspectives were different than developers in cities centered around downtown cores.

"The idea of an urban node can be a suburban trend—Las Colinas is an urban node—and there are going to be more of these over time"

Denton Walker III
Trammell Crow

"The definition of urbanization has moved beyond the CBD," said Lucy Billingsley of Billingsley Company. "We're seeing the creation of high density neighborhoods in the suburbs. Life in suburbs is lively and strong, but development doesn't need to be haphazard."

"Our brokers and tenant reps we work with are telling us that companies like to be in a work-live-play neighborhood, where they can walk out their front door to amenities," said Denton Walker III of Trammell Crow. "The idea of an urban node can be a suburban trend—Las Colinas is an urban node—and there are going to be more of these over time."

Finding future markets where demand was growing was coupled with the need to future proof the markets where REIMs were already invested. "We're trying to future-proof our developments, and the biggest expense to doing that is technology," said David Cunningham of Granite Properties. He agreed that's it's important to offer nearby amenities that tenants want, and finding those amenities meant figuring out where there was market demand. "The last thing we wanted to do was a hotel, but we wanted to fill our office buildings and that meant having a hotel."

Return on Human Capital

Just as important as attracting tenants to properties is attracting talented people to your business. Several speakers addressed the question of how to bring in new people and help them grow their careers over time.

"Millennials never ask about compensation or parking spaces. They want to know about the company culture," said Chris Hipps of CBRE. "But that can change in the first five years, and a 30-year-old person still has 30 years to grow in the business."

"I continue to be surprised at how much your average 25 year-old values flexible work hours"

Josh Anbil
FPL Associates

"I continue to be surprised at how much your average 25 year-old values flexible work hours," said Josh Anbil of FPL Associates, a consulting firm focused on the real estate industry. "A lot of real estate companies can't answer the question, 'What's your work from home policy?' because there has never been a work-from-home policy."

Anbil also noted that young people want to know and feel like they're truly a part of the team, namely that their contribution is valued by others within the organization. "I originally thought that these were relatively minor factors since they're only getting started in their careers, but it's higher on the list than you'd expect," he said

Employees new to the business also value learning opportunities and training, as well as the company's investment in technology, according to Helen Rivero of Rosemont Realty. "They may want a new challenge after a year, and when they're deciding what firm to join they want to know you will have an open spot for them to grow later on."

Changing Capital Markets

U.S. capital markets are now in their third year of what has been dubbed "The Great Rotation," the growing movement out of fixed income investment into equities. Recovering real estate prices constituted one factor driving this shift, which in turn is prompting institutions to reallocate capital to maintain balanced portfolios.

Despite the hurdle presented by FIRPTA, "flight capital" from investors in less-stable countries is flooding into U.S. real estate markets, where investors hope to gain diversification out of their own countries and currencies along with better risk-adjusted returns, said Mark Gibson of HFF. "There is now plenty of capital across the equity markets, and debt capital from banks, insurance companies, CMBS underwriters, and mortgage REITs is abundant." Underwriting, Gibson explained, should be expected to remain disciplined in the first-line tranches, with ample mezzanine financing to fill any gaps.

Core properties for sale in gateway cities are becoming scarcer, while demand for this product continues to be substantial, Gibson said. Although this is affecting pricing, he predicted that compression in total returns will be limited in 2014. Properties in major markets are still 1.7 percent below their peaks, but in other markets properties are trading 18 percent below their peak, on average. In 2014, more investors may shift focus to higher-performing opportunities in secondary markets.

Gibson observed ways that changes in one market can affect other markets. For example, the fiscal soundness of state and municipal bonds will affect real estate in terms of changing investor allocation models, but will also have an impact on corporate location decisions. In addition, the dramatic rise in the share of the U.S. population that's over 60 years of age affects real estate markets not only in the demand of various property types but also in the level of institutional allocation of short-term versus long-term investments; as more and more people can draw down their retirement savings at any time, investors will shift allocations to investments that match those liabilities.

"For my colleagues who invest in public markets, it's easier to benchmark performance. I tell them that in real estate we're buying a process"

Robert Sessa
Employees Retirement System of Texas

Investors' Viewpoints

HOOPP employs a liability driven investment approach in managing its assets to align investment risks to the annual liability of future pension payments. "We currently have about $1.5 billion in annual liabilities to pensioners," said Richard Varkey. "We need to ensure that we can meet such liability obligations both in the short term and long term, which has resulted in a shift more towards fixed income and income producing strategies".

Although real estate investment managers come to NAREIM conferences to learn from each other, they are also eager to hear views of their business from investors. A key question to investor panelists was how they have dealt with REIMs in the wake of the downturn.

"We had to do some workouts and there are borrowers who we still want to work with as much as possible. At the other extreme, there are also borrowers who I would never talk to again," said Susan Doyle of GE Pension Trust State. "It's the same with investment managers. There are some people who lost a lot of money for us, but if we understand how they made their decisions, and if we can work things out, the relationship might not be damaged."

Robert Sessa of Employees Retirement System of Texas agreed that understanding the decision process is key. "For my colleagues who invest in public markets, it's easier to benchmark performance. I tell them that in real estate we're buying a process," he said. "We also want to be sure there are actions we can take if there are things that need adjustment."

After the downturn, the dynamics of investment relationships "swung a little more to the LP," Sessa said. "As markets have improved, GPs are in a little better position to say no to capital." However, partnership clauses that give LPs recourse if the GP has done something seriously wrong "are not going away."

2014 already looks like an interesting and busy year for all investors. The users of real estate are changing, the markets are changing and even the capital is changing. The need for thoughtful and forward thinking investment strategy, however remains the same. There are no easy answers, no guaranteed formulas and no sure things. Real estate investment leaders like those at the recent NAREIM Acquisitions & Asset Management meeting may not have all the answers, but seem to have the determination and flexibility to find a path through change.

Visit the iTunes App Store on
your iPad to download the new

NAREIM Dialogues iPad App

ABOUT NAREIM

The National Association of Real Estate Investment Managers (NAREIM) provides members the opportunity to refine strategy, improve operations, and provoke new thinking through meetings, surveys and thought leadership activities.

NAREIM members manage investment capital on behalf of third party investors in commercial real estate assets such as office, retail, multi-family, industrial and hotels. Collectively, NAREIM members manage over a trillion dollars of investments assets.

NAREIM members invest in office, retail, multi-family, industrial and hotels. Investment is made throughout the "capital stack" meaning that investments are made both in equity positions (direct ownership) and debt (first and subordinate mortgages). In the debt sector, investment managers have platforms to buy existing debt (mortgages and other instruments such as mezzanine and CMBS) and to make private equity financed loans.

BOARD OF DIRECTORS

NAREIM
National Association
of Real Estate Investment Managers

410 North Michigan Avenue
Chicago, Illinois 60611

312.884.5180
www.nareim.org