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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS

SHARP SHOTS BEFORE DAWN

US managers buy in pockets as they struggle to see a downturn

From left: Ron Lamontagne, Eric Wurtzebach, Scott Brown, Michael Acton, Peter Merrigan, Matthew Strotton

Preparing for a hidden downturn

On the 10th anniversary of the global financial crisis, six senior industry executives discuss how they are positioning themselves late in the cycle, while still exploiting pockets of opportunity in the US private real estate market. By Marine Cole

In the past 12 months, the US government has taken several major steps that have strengthened the overall economy and the private real estate market.

In December, the Trump administration passed its tax reform bill, providing perks to the business community and throwing more fuel on an already heating economy. Shortly after, it passed a generous spending bill. The result is a US economy showing signs of having reached a cycle peak, and an increasingly challenging real estate investing environment for some investors amid rising costs and falling returns.

A decade after investment bank Lehman Brothers filed for bankruptcy, it is difficult for the six participants gathered for *PERE*'s annual US roundtable not to consider comparisons with market conditions ten years ago.

"I am worried about the significant amount of debt capital available and if the supply imbalance changes the behavior of lenders"
Eric Wurtzebach

Risk-taking on the rise

Gathered around the table at Partners Group's offices in the Grace Building overlooking the Empire State Building and southern Manhattan are Michael Acton, managing director of research at real estate fund manager AEW Capital Management; Scott Brown, global head of real estate at investment manager Barings; Peter Merrigan, chief executive officer and founding partner of real estate investor Taurus Investment Holdings; Matthew Strotton, global director, capital, at retail real estate management firm QIC; Eric Wurtzebach, senior managing director at investment bank Macquarie's real estate advisory platform Macquarie Capital Real Estate Investments, and Ron Lamontagne, managing director and co-head of private real estate Americas at hosts, the private markets investment manager Partners Group.

"Everything is more late cycle than it was a year ago," says Acton. "Development costs are higher. There's less labor availability. Vacancy rates have really gone flat. Leverage is less accretive. Everything is very typical of late cycle."

> **"With the conventional product types, like apartments and warehousing, it's very hard to deliver the same returns that you were able to deliver two or three years ago so [investors are] trying to push into alternative classes or other things like that. I'm actually finding it to be very challenging"**
> **Peter Merrigan**

Indeed, construction costs increased for the 23rd straight month in September, according to the IHS Markit PEG Engineering and Construction Cost Index, due to more expensive labor and material. Meanwhile, office vacancy rates nationally remained at a cyclical low of 10 percent as of the end of July, according to data from CoStar Group. Cap rates, which fell to 5 percent in 2017 from a high in the past decade of 6.9 percent, are projected to remain mostly unchanged in 2018, according to data from the National Council of Real Estate Investment Fiduciaries.

"It seems like antigravity for the whole year," agrees Brown, citing yield compression and cap rates that have remained flat or have tightened. "Market correlations have also started to differ in the past year. Now you have to look very closely at local economies. It feels like we're back to local demand mattering."

The other major shift since a year ago has been the rising cost of borrowing. The Federal Reserve has raised its benchmark short-term interest rate eight times since December 2015 – including three times in 2018 – to 2.25 percent as of the end of September. With higher interest rates, borrowing rates have also gone up. The executives around the table agree this high price environment is pressuring equity returns.

Total returns on investments in core, unleveraged institutional properties are forecasted to go down in the years to come, from 6.5 percent in 2018 to 6 percent in 2019 and 5 percent in 2020, according to the NCREIF Property Index.

Inevitably, it is pushing some investors to go further up on the risk spectrum, according to the roundtable participants.

"I think the increase in the debt market in the last 12 months is causing people to actually chase returns a little bit more from our perspective," says Merrigan. "They've been a little bit spoiled. With the conventional product types, like apartments and warehousing, it's very hard to deliver the same returns that you were able to deliver two or three years ago, so they're trying to push into alternative classes or other things like that. I'm actually finding it to be very challenging."

Acton says some investors are even taking on more risk themselves.

"Also typical of late cycle is that you see more and more investors, particularly public plans, go in direct with the operators," he says. "They're under so much pressure from their own state legislatures, and they lower their fee base with that structure. Investors are taking that risk because a 6 percent return doesn't work for them."

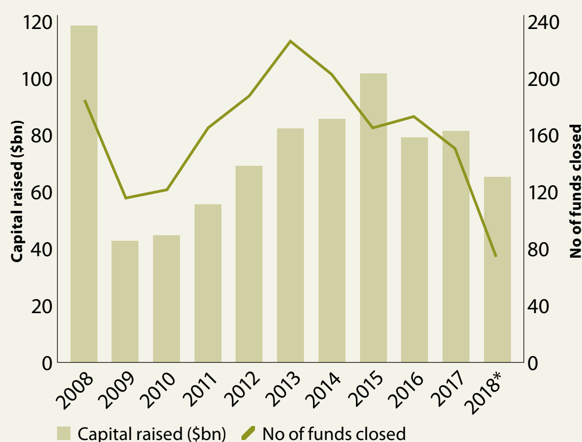
Investors are shifting strategies at this point of the cycle to take advantage of structural tailwinds. They are investing into asset classes with defensive characteristics like multifamily, logistics and niche real estate, such as manufactured housing and storage. Wurtzebach explains that investors are going into asset classes they are not familiar with that may offer more yield. Such investors are generally looking for cashflow coupled with good relative risk adjusted returns in less traditional asset classes, he says.

"While these asset classes may be new to some investors, I don't think they are necessarily riskier sectors and I think that a lot of these groups are taking the appropriate amount of time to understand asset classes they have not invested in before," Wurtzebach says.

Strotton agrees that now is the time to be more defensive and "maintain commitments in asset classes that give you those building blocks and protections against late-cycle volatility."

Meanwhile, Lamontagne notes that investors which used to focus on primary markets are now also moving into different geographies – secondary markets, for example, and markets ranking around 25-35 in the top 50.

"We're seeing players in these markets that we haven't seen



> **"You see more and more investors, particularly public plans, go in direct with the operators. Investors are taking that risk because a 6 percent return doesn't work for them"**
> **Michael Acton**

Scott Brown

Global head of real estate, Barings

Barings has more than $306 billion in assets under management, including $43 billion in real estate. The firm also invests in in fixed income, equities, alternatives and multi-asset strategies. Barings Real Estate, a part of Barings, actively invests across private equity, private debt, public equity and public debt. Prior to joining Barings in 2014, Brown was head of the Americas at CBRE Global Investment Partner.

Michael Acton

Managing director, research
AEW Capital Management

AEW invests across property types globally. With about $70 billion under management, including about $35 billion in the US, it invests in all strategies and also manages REITS. Acton joined AEW in 1990 and focuses on the firm's in-house research group, AEW Research.

Peter Merrigan

CEO and founding partner
Taurus Investment Holdings

Taurus is an investor and operator based in Boston with about $6 billion in real estate projects and $3 billion in assets under management. Merrigan founded the firm in 1997 and focuses on defining the overall strategy of the company and overseeing its execution.

Matthew Strotton

Global director, capital, QIC Global Real Estate

QIC is an alternatives manager based in Australia with five offices in the US. It invests in global private markets and manages about $20 billion in real estate assets. Strotton, who joined the firm in 2000, leads QIC Global Real Estate's capital markets strategy across Australian and US markets.

Not always riskier: Wurtzebach argues the case for certain alternative sectors

before," he says. "It's all about getting that good perceived risk-adjusted return. They're chasing [that] higher yield."

Some participants around the table express concerns about deal structuring practices. Wurtzebach mentions seeing large, multi-billion-dollar deals that are levered up to 80 percent, and where the sponsor has little skin in the game, relying instead on co-investors for the majority of the equity portion.

So far lenders and allocators have shown good market discipline, he believes. "However, I am worried about the significant amount of debt capital available and if the supply imbalance changes the behavior of lenders," he says. "Additionally, I am concerned by the potential behavior of certain equity investors at this point in the cycle. As deals get harder, GPs are pushing for more favorable terms from LPs. There is becoming a significant misalignment between GPs and LPs. When GPs are doing deals with very little co-investment, much of which is syndicated, coupled with high GP fees, the LPs end up bearing all the downside risk. I worry about transactions with these aggressive terms."

Retail conundrum

While these investing conditions are increasingly competitive and can be tough to navigate, the six executives around the table continue to see attractive opportunities to put their dollars to work and at the same time prepare for the next cycle.

This is especially true for Strotton. He says he finds this late cycle the ideal time for investors to take a step back and rethink the shopping mall experience, for example, as retail continues its structural transition.

"When we see capital markets reach this stage in the cycle,

Ron Lamontagne

Managing director and co-head of private real estate, Americas Partners Group

Partners Group manages $78 billion in assets, including $14 billion in private real estate. In the US, it focuses on value-add investing in the top 25 markets in multi-family and office properties. Lamontagne joined Partners Group in 2015 from GE Real Estate.

Eric Wurtzebach

Senior managing director Macquarie Capital Real Estate Investments

Macquarie Capital Real Estate Investments (MREI) has raised more than $64 billion of private capital for clients since 2003 and more recently has invested its own balance sheet capital to partner specialist real estate platforms around the world. Wurtzebach joined MREI in 2008 and now leads the group's North American team, focusing on principal investment initiatives and advising clients on accessing capital from the world's largest sovereign wealth funds and global pension funds.

we place greater emphasis on preparing our assets to be redeveloped, increasing our market position for the phase of growth," he says. "We plan to integrate and grow our program organically into the next cycle. At the same time, we would also look to acquire new stock. That's where we would redirect our energy as we see a potential shift in yields."

Strotton explains that new malls in the US will be more like town centers, going beyond shopping to include experiential dining, entertainment, health and wellbeing and other personal services, offering a more complete experience to consumers. "Retail in the US has taken a different path and stands now to evolve into the creation of dominant town centers that enhance the retail experience," he says.

"The US consumer is ready for this shift, and our communities want central locations to thrive beyond traditional retail. We have noticed this shift in preferences over the last 10 years. But therein lies the challenge. The way we execute the new town center experience is our challenge, and that's where we're devoting our time and resources. Our peers at Simon, Brookfield and Macerich think along these lines, and as a result you will see the retail sector evolve. While our growth in the US will come organically, I do think that it won't be long before the prospect of acquisitions will become even more attractive than what we see today."

Barings, for its part, has been busy lending in addition to buying and selling real estate.

"Generally, we spend a lot of time building multifamily, industrials, some office, some self-storage," says Brown. "We've been lending on all of those, plus on medical offices, senior housing and also transitional assets. We have also been a disciplined seller over the last four to five years, locking in strong exits and performance on our clients' behalf, and continuing to recycle the capital into attractive relative value investments. We've been a big buyer, but we have also been a big seller."

> **"Retail in the US has taken a different path and stands now to evolve into the creation of dominant town centers that enhance the retail experience"**
> *Matthew Strotton*

Overall, Brown says Barings has invested in a lot of value-add and development over the past several years, adding "we still like core, which we think is fairly priced," he says. "It's certainly very attractive to non-dollar denominated investors."

This mention of foreign investors in the US market leads to a short detour discussing CIFIUS – or Committee on Foreign Investment in the US – approvals and the lengthy review process that entails for buyers or capital from overseas.

The review lasts about 90 days and has derailed some deals. Barings has had client transactions undergoing CFIUS review that ultimately received the green light.

"We were selling a large hotel portfolio to a non-US entity," says Brown. "A CFIUS review was recommended. They were professional and the analysis is complex and can take every minute of the

Beyond the gateways: Nashville is an attractive market in the current late cycle

90 days available. It is a delay. But it was a unique transaction and we had a strategic buyer that was a good fit, so it remained a good fit 90 days later."

Tax reform boon

Back to discussing areas of interest in the market, Acton delves deeper into senior housing, which he says AEW has been actively building. "That's the one place where your stabilized return on cost is still a pretty wide spread. Cap rates on senior housing keep drifting down toward apartments, so it's still a good story. But you have to be careful because there are a lot of places in the US where there are a lot of senior housing projects being built."

> "We're 10 years in so fasten your seatbelts. I don't see data indicating that things are going to slow down much in the next 12 to 24 months"
> **Scott Brown**

He explains that AEW's work on senior housing has been mainly through joint ventures with operators. The strategy typically carries high rents, he explains, but AEW is also experimenting with different models. "We've done a program in New England with a JV partner where we're building units for two people sharing," says Acton. "They have their own bedroom, but they have a common area. You take the rate down by one-third of what it would normally be. Those programs are really popular from a financial perspective, but also from a social perspective."

Taurus, for its part, is taking advantage of US tax reform and considering raising a qualified opportunity fund, a new product created by the legislation to invest in qualified opportunity zones in the US's 50 states, all five territories, Washington, DC and Puerto Rico to spur economic growth in low-income housing in distressed communities.

It allows tax paying-investors to take a realized capital gain from any type of investment and invest it in a qualified opportunity fund under specific conditions. In connecting the program, Taurus is catering to its investors, which are predominantly family offices and high-net-worth individuals. "It's a big focus for us because of the mix of our clients," says Merrigan. "Exempts don't care, but families care a lot."

Acton is skeptical of the future impact of the government program on the market. "There was something similar in the tax reform in 1986 and it ended up being a disaster because of massive oversupply," he says. "To take the tax advantages you have to redevelop the property, so people were doing deals for tax reasons."

Apart from working on qualified opportunity funds, Taurus also focuses on value-add strategies.

"We're exiting everything that we've stabilized at this point and we're buying projects requiring extensive work," Merrigan says. "But we don't go way out on the risk spectrum right now. We are buying some vacancies, we're buying some challenges that we have to work through because that's our thing. But everything that we buy, we feel that if this cycle does come to an end, we'll be fine."

He explains that Taurus favors buying apartments, office buildings and warehouses, focusing on Class B, small multi-tenants in major markets such as Dallas, Atlanta and Chicago. In the last twelve months, it has bought about $600 million worth of warehouses. "It's a lot of heavy lifting, but we see ourselves doing another $3 billion or $4 billion of that in the next couple of years," Merrigan says.

The power of secondaries

Partners Group has also zeroed in on value-add office buildings, multifamily and industrial properties, particularly in markets ranked between seven to 25.

"That's where we find a lot of our opportunities," Lamontagne says. "We are not finding opportunities in gateway cities because of all of the foreign capital that has come into these cities, making the value-add return more like core returns. We find our opportunities in markets like Austin, Portland, Seattle, even Nashville, Raleigh and Charlotte, Orlando."

Partners Group is a primary fund investor and a secondaries investor in addition to making direct investments, which helps the firm source attractive transactions, particularly through fund recaps and joint venture recaps.

"We have strong relationships with operators and fund managers, which allows us to leverage opportunities, either in their existing portfolios that need to be recapped, or in their markets where it could be an off-market opportunity," Lamontagne says. "That's where we've been doing most of our deals. Eighty percent of our investments in these past 12 months has been either JV or fund recaps."

He explains that a typical fund, which initially had about 20 assets, might reach the end of its fund life with four assets remaining. "There's still value to be created, but they have to sell or do something," he says. In such a situation, Partners Group would recap the fund, providing a liquidity solution for the investors, restructure the fees, promote the fund managers and provide capital to support further growth of the remaining assets.

The firm has also taken more prudent measures to prepare for a potential turn in the cycle. For example, it contemplates a hold scenario of seven years in every analysis of potential investments in case the economic cycle changes. "We talk about that hold scenario at length to make sure we still have attractive returns if we need to hold it longer than five years," says Lamontagne.

Macquarie, meanwhile, likes manufactured housing, which Wurtzebach considers one of the sectors in the market that is only now becoming institutional and where significant arbitrage opportunities exist.

> **"We talk about that hold scenario at length to make sure we still have attractive returns if we need to hold [an asset] longer than five years"**
> **Ron Lamontagne**

"Manufactured housing, we absolutely love," says Wurtzebach. "It's low risk, supply is limited and the investment is straightforward. It's profitable, there's very little cap-ex, so a significant portion of any rental increase falls to the bottom line. That's a phenomenal asset class. I think it's a fantastic place to be on a risk-adjusted return basis."

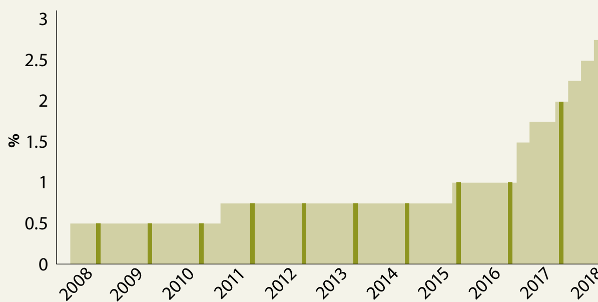
While the roundtable participants debate what could put an end to the current period of economic growth – from rising interest rates to increased volatility in the public equity markets – they also acknowledge that timing a downturn is impossible. The US economy is in the midst of the longest expansion it has ever experienced, and very little at this point signals it will come to an end anytime soon.

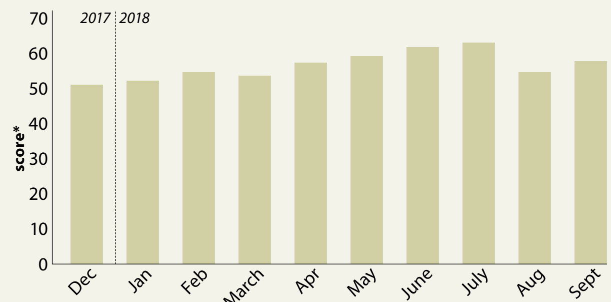
"We're 10 years in, so fasten your seatbelts," says Brown. "I don't see data indicating that things are going to slow down much in the next 12 to 24 months."

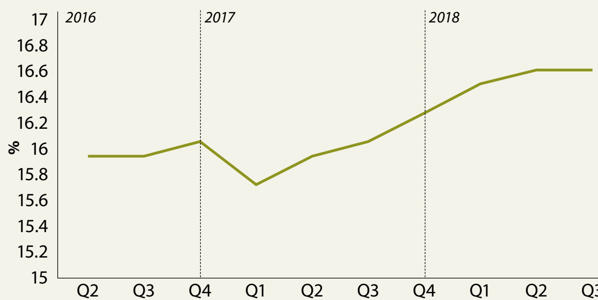
So at least for now, drawing comparisons with the period around the Lehman Brothers crash is proving a fruitless task – a worry in itself. ☐

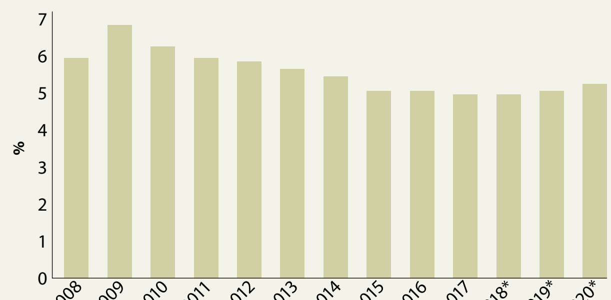
Bundle of nerves

PERE's roundtable is eyeing increasing rates, building costs, vacancy rates as well as cap rates for signs of trouble









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