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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS

## LAND OF PLENTY

Market pros discuss how relative strength keeps US real estate on top

# IT'S ALL RELATIVE

Six real estate professionals examine the merits of and opportunities in US real estate

Photography by Donald Bowers

# The power of relativity

Despite a spotty economic recovery and a brush with fiscal disaster, the US remains the top destination for institutional real estate capital, thanks to its relative strengths versus the rest of the world. By Evelyn Lee

(l to R) John Ferguson, Martin Brühl, Michael Levy, Mark Grinis, Pat Halter and Olivier Thoral

**The US roundtable:** while the US market continues to improve, investors need to be selective with their investments

Five years after the global financial crisis sent the world into a tailspin, real estate investing in the United States still is a long way from its go-go boom years. Indeed, the country's economic recovery in the ensuing years has been, and continues to be, modest at best.

This year, US gross domestic product has grown at an annual rate of just 1.25 percent, hampered by a prolonged budget sequester that now is expected to continue through September 2014, according to the International Monetary Fund (IMF). And there were even deeper fiscal troubles. As of press time, the country narrowly averted its first-ever default, with Congress approving an 11th-hour plan to fund the federal government and raise the debt ceiling through early 2014. The approval of the plan also ended a two-week federal government shutdown that went into effect after legislators initially failed to reach a debt agreement.

All of these troubles, however, have not kept the world's largest economy from remaining the top destination for institutional capital from around the world. Last year, the US attracted the strongest property investment volumes of any region, with transactions up 16 percent to $167 billion, according to a May report from real estate adviser DTZ. The firm also ranked the US as the most attractively-priced global real estate market, partly the result of lower bond yields.

The IMF, moreover, projected last month that the US will be the main driver of global growth, bolstered by accelerating economic activity amid a recovering housing sector, higher household wealth and a less-stringent bank lending environment. The US gross domestic product, meanwhile, is projected to grow 2.6 percent in 2014 – higher than any of the other G7 countries, the seven wealthiest nations in the world by global net wealth.

## Absolute versus relative

While the US real estate market still can't be described as robust, its appeal comes from being better positioned than other regions of the world. "On a global basis, if you are looking for a large, developed institutional market with some growth, the US is one of the best places to look at on a relative basis," says Olivier Thoral, head of North America at AXA Real Estate Investment Managers. "On an absolute basis, things could be much better."

Michael Levy, global chief operating officer and chief financial officer at Morgan Stanley Real Estate Investing, agrees. "We live in both an absolute world and a relative world," he says. The growth and stability of the US marketplace continues to attract real estate capital from around the world, potentially in excess of last year's expectations, he adds.

Meanwhile, the country has seen a greater influx of foreign capital as investors grow more comfortable with cross-border real estate activity. "The sort of home-country bias that we've had over the last four or five years definitely is dissipating," notes Pat Halter, chief executive officer of Principal Real Estate Investors. "For example, UK investors, who always were challenged to get to the US, are looking for additional exposure here. And Australian investors are starting to look at different parts of the world and the US again."

Martin Brühl, head of international investment management at Union Investment Real Estate, says the US remains a safe haven and has outperformed the global economy, in line with his firm's investment criteria to invest in markets that are considered outperforming economies. He adds that the transparency and the sophistication of the US market are unparalleled.

"This is top notch," Brühl says. "This is something for the grown-ups, nothing compared to what you see elsewhere in the world."

Such a comment leads Mark Grinis, global leader of real estate fund services at Ernst & Young, to quip: "What's the number one thing most sought after by opportunistic investors? Lack of transparency, bad information, confusion, distress – that's the catnip for an opportunistic investor."

Taking on a more serious tone, however, Grinis notes that an investor's interest or appetite is measured by the amount of capital they commit to a marketplace. Investor allocations to opportunity funds have remained at fairly predictable levels, generally in the $50 billion to $65 billion range annually, over the past few years.

"I'm waiting to see allocations increase to really provide the evidence that there's a vote of confidence that we're really doubling down to some extent in the US marketplace," Grinis says. "After three or so years of pretty steady levels of commitment, you can build a case that those allocations will start to go up in the near term."

**Research Park Plaza, Austin:** A Union investment

## An uneven recovery

What's important to note about the US economy is that the recovery has not taken hold nationwide; rather it has been limited to certain areas of the country. "The economy seems to be gaining momentum and things are getting better, but I think there is a dramatic underlying seismic shift that's happening as well around a much more technology- and services-focused economy," says John Ferguson, co-chair of the real estate private investment funds practice at law firm Goodwin Procter. "This time, everything does not seem to be uniformly getting better the way it may have in past recoveries."

Indeed, unemployment continues to be a challenge for the overall US economy, but job growth has flourished in cities where thriving local industries such as technology, energy, healthcare and education have served as economic drivers. While Houston, Dallas and New York are among such growth markets, other large cities such as Los Angeles and Phoenix still are only at about 40 percent to 50 percent of peak employment growth prior to the global financial crisis.

"We have to be careful not to make broad statements in terms of the growth, but there are pockets that are growing quite nicely and cities that will accelerate their future growth as the economy improves," says Halter.

Grinis, however, points out that it's not just where the growth is occurring, but when it is occurring, that has an impact on real estate investment opportunities. He cites the concept in the US of the 'rolling recession', where economic growth – or lack thereof – follows the movement of the talent pool throughout the country. "I once asked a top-tier homebuilder, 'How did you survive the big oil bust?' He said, 'I moved'," he recalls. "From an investment strategy perspective, you're going to have to move if you are going to stay out in front."

## A pickers' market

Meanwhile, the issue of rising interest rates continues to loom over the US real estate market. Although the IMF projects that the Federal Reserve will not initiate an interest rate hike until 2016, many investors already are thinking ahead. The shift in US monetary policy from ultra-accommodating to less accommodating will put pressure on investors to focus on real estate assets that can outpace interest rate growth, explains Halter. For Principal, this means investing in assets that will have pricing power, rent growth and occupancy level increases to offset the impact of rising interest rates.

"It is much more of a pickers' marketplace now to find those well-positioned properties that are going to outpace this challenge of interest rates ultimately moving upward because of the shift in monetary policy," Halter says.

Indeed, successful real estate investment now call for not only choosing the right market but the right properties within those markets. "It's less the case that people can be successful just on a macro level, picking a market and having that market float everyone up," says Ferguson. "Within the particular markets, you really need to get down to the dirt. That's a trend that I've seen coming out of the crisis."

The evolving US interest rate policy will lead some investors to be more careful about the transactions they make, adds Thoral. At the same time, those investors will be more focused on real estate fundamentals, particularly income growth and leasing activity at a property.

"It's about cash flow creation and growing that cash flow in real estate," says Halter. "It's about sweating the details – finding ways to reduce expenses, hiring the best people to lease the properties and positioning the asset into the competitive marketplace."

## One step ahead

While the US economy is recovering and expected to continue to improve, pricing of assets already has rebounded. "The capital markets are actually one step ahead of that," says Brühl. "There are instances where pricing already reflects the growth without the actual rental growth being there."

It will be difficult, however, for the economy to catch up to the growth already reflected in low capitalization rates, and the lack of correlation between interest rates and cap rates may become problematic for property owners. According to Grinis, with both interest rates and the cap rate spread at historically low levels, a significant move in interest rates will not be able to keep up with a 150 or 200 basis point movement in the cap rate.

"The economic growth will not be there," Grinis says. "For those that have long-term debt at low interest rates, time will be an ally. But for those that have to refinance in the near term very quickly, it could be problematic."

An interest rate hike also could be a concern for the rental growth of properties with long-term leases. "Assets with shorter-duration leases can re-price and recalibrate their rental rates and stay closer to the movement of interest rates," says Halter. "If you have a credit tenant on a long-duration lease with limited or no built-in rent escalations, that's not going to feel good in a rising interest rate environment."

An expectation of rising interest rates goes hand-in-hand with the expectation of inflation. Property sectors that typically have shorter lease durations – including multifamily, hotels, student housing and self-storage – stand to benefit from an inflationary environment, notes Levy. "Those shorter-lease asset classes may provide greater levels of inflation protection, and that is a more interesting discussion today than it was a year ago."

### Mark Grinis
Global leader of real estate investment funds services
Ernst & Young

Grinis is a partner in the real estate group of Ernst & Young's New York office and leads the real estate private equity practice globally. A 28-year veteran of both the firm's real estate transaction advisory and audit groups, he assumed global leadership of the real estate funds practice in 2010 after serving as head of its real estate distressed services group.

## Moving up the risk spectrum

In many cases, low capitalization rates in core markets have led more investors to expand into secondary markets in search of higher returns. "There clearly is a search for yield occurring, so investors are starting to move into secondary markets," says Halter. "There is more liquidity in those markets now, debt is more available and leverage is accretive because of that." Many investors now are broadening their scope from the top five or six markets in the US to the top 10, 15 and even 25 markets, he notes.

Of course, the appeal of secondary markets depends a great deal on the type of investor and their strategy. "If you're a core investor, one of the very long-term investors or a core fund, you may have a continued singular focus on the top markets and the best assets," says Levy. "As an opportunistic investor, your objectives generally are a bit more ambitious and you may go more out on the risk spectrum in terms of tertiary markets or even development."

Halter, however, is quick to point out that views on secondary markets also differ somewhat between US and foreign investors. While domestic players may be more willing to venture beyond the top 15 cities in the country, "foreign investors have been very clear about not going beyond their comfort zone," he adds.

Brühl, for example, sees the appeal of enhanced-return strategies, but Union Investment is restricted to managing to core because of the negative external rating the manager would receive for having vacancies in its property portfolio. At the same time, the firm has adopted a secondary cities strategy in the US, focused on half a dozen markets outside of the main gateway cities.

"This is not rocket science," says Brühl. "This is what you do when, in the very core, it gets too hot, too expensive. For a return, you move out."

For example, with the help of Metzler North America, the Seattle-based subsidiary of German bank Bankhaus Metzler, Union Investment Real Estate recently invested $103 million in Research Park Plaza III and IV in Austin and is looking for additional quality assets outside the usual gateway cities.

## Shifting into development

Meanwhile, sourcing higher-risk, higher-return investments in the US real estate market has proven to be more of a challenge than initially anticipated. The hundreds of billions of dollars of equity opportunities that were expected to arise from the massive gap between values and debt levels following the global financial crisis have not materialized. "The lending community has worked with the borrowers to effectively recapitalize the asset without creating that opportunity for the market in general," explains Levy.

"If you're anticipating distress in the US, you're going to wait a long time," adds Grinis. Vintage 2008 distress occurred when asset prices and risk perception were significantly mismatched.

### Patrick Halter
Chief executive officer, real estate
Principal Real Estate Investors

Halter is the chief executive officer of Principal Real Estate Investors, the real estate investment arm of Principal Global Investors. As head of real estate, he is responsible for overall global real estate strategy, new business development and business management, including overseeing staff in the US, Europe, Asia and Australia. He joined the firm in 1984 and has held various posts within the real estate group.

## Olivier Thoral

**Head of North America**
**AXA Real Estate**

Thoral is head of North America for AXA Real Estate, one of the largest real estate portfolio and asset managers in Europe. Based in New York, he is responsible for growing new business opportunities for the firm in North America, as well as coordinating its US activities and clients. He joined AXA in 1999 and served as the firm's head of opportunistic funds and global head of corporate finance before being named North America head in late 2010.

Today, however, equity capital is readily available to help recapitalize the owner or asset, while borrowers also can more readily obtain debt, he explains.

The lack of distress has instead driven more capital into development. "That's the most interesting thing in the past 12 months in the US real estate markets," says Levy. "There's limited value through distress, and therefore the opportunity is in development. That's what characterizes the US market today."

The fundamental risks associated with development – ranging from the entitlement process to construction to leasing – have not changed significantly in the last 10 or 20 years, Levy notes. "If you are pursuing enhanced return, opportunistic or value-added strategies today, development opportunities certainly are more interesting because there are less other stabilized asset opportunities that will underwrite to the return profile that you're looking at," he says.

Even within development, there are varying levels of risk, Halter points out. On the very conservative end of development is build-to-suit, which involves construction risk but has a tenant in place. On the other end of the spectrum is speculative development, where a property is being built with no tenant on hand but with the expectation there will be demand for new space once the building is completed.

In fact, new space is a hot commodity for tenants. Nationwide, much of the absorption is occurring in buildings that are less than seven years old, according to Halter. Moreover, developing high-quality properties has proven to be most attractive in markets where properties are trading at prices above replacement cost. "That's where development started to make sense because you can compete relative to the marketplace," he says.

Moreover, developing in high barrier-to-entry markets also may a smarter bet than building in cities where entitlements are easier to obtain, adds Levy. He points to a number of markets where real estate demand remained strong even during the financial crisis. "Those markets are the first markets to attract capital for development and may be safer than some of the other more commoditized markets, where entitlement processes are simpler," he says.

### Not all created equal

Investing in the US, of course, requires capital, but what has become apparent about the local fundraising environment is that not all of the investors in the market are the same. For example, while AXA Real Estate continues to raise funds, the firm also is gathering capital through joint ventures or club deals with investors that are seeking greater control over their investments.

"It also depends on the risk profile," Thoral says. "If you are investing in opportunistic strategies, you're more likely to give control to the GP because that's the smartest way to make the right decisions. If it's a less risky transaction, a number of investors believe they are better off with strengthened management teams in-house than dealing with various managers."

In response, fund managers need to better adapt to investors' changing needs. "Across the world, institutional and high-net-worth allocations to real estate are increasing materially, and it is up to us as an industry to work with those investors to develop structures and vehicles and investment opportunities," says Levy.

Adds Halter: "The sort of push strategy of just putting products out in the marketplace is no longer a viable strategy." What's more, the discussions that managers are having with clients and potential investors is very different today, as such talks no longer are focused solely on real estate, but how real estate fits within other alternatives and as part of a broader investment portfolio, he explains.

### Back to funds

At the same time, institutions also have shifted the way they have committed to real estate over the last several years. Two

## Michael Levy

**Global chief operating and chief financial officer**
**Morgan Stanley Real Estate Investing**

Levy is the global chief operating and chief financial officer of Morgan Stanley Real Estate Investing. He currently is responsible for the financial and operational activities of the division, which includes portfolio management, capital markets, risk, regulatory and other infrastructure activities. Levy, who joined the firm in 1998, also serves as portfolio manager for the firm's seventh global real estate opportunity fund and leads investor coverage and capital markets efforts across its alternative investment businesses.

or three years ago, many investors were setting up separate accounts or club deals as they pushed for more control, Ferguson notes. Meanwhile, traditional commingled funds with GP discretion fell out of favor.

Over the past year or so, however, commingled discretionary vehicles have seen an uptick in commitments, as some LPs have found that they missed out on investment opportunities that were available while they were negotiating vehicles offering a higher level of investor control or while part of vehicles that have less ability to execute quickly, Ferguson explains. Consequently, fund managers have been able to attract some separate account and club investors back into commingled vehicles again.

"It's sort of a rebound of the fund model, if you will," says Ferguson. However, sponsors that have been successful raising capital overwhelmingly are those that have a pipeline or access to deals, he notes.

Investors also have become savvier about investments as funds reach their harvesting stage. Ferguson notes that some limited partners in opportunistic vehicles have expressed interest in staying in the now-stabilized assets rather than having them be sold off after a value-added stage, as typically would be the case.

Still, fundraising remains a challenge, especially as many investors are maintaining or reducing the number of manager relationships and instead are making broader allocations with current managers. "That's a bit of headwind in terms of fundraising today," says Halter. Additionally, "there is a lot of capital they already committed that's not closed yet, so some are not seeking out new endeavors."

Interestingly, market players don't anticipate regulatory changes, such as the lifting of the general solicitation ban under the Jumpstart Our Businesses Act, to make fundraising efforts more challenging in the US. "In a way, it's better today than a year ago because at least the rules are now clearly stated," says Thoral, referring to the adoption of Rule 506(c), which eliminates the solicitation ban on private offerings, in July. However, he doesn't see the regulatory change boosting his firm's fundraising efforts. "Frankly, an advertisement is not how you would convince a pension fund's CIO."

From an investor perspective, regulations have even less impact. "Private institutional investors have looked at the marketplace and adjusted their allocations on what they are comfortable with, in spite of any regulation or oversight," adds Grinis.

### John Ferguson

**Partner and co-chair of real estate private investment funds practice**
**Goodwin Procter**

Ferguson is co-chair of the real estate private investment funds practice and partner in the business law department at Goodwin Procter. He represents a wide range of clients in forming private investment funds, partnerships, joint ventures and other structures, as well as in acquisition, financing, restructuring and disposition deals. He started at Goodwin Procter in 1998 and was named partner in 2005.

### Martin Brühl

**Head of international investment management**
**Union Investment Real Estate**

Brühl is head of international investment management at Union Investment Real Estate and is responsible for managing the German firm's real estate investments in the UK, the Americas and Asia. Prior to joining Union Investment in May, he was a longtime managing partner at Cushman & Wakefield, where he was in charge of the real estate services firm's business operations in Germany and from 2007 was part of the firm's European management team.

## Strategically bullish

Despite the tepid economic recovery, the general outlook on the US real estate market is the strongest since the global financial crisis. "The historical perspective jades a lot of our ability to look forward and clouds our vision because it's still relatively fresh," says Grinis. "But I think if you look at all of the risk factors that have been present, they have diminished to a great degree and I think it's really a time to be strategically bullish."

One such strategically bullish investor is Union Investment, which plans on deploying a sizable amount of capital in the US over the next three years. "The biggest challenge for me and my team is to actually invest significantly and diversify outside the Eurozone and Germany," says Brühl. Despite the vastness of the global investment landscape, the number of core markets that offer transparency, liquidity and proper business conduct are limited.

"Because we're core investors, we're herd animals and we need to have assurance that other members of our herd already are there," Brühl says. "So the globe actually shrinks to quite a low number of markets where we can diversify intelligently out of that focus, which we currently have in Germany and the US."

For Brühl, "wisely and intelligently" are the operative words to describe Union Investment's real estate strategy in the US. "I always think the best deal in the world is the bad one we don't do," he says. ◻

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