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Investment and development behavior following the Great Recession

Raymond G. Torto

Abstract

Commercial real estate is capital intensive, and managers operate their businesses to serve the expectations of capital: to invest in and develop commercial real estate. This chapter investigates the operations of the global commercial real estate (hereafter, CRE) investment management business within the context of the changed environment of investing and developing into CRE since the global financial crisis and the subsequent Great Recession.

The chapter documents the changes in the market along with changes in the operations of CRE investment management. These changes have been observed by the author and have been corroborated with interviews with senior professionals in the CRE investment management business.

The chapter draws out the implications for market performance from the changes in the investment management business operations. While it is clear to this writer that the industry has moved from a deal-making culture to a business operational culture, aligning its interests with its institutional clients, targeting to minimize risk rather than reach for performance, it is ironic that the pricing in the market is pushing these same managers to take on more risk today.

The interesting and unanswered question, from the point of view of the market for commercial real estate, is what will be the amount of supply coming to market due to this change in investment strategy. Will it follow the traditional path of a building/construction boom which was the case when development was financed by lender capital? Or will equity capital, provided through the vehicle of CRE investment management firms, be more tempered in financing new development? Of course, time will tell.

Introduction

In an industry that is capital intensive, such as commercial real estate, the quantity, expectations, and behavior of the capital sources are paramount. “Capital sources” in this chapter are institutional capital, which is usually sourced from pension funds, sovereign wealth funds, insurance companies, etc. The dimensions of this behavior are usually captured in metrics such as transaction volume, asset pricing, investment structures, return expectations, holding period, investment
strategy, etc. Generally lost in these details is how investment managers operate their businesses, as opposed to their choice of investments, to serve the expectations of capital: to invest in and develop commercial real estate. Importantly, investing in and developing commercial real estate have different return and risk profiles, and therefore are not one and the same goal.

This chapter investigates the operations of the global commercial real estate (hereafter, CRE) investment management business within the context of the changed environment of investing and developing into CRE following the global financial crisis and the subsequent Great Recession. The chapter is divided into several parts. The first section compares the commercial real estate market as of the end of 2015 to the market pre-2007. This section is followed by several sections that provide a comparison of the management of assets or investment management of CRE and how investment management has changed since the Great Recession. The final section pulls the lessons together to analyze the prospects of an emerging “bubble” and a subsequent “bust” in CRE. As we entered 2016, the issue on most minds in the industry was whether CRE was priced too high, and therefore, the market on the edge of a bursting price bubble, or as many phrase the question “will we do it again?” In other words, will the CRE industry bid prices too high leading to a price bubble that will subsequently burst!

**The commercial real estate market**

By the beginning of 2016, the CRE market had recovered significantly from the Great Recession. As shown in Figure 5.1, global transaction volumes, as measured in dollars, had almost recovered to the level last seen in 2007, with some shift in underlying volume by region (Real Capital Analytics 2015a). Volume was very strong in North America (Canada, United States, and Mexico) while the dollars invested in Asia were down significantly, reflecting the fact that the number of development sites being sold or bought in Asia (particularly China) was down significantly. European investment volume was up 23% in 2015 over 2014, with more caution reflected in the market as the year ended. The fourth quarter volume was about 6% lower than in the fourth quarter of 2014. However, London, particularly Central London, which is the top market in volume and pricing in Europe had an increase of 30% in 2015 (Real Capital Analytics, 2015b, p. 9).

This decline or shift as to where transactions were being globally undertaken mirrored the changes seen since 2007 in the economic prospects of the regions/countries and also the degree to which investors decided to make defensive decisions: judgements to invest in existing properties versus develop new properties.

In addition to volume having rebounded since 2007, prices in the CRE sector were generally above the peak levels of the earlier period. In addition, prices were growing faster than rents (Figure 5.2), and did so with pronounced strength in 2010 and 2011 when investors eschewed development in favor of buying existing assets. The faster growth in prices, in contrast with market rents, reflects the volume of capital in the market for existing properties. In the United States several indices reached new heights. The Moody’s/RCA Commercial Property Index increased 14.7% year on year (Y0Y) in 2015 and extended its streak of double-digit annualized gains to 34 months. The CoStar value weighted index increased 12.2% through November 2015 and by the beginning of 2016 was 18.4% above its 2007 prior peak. The equal weighted index, which reflects pricing for smaller properties, gained 11.7%, but remained 4% below the 2007 peak.

This phenomenon reflects the investment priority of capital in the early part of this recovery. Capital was invested in “safe” or core assets, defined as assets with attributes such as credit
Figure 5.1  Global transaction volume
Source: Real Capital Analytics, 2015a

Figure 5.2  Global capital and rent indices
Source: Real Capital Analytics, 2015a
tenants and good locations. With many investors having the same priorities, prices of these core assets rose quicker than assets in general as many investors were motivated by safe assets, i.e. looking for downside protection. This was reflected in comparative yields or capitalization rates for core vs non-core assets, where rates for core assets were lower.

With volume and prices above 2007 peak levels, some observers have raised concerns that CRE is in a “bubble” again, i.e. that prices are unsustainable, and that this bubble is about to burst and prices will decline precipitously. These observers maintain that the CRE industry has not learned the lessons of the Great Recession and, hence, will repeat the mistakes of the past (Allen 2015).

There is no doubt that the amount of capital looking to invest in CRE has ballooned over the last several years. There were 492 funds in the market as of the end of 2015, and in 2016 Andrew Moylan, head of real assets products for Preqin, suggested “investor demand for real estate remains considerable, and the strong fundraising seen in 2015 is expected to continue well into 2016,” although he predicted there would be some “softening” in 2016 (Preqin 2016).

This international money has multiple motivations: higher returns in CRE, diversification for the portfolio, money into another currency or country, among others. Some in the industry are concerned that this money/capital will bid up prices, in order to gain/acquire a long position in the CRE market, and at prices that will be unsustainable. Prices will become frothier and debt on these assets will not be supported by the operating income of the assets, nor by the ultimate values after the expected decline.

Prices have been bid higher. But if it is frothy, it is happening due to an abundance of equity capital, not debt capital. For instance, a closer look at the debt side of the market does not show a high level of loan to value ratio. For example, the data for the USA – the largest CRE market in the world – shows that loan to value ratios are in the 66% range (Real Capital Analytics 2015a) versus 70% in the 2006/7 time period (Figure 5.3).

Also supportive of pricing in 2016 were the fundamentals of the market – the relationship between the demand and supply of space. Because of the Great Recession, all supply channels for new property were halted for several years following 2007/8. It took time for the demand side of the market to recover and even more time for supply to respond as excess capacity needed to be reduced first. At the beginning of 2016, the supply/demand relationship in the leasing market was fairly balanced with vacancy levels stabilizing and rents rising in many markets. The fundamentals implied steady or rising net operating incomes (NOI) and suggested support for the high prices in the market. Of course, this statement is not true universally. As one example, the Houston market was hit with the oil supply glut, and the reduction in that business’s demand for space, just as several new office buildings were entering the market. In 2016 Houston vacancy rates were 16.5% up from 12% in 2015.

The commercial real estate investment management business

The overall investment management business has shifted over the years as documented by Matthew H. Lynch, CEO of UBS at the Advanced Management Program in Real Estate at the Harvard Graduate School of Design, July 24 2015. Overall, portfolios have grown but there is even faster growth in alternative asset classes, of which CRE is one alternative. The reason for the shift to alternative assets is that the returns were better in alternative assets: in 2014 alternative assets were 30% of industry revenue and 12% of assets (Lynch 2015, p.8) (see Figure 5.4).

According to the Tower Watson Global Alternative Survey 2015 (Tower Watson, 2015), direct real estate funds accounted for about 33% of alternative assets under management and were projected to grow quite handsomely through 2020. With strong direct CRE investments, the
Figure 5.3  US CRE loan underwriting
Source: Real Capital Analytics 2015b

Figure 5.4  Alternative investments have grown twice as fast as traditional investments since 2005
Source: ANREV/INREV/NCREIF 2015
large fund managers turn out to be larger, capturing more investors and funds. The top ten managers saw growth of 12.9% YOY for 2014 and they control US$790 billion or 36.5% of assets under management (AUM). The top 10 CRE managers as of 2014 are listed in Figure 5.5.

Not only are CRE managers growing in size, but also their client base is changing. Based on a 2014 survey the majority of the client base was institutional and pension fund orientated, as shown in Figure 5.6, and this trend continued in 2016. A 2016 survey by BlackRock, who polled over 170 of its largest institutional clients, representing US$6.6 trillion in assets under management, found that 47% of their investors were increasing their allocation to real estate in 2016 while only 9% were reducing allocations (Duffell 2016). The authors of the survey noted that investors were shifting into “illiquid assets” as they reduced their allocations to equities and were looking for “alpha generating opportunities that match their liabilities.” It is of note that this shift into liabilities is long term. As we will argue in the last section, this shift in focus is having an effect on the management philosophy of CRE firms, and by implication on the market for CRE.

The post-Great Recession real estate investment market

Following the Great Recession, the investment market in CRE saw early risk takers return to the market in earnest and volume, beginning in 2011. The focus at that time was on buying existing assets, not new development. The early focus on existing assets meant that real estate development across all property types and all regions was limited, especially in North America and Europe. There was little excess supply of existing space but nevertheless there was limited equity or lending capital for development. Some limited development was undertaken in parts of Asia, where some emerging economies were recovering fastest from the Great Recession and prime quality assets were in short supply. In such markets, only through development could
tenant demand be met, but even here, much foreign equity capital was repatriated for several years following the Great Recession.

They invested mainly into existing core assets, which are thought to have a combination of good location and credit tenants and are therefore safe assets, investment structures, and locations. As a result, asset values rose in urban areas, but not in the outer locations as equity capital avoided the less popular and less populated cities. This pattern was particularly evident in the USA and the UK as cities such as New York, San Francisco, and London had a plethora of buyers that did not venture to the outer regions of these metros. As prices of core assets reached record levels, and yields were low, equity capital began investing in 2015 in areas outside the larger metros and in assets with more risk than found in core assets.

One data point to support the above conclusion is from London and the rest of the UK (Real Capital Analytics 2015b) where the data on development site sales in the UK is shown in Figure 5.7. The data shows that as we moved into 2015, more development sites were transacted outside London than in earlier post-recession years. Additionally, development site sales in the UK, both in London and outside London, were equal to or above pre-2008 levels.

As the focus on buying existing assets was driving prices higher, equity capital and investment managers recognized that the price of existing core assets was higher than estimated development costs – i.e. replacement costs – and these managers started to ask: “why buy it when we can build it cheaper?” Slowly, investment managers began shifting their strategy from core existing assets to adding value, or put differently, from buying existing assets to developing new assets.

The development incentive today is not only driven by the price of buying existing assets versus building assets but also by tenants shifting their preferences for space amenities and locations. This shift makes some existing assets and existing locations obsolete (Peiser and Torso 2015). Most particularly, tenant preferences are changing with regard to location and design. Users want fundamentally different environs and appear less price sensitive. In the former category is the desire of many housing tenants to find areas of density and proximity to work and play, and in the latter category are the changes dictated by how work is defined. As one
observer has noted: “work is not where you go, but what you do.” Both of these factors are changing what is a viable investment for the long term and are changing land use policies and obsolescence rates for commercial real estate assets.

As we have shown above, following the Great Recession, the CRE investment management industry grew, with growth coming from a client base of new institutional investors, whose investment horizon is long term, not short term.

**Investment management**

There have been changes in the market along with changes in the operations of the CRE investment management business since the Great Recession of 2008/9. The above sections note some of the changes in the CRE market, while this section will identify the changes within the business operations of the CRE investment management firms. These changes have been observed by the author and have been corroborated with interviews with senior professionals in the CRE investment management business. There are implications for market performance from the changes in the investment management business operations, which will be discussed in the next section.

We would categorize the changes in the operations of the investment management business as follows:

*Globalization* – prior to 2008, probably 10% of the clients of large investment managers were global capital. Now, over 50% are global. This requires investment managers to go beyond their country borders as global capital sees fewer borders and boundaries for investing their funds.
Additionally, we are seeing global capital “clubbing-up” with other large scale investors or investment management firms to buy scale and diversity. This means they are considering bigger investment deals as a means to deploy large capital blocks with like-minded partners. Investment management firms need to keep pace and this is reflected in further growth of the largest firms.

Due diligence – there is more requirement for a thorough due diligence as regulations require that new clients as well as the seller or buyer of properties go through a due diligence background check. For example, in the USA, the Office of Foreign Assets Control requires a representation and warranty from the investment management firm that the client is not on the terrorist list. This requirement has certainly added to costs through overheads and time and is another factor leading to larger sized investment managers.

Fees – the fees that investment management firms can charge – assets under management (AUM) and performance-based fees – continue to drop. Fifteen years ago, asset management fees were around 200 basis points (bps). Now they are closer to 50bps and for large investors fees are in the 35bps range. Investment manager’s payments put more weight on the “back-end” performance instead of the annual AUM fees.

Returns – there has been a significant change in client return expectations. Internal-rate-of return-driven capital has seen expectations forced steadily downward since 2009. And with yields compressed over the last few years due to central bank policies, there seems to be acceptance of “low yields for longer.” This has changed investment strategies, which we will discuss in the next section.

Technology – there continues to be dramatic technological change in the investment management operations making the business more efficient. Reports and offering memoranda are prepared electronically for clients and accessible on the internet, and it is no exaggeration to say that “everything is in the cloud now.” Fast networks and wireless connections, video conferencing and large screen videos allow group reviews of deals and more interactions. As one interviewee noted: “Not sure we are better investors or sellers, but definitely faster and can use less people to do more.”

Governance – CRE firms now have a Head of Compliance, who has to review many aspects of the business operations, including all external presentations. There also are strict rules and regulations on tracking internal information. For example, investor reports must itemize affiliate fees and there is an abundance of footnotes! There are also independent members on the Investment Committee whose vote on investments is theoretically not biased or based on fees earned. All together these changes have added significant staff to compliance and legal (not to review deals but to make sure things are done correctly and engage outside counsel properly).

Conversations with investment management professionals indicate that the above items are unblemished changes in the operations of the investment management business. However, a number of observers noted that the institutional changes, the search for good governance, among others, were in the air prior to the Great Recession and just continued and intensified subsequent to it. We do not think it matters when this shift in the industry started, but rather, what impact has or will this shift have on the current and future CRE market?

Evidently, investors are looking for good government, transparency, and long-term investments. This is different from earlier periods when investment managers were measured only on performance. Today’s capital sources expect several professional, distinguishing attributes in their investment managers. For instance, they expect their managers to have policies for succession planning, policies for maintaining depth on their bench, and compensation procedures that align interests and motivate staff. Along these lines, the Global Real
Estate Standards Board was brought up by interviewees, and it was noted that Environment, Social and Government (ESG) policies and data supporting such are requested in all client Requests for Proposals. It is “good governance and performance today, that is important, not just performance” noted one interviewee. Another noted that the strategy of his firm, which has been very successful, is threefold: “to de-risk, de-risk, de-risk” implying that less risk is paramount to higher returns.

Conclusion

The above begs the question as to why the industry has changed. Some argue that it is transitioning from “deals” to “structure” because of the nature of the clients and their demand for an “institutionalization” of the industry. But others, while acknowledging that institutionalization has played a role, emphasize that “regulation” has also been an important factor. As one observer put it: “Partly the institutionalization of the business, but to a large extent the vast array of new government/regulatory mandates. The new rules have definitely had an impact.”

While it is clear to this writer that the industry has moved from a deal-making culture to a business operational culture, aligning its interests with its institutional clients, targeting more to minimize risk than reach for performance, it is ironic that the pricing in the market is pushing these same managers to take on more risk today. Initially, these managers served their clients by focusing on existing core strategies, looking for “safe/core” investment assets. But since this is a crowded strategy, prices of these assets have moved above replacement costs, and investment managers realize that they can achieve better performance by developing property, rather than buying assets. One example of this shift is the actions of the California Public Employees Retirement System (CalPERS) in the spring of 2016 to formalize a “build to core” strategy, which would allow “for the creation of new core assets in markets that offer limited opportunities to acquire existing assets” (Peterson 2016). But, of course, development has more risks – construction risk, leasing risk – associated with it than does buying an existing asset.

The interesting and unanswered question, from the point of view of the market for commercial real estate, is what will be the amount of supply coming to market due to this change in investment strategy. Will it follow the traditional path of a building/construction boom, which was the case when development was financed by lender capital? But in today’s market the lending capital is sparse, and the lending regulators are raising capital requirements and are watching CRE markets very closely, remembering well the past boom/bust cycles in commercial real estate. Will equity capital, provided through the vehicle of CRE investment management firms, be more tempered in financing new development?

Of course, time will tell, but the view in the CRE industry is that CRE has a lot more equity backing it than during the last cycle where high leverage was the norm. Additionally, loan underwriting today is not nearly as aggressive as was the case during the last cycle. Regulatory pressures are increasing, capital requirements for banks are making it harder to lend in the secondary market – all of these factors are making lending a bit harder and more expensive as well. And together these factors should keep development in check as well. Furthermore, the CRE market is a lot more transparent than it was in earlier cycles. There are more independent research firms following pricing and fundamentals, and more media following CRE and asking tough questions. If the market shows weakness it will be fully reported and I would expect this will feedback quickly to the investment management boards and clients. In this environment, firms will not be chasing deals as much as managing risk, which is foremost on the minds of the long-term investor clients, and therefore on the minds of those managing CRE investment firms.
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