Chicago – August 2016

NAREIM HUMAN RESOURCES MEETING

NAREIM

National Association
of Real Estate Investment Managers

NAREIM Human Resources Meeting
August 4th, 2016

REAL ESTATE IS REALLY ABOUT PEOPLE.

"The most valuable of all capital is that invested in human beings."
– Alfred Marshall

Real estate is about raising capital and acquiring assets. It's about managing portfolios and hitting target rates of return. This all goes without saying. But underneath all that, and above it, and in-between it is people. The real assets of a great investment platform are not the buildings, or the portfolios, but rather the people that invest in and manage the assets.

At a time when the industry is experiencing a dramatic generational shift of human capital, the economy is also experiencing volatility and even, perhaps disruption. The need for the best human capital has never been greater, nor more difficult than it is now. That's why human resources leaders from NAREIM member firms gathered in Chicago this August – to better understand and prepare for meaningful change.

What is the Economy Really Doing, and What Does it Mean for Real Estate?

"There are some scary headlines out there in the press," said Lucy Fletcher, Managing Director for JLL, in her introduction. "Issues in China affecting the stock market, low oil prices which have had some significant effect on petro-based capital, and a negative interest rate environment. We had Brexit, which no one thought would happen. And then there is, of course, the Hillary Donald situation." But how is all this doom and gloom impacting the economy? "In our tracking of all transaction volumes across all real estate classes, we have seen a 10% decrease year on year for the first half of the year." That may be cause for concern, but Mrs. Fletcher is not worried. "We are still significantly above where we were coming out of the last down cycle." So even though there is quite a bit of turmoil in the world, real estate across the board is simply plateauing momentarily, rather than declining. "Last year was an exceptional year and if you strip some of the outlier transactions out of the comparison, you are likely to see closer to a 2% difference."



“Investors are trying to buy into the market and sellers are expecting too much from them.”

Lucy Fletcher
Managing Director at
Jones Lange Lasalle

However, markets are based largely on perception and investor sentiment rather than statistics, and Mrs. Fletcher sees a disconnection between the perception of the sellers and the sentiment of the buyers. “Investors are trying to buy into the market and sellers are expecting too much from them.” With the influx of foreign money, especially from the east, the perceived worth of real estate is quite a bit higher than most on-shore investors think it should be. Despite this fact, the US was firmly in first place on the list of most traded regions in the first half of the year, with New York City leading the way. London came in second. “The US is the largest most transparent real estate market in the world and so it will continue to dominate.” Eight or nine years ago you would have seen quite a few cities in Asia on the list but they have dropped. An interesting change on the top 20 list is from secondary US markets. “Cities like Philadelphia, Dallas, and Denver are new appearances.”

There is one inherent problem with secondary markets, however attractive they may seem at the moment: future demand. Consider a rare $200 million property in Cincinnati, OH that has a long term net lease. Many offshore investors would basically look at this investment as akin to a corporate bond. Guaranteed income on a class A property with all operational expenses covered by the tenant. Sounds good right? Consider what would happen if that tenant was Xerox, or Kodak. These are huge successful businesses that held similar leases in secondary markets, however they failed to adapt. As a result of disruptors they had to downsize significantly and move. How many potential lessees are available in Cincinnati that can, or would want to, take over a lease that massive? Maybe three? And how long would it take to re-lease? This situation saddles the investor with an albatross that may not see positive NOI for multiple quarters if not years. So there is a considerable amount of risk associated with large transactions in secondary markets that would not be present were the investments in primary markets.

Such risk is present in a healthy economy, but even greater risk is present in an economy about to take a turn for the worse. “There is a seismic shift back to primary markets this year because people can smell another downturn,” says Fletcher, “and while New York and San Francisco would fall off a cliff if there was another Great Financial Crisis, they would also bounce back more rapidly than anywhere else.”

"If I had to point to one thing that marks the difference between successful and unsuccessful compensation strategies, it's communication."

Josh Anbil
Senior Managing Director at FPL

"The first two quarters have not seen the increases that we saw last year so you have to assume the earnings will reflect that."

Michael Pekkarinen
Associate Partner at McLagan

Do We Need to Re-Think Compensation?

"Many of the real estate companies that are currently operating were started in the 80's by people in their 30's and 40's," says Josh Anbil, Senior Managing Director for FPL Associates. "There is a generational shift happening as they reach retirement age." As the second tier of management is taking over and the so-called "dinosaurs" are moving out, the philosophy around compensation is changing. "Historically, real estate has been old fashioned in the way it compensates people," claims Anbil. "We are still playing catch up with other industries." The old way is much more seniority based while the new way is based much more on merit. The Millennials are coming and they are pushing for much more communication in how they get paid. "If I had to point to one thing that marks the difference between successful and unsuccessful compensation strategies, it's communication and a big part of that issue relates to transparency." The days of arbitrary bonuses doled out by senior management based on perceived merit are waning. "Now is the time for HR to step up and guide the new crop of managers. And you have a unique opportunity in that existing senior management knows you well and is more willing to listen." The next generation needs direction and HR directors are in a perfect position to positively influence the future of compensation structure.

"There are many who are concerned about the future at the moment but we are cautiously optimistic. Earnings are up," according to Anbil. Furthermore, managers have been keeping a larger share of those earnings in the pot. "Compensation was up as well but the increase in earnings was disproportionally larger than the increase in compensation. So people are being conservative."

Ten years ago most companies were consistent in their performance. Today this is not the case. "There have been clear winners and clear losers. The top 10 firms have raised 70% of all capital. The little guys have to either specialize or really fight to stay where they are." The rich are getting richer and the big are getting bigger. "You're going to see more separation in performance and capital raising and you're going to see more separation in compensation."

Another revealing trend is emerging in hiring. "Things are pretty calm right now. There is movement but we are starting to see some flattening. At the top levels it's quiet." This is usually an indicator of things to come. Companies are bracing for a downturn, but it seems that economists have been planting the recession seed for a while now and companies have been watering it, but that darn thing just won't sprout. Recession or no recession, "we are getting into a slow period that is going to affect pay."

Last year was good for wage increases at the top of the food chain. According to Michael Pekkarinen, Associate Partner at McLagan, "We saw some opportunistic and acquisitions people paid very handsomely. We are talking 20-25% increases year on year." This presents a problem though. "What do we do for an encore? What happens next?" Should we set bonus targets so that there is some grounding in reality when these large bonuses occur? Without them many people will benchmark last year's number and expect an increase the following year. After a year like 2015, they are probably going to be disappointed. "The first two quarters have not seen the increases that we saw last year so you have to assume the earnings will reflect that."

"Starting in 2015 the EEOC has started to include sexual orientation as a protected class."

Jessica Brown Wilson
Partner at FisherBroyles

Regulatory Policy Has Changed. Are We Changing With It?

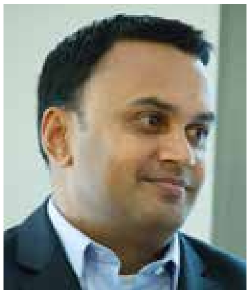
There are some new regulations that are changing the way we compensate people as well. "The issue that I am focused on is proper classification," commented one member, "we have too many people who are exempt status." The problem here is that most employees would rather be exempt and not have to deal with hours. The fact that you cannot offer exempt status to potential new hires makes an open position slightly less attractive. In addition, changing someone's existing salary status could result in them going elsewhere.

"The salary threshold has changed dramatically," according to Jessica Brown Wilson, Partner at FisherBroyles, "as of December 1st there is an increase in what constitutes the minimum salary to qualify as exempt for overtime wages. Last year the minimum salary was $23,660 to be considered exempt from overtime wages, this year its $47,476." So that will have a palpable effect on who qualifies.

Discrimination legislation is changing as well. "Starting in 2015 the EEOC has started to include sexual orientation as a protected class," says Wilson. The case law has not yet adopted the EEOC's view that sexual orientation is protected from discrimination in employment, creating a strange grey area where a gay or lesbian employee "could get married on Saturday and fired on Monday because of orientation." While there is no current federal law creating sexual orientation as a protected class that must not be subject to employment discrimination, "this issue will probably appear before the Supreme Court within the next 12 month and you do not want to be the test case." So should employers include sexual orientation as a protected category in their written policies? At a minimum all employers should be doing anti-harassment and sensitivity training for employees (especially and including managers). "This is happening, and it's happening quickly." People are not satisfied with having the token diverse member anymore. Along with the fast changes in the law, investors are looking for actual diversity.

"To have an exciting work environment that is full of energy you need to allow people to take risks."

LeAnn McCrum
Global Strategic Manager at Development Dimensions International, Inc.



"We spend hours and hours talking about investing in properties and investing in companies but we cannot do that effectively if we do not invest in ourselves."

Dave Kutayiah
Head of HR at Clarion Partners.

How Do We Find The Best Talent?

The old real estate adage goes, "if you can't buy it, build it." But does that apply to people as well? Is it better to build a strong leader and hire from within? Or is it more effective to hire strong leaders from outside the company. "Many people complain that people promoted from within their own companies do not perform well when placed in senior positions," says LeAnn McCrum, Global Strategic Manager at Development Dimensions International, Inc. "Even the most optimistic outlooks show that only 47% percent of potential positions can be filled by people from within a given company." For whatever reason, talent pools don't really work. But why is that? "When you're thinking about growing more leaders faster, the status quo is the enemy. Many people simply tweak existing practices and hope that will fix the problem. Generally this only results in incremental change." However, when you have a major hole to fill, incremental change doesn't cut it. Simply promoting your best employees isn't always the right answer because people who are promoted into jobs they feel ill equipped for or uncomfortable doing will tend to move on.

But why are they ill equipped to begin with? Risk. "To have an exciting work environment that is full of energy you need to allow people to take risks." The best and brightest in your company may have the talent to lead at senior levels, but have they been allowed to take risks in their decision making throughout their journey? Have they been able to act with a healthy amount of autonomy? "People need to have the opportunity to undertake growth challenges."

It stands to reason that if you let people lead small, they will be able to lead medium. If you let them lead medium, they will be well prepared for leading big. Coddling employees, micro-managing, and never allowing risks to be taken or mistakes to be made is a sure way to grow non-leaders. No technology or company process will be able to take the place of the lessons taught by a good leader who allows little mistakes to avoid the big ones. According to Mrs. McCrum, "Leaders grow leaders."

"We spend hours and hours talking about investing in properties and investing in companies but we cannot do that effectively if we do not invest in ourselves," according to Dave Kutayiah, Head of HR for Clarion Partners. "We as HR professionals need to stay ahead. We need to stay relevant. To that end, we should focus just as much energy on growing ourselves as leaders as we focus on growing the leaders of our companies."

"The Cloud is nothing more than someone else's computer. It's that simple. Anything you're putting there is not really yours anymore."

Mike Pappacena
Managing Director at
ACA Aponix

What Should HR Do About Cyber Security?

This is a very big issue at the moment. With phishing scams, credit card fraud, and seemingly endless stories about people and even our government getting hacked, cyber security is a major concern. Despite tech company's claims that any information stored "in the cloud" is encrypted and protected, that information seems to be plucked from the ether very easily. Whether it be sensitive photos of celebrities or entire rosters of public sector employees and service members, it doesn't seem very secure. Mike Pappacena, Managing Director for ACA Aponix (a risk and cyber security firm) thinks he knows why, "The Cloud is nothing more than someone else's computer. It's that simple. Anything you're putting there is not really yours anymore. You're essentially giving your information to someone else to hold on to." The SEC is paying attention to this phenomenon. The consequences of a breach are fairly dire so the SEC isn't really policing the hacks and leaks. They are more interested in company policy. "How many of your companies have a written security policy that includes more than just the acceptable use of electronics?" Asked Pappacena. "And if you do, how many of those policies are actually enforced?" The SEC is also concerned with vendor management. "You have to look at the policies and practices of any vendor that is going to touch your data." Their policies have to be at least as robust and comprehensive as yours are.

"We have a really high threshold at Clarion," according to Dave Kutayiah, "Safeguarding of data is something we actively think about and practice. We regularly conduct mock "phishing expeditions" internally and use the results to strengthen our infrastructure as well as educating our employees. This requires the right technology tools and engaged technology professionals." This is forward thinking prevention and exhibits an unusually high level of follow through.

"What we see in most firms is a loosely written policy, and very little enforcement," according to Pappacena. Clarion may have a hard time finding vendors who are equally as fastidious.

“Companies need to have formal training programs to teach people about phishing awareness, phishing testing, and password policies,” says Pappacena. “How many people write their passwords down? How many people keep their passwords in their phones? We see people who keep a word document called ‘passwords’ on shared drives. That is not very secure.” There are apps available specifically designed to protect and encrypt your list of passwords. “A good one should allow you to create the key and should time out to protect you if you close the phone but not the application.” But how should someone create a strong password? “Having 10 different passwords doesn’t mean much if your passwords are chicago1-chicago10.” There are only three ways of identifying yourself: “Something you know: a birthdate, a mother’s maiden name, etc. Something you have: a key card, magnetic fob, or driver’s license. Or, something that you are: your DNA, an eye scan, or a fingerprint.” It’s best to utilize two forms of identification at all times.

Screen protectors should also be used on laptops and phones to mitigate the curious eye of a stranger. “I was sitting on a plane behind a person with a 17 inch laptop who was staring out the window while her Citi-Bank statement was on the screen.” That information was personal but how many times have you worked with sensitive data on an airplane? Or looked at documents on your phone on a train? Could someone know that you are out of town by looking at your Facebook page?

The methods that should be included in any SEC compliant company policy are fairly simple, they are largely inexpensive and they will protect you from 99% of the “wide-net” phishing scams and breeches of opportunity. If someone targets your company and decides to wage a full scale hack war on your firewalls, there is not much you can do to protect against that. But those are fairly rare occurrences on the grand scale.

This is a time of extreme change. We are seeing it everywhere from geo-politics to social issues and from financial sources to energy sources. Jobs still need to be done, but they need to be done better and by people that actually represent the demographic tapestry of the country. Those that are at the helm need guidance along the way, and the investors who contribute their fuel to our fires need assurance that senior management is capable and their investments are sound. HR is a source of guidance and intellectual capital. “Immense change presents us with immense opportunity,” says Gunnar Branson, CEO of NAREIM. “Maybe now those diversity programs can be more than just lip service. Maybe now we can start really investing in people and investing in leaders rather than just sending them off to some leadership course. These things have to happen, and now is the time.”

The HR department of any corporation is more than just a means to vet resumes and offer candidates for hire. A good HR department is an agent for change and at the same time an agent for stability. “HR needs to be more visible to investors,” Branson asserted, “because you are more important to them than even they may understand.”

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

312.884.5182
www.nareim.org