Atlanta – February 7th, 2017

NAREIM ACQUISITIONS & DISPOSITIONS MEETING

NAREIM

National Association
of Real Estate Investment Managers

NAREIM Acquisitions & Dispositions Meeting – February 7th, 2017

LIVING WITH UNCERTAINTY: INVESTING IN A NEW ERA OF CHANGE.

"The only thing that makes life possible is permanent, intolerable uncertainty; not knowing what comes next."
– Ursula K. Le Guin

"It is perplexing how we might achieve 4% growth with all this talk of cracking down on immigration."

Brian Bailey
Senior Financial Policy Analyst, The Atlanta FED

The first few months of 2017 have been remarkably positive, and yet most investors are anxious about what might happen next. More than eight years into an economic recovery, with core markets seemingly priced to perfection and capital aggressively moving into secondary and tertiary markets, it is difficult to feel entirely comfortable. At the same time, changes in real estate demand and an unpredictable political and regulatory environment make it difficult to know what will happen tomorrow to the deals made today.

Perhaps it's time to be cautious. Perhaps it's time to examine assumptions. Perhaps we need to prepare for the unexpected.

NAREIM acquisitions and dispositions professionals gathered at the Mandarin Oriental in Atlanta recently to discuss approaches to uncertainty. Here are some of the insights shared.

Where are we in the economic cycle and can we find more growth?

The longer a recovery lasts, the more economic growth is challenged and the more pressing the cycle question becomes. Brian Bailey, Senior Financial Policy Analyst for the Atlanta FED, discussed his point of view on growth and the economy, "there is a lot of talk about: Can the government really get the economy to 3.5 or 4% growth?" It is remarkably difficult to create economic growth without population growth and yet, "the US population is currently growing by .8%. 60% of that growth is driven by immigration. So it is perplexing how we might achieve 4% growth with all this talk of cracking down on immigration."

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Andrew Flint
SVP of Enterprise Sales, VTS

"How much management time is taken up just trying to find the information you need?"

Diane Vrkic
CEO, Waypoint Building Group

"Another major factor is unemployment," said Bailey. There are two ways to look at this: Those who are registered for unemployment, and those who are actually unemployed. "I tend to like the broader view because if you work one or two hours a week you should not be considered employed." The broad measure of unemployment, referred to as "U6," counts those who have given up and also those who have multiple part time jobs but would like a full time one. "We make the assumption that the economy was fully employed in 2007. We were at 8.4% then, and today we are at 9.2%. So we are fast approaching that 'fully employed' level."

However, when one looks at the employment picture at a more granular level, it is difficult to be sanguine. "At the county level, 17-18% were experiencing negative job growth as of April 2016." Many of these counties were in the south/southwestern regions and therefore can be connected to low energy prices. "However, if we look at September of 2016, 36% of counties show negative growth." The rise in job losses are no longer focused in the oil regions; they are spread more evenly around the center of the country. "The headlines tell us that the economy is continually adding jobs, but if the negative growth area continues to expand that would indicate that we are nearing the end of the cycle."

Consumer debt, as always, is an important place to look for stress in the system, and can become a drag on any potential uptick in growth. "Seriously delinquent mortgages are way down compared to three or four years ago where we had rates of 12 or 13%." This can give some confidence that we are not headed for a significant correction soon but recessions are not only caused by a failure of the housing market. If a bad oyster led to your last case of food poisoning and you might avoid shellfish in the future, but that won't guarantee you will never get sick again. Are there other consumer debt indicators that might provide a meaningful signal? "Auto loan delinquencies are way up," according to Bailey. "This is not what I would expect to see when we are so close to full employment. There is a group of consumers – many of whom do not have home mortgages – that are feeling a pretty significant amount stress at the moment and that can have a fairly drastic effect on the market." At the same time, "as we get further and further into the cycle, more and more risk is added into the market." Lending activity is accelerating and more aggressive debt offerings are appearing.

Politicians can promise 5% growth all they want, but given where the economy is right now, it will take quite a lot to get there anytime soon.

"We were closing a lot of deals right around the election but there was definitely a slow down of in-bound."

Raphael Fishbach
Principal, Mesa West

"The year started off well, but there is a slowdown."

Melissa Frawley
SVP, Wells Fargo

Will data transform how we invest?

Quite a few companies might be able to change the relationship of real estate and data. Andrew Flint, SVP of Enterprise Sales for VTS pointed out, "we have always had tons of information, but accessing it in a way that is quick and effortless has been a problem." Data driven applications like VTS, are starting to make big data a reality for commercial real estate by tackling different parts of the investing and managing process. "Our clients currently manage over 5.5 billion square feet of space with our app. When you buy a building, you're putting huge assumptions on each unit: What can I rent this for? What will be the downtime? What concessions will we have to give? We give you access to the day-to-day leasing activity so you can compare them to your budgets. Lease expiry, deal velocity, demand for sq. footage, etc. VTS lets you benchmark your own portfolio." All of this is delivered instantly on a smart phone.

Diane Vrkic, CEO of Waypoint Building Group, discussed a bit about how a database of detailed operational and property level data can provide financial benchmarking, real-time data driven decisioning, and insight into acquisitions and dispositions opportunities. "How much management time is taken up just trying to find the information you need? And what might happen to the quality of your decision and investment process if you can learn from your own data?" A more accurate and real time data picture of how a building works, as well as the demand picture you can access through a group like VTS, might actually allow investors to start uncovering value – and risk – in places never before considered.

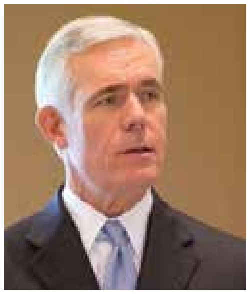
How have the debt markets responded to uncertainty and a change in the white house?

The impact of the election on debt markets has been mixed so far. "We were closing a lot of deals right around the election," said Raphael Fishbach, Principal at Mesa West, "but there was definitely a slow down of in-bound." Over the past months, everyone is trying to figure out what this all means for the future. "If you had told me last year that Trump would be president and the Cubs would win the World Series, I would have laughed you out of the room." But markets have been steadily rising and breaking record after record, "The deal flow has started to pick up again."

"The year started off well, but there is a slowdown," according to Melissa Frawley, SVP at Wells Fargo. "Here in Atlanta we've seen significantly fewer construction loans especially in multi family. We probably closed 15 in 2015, we did 3 last year, and this year there are none in the pipeline." The only discernable excess in commercial real estate has been multi family construction. But has the decrease been due to lack of interest from developers? Or have banks been turning away deals. "It's both really."

"[Equity guys] are weighing how heavily to invest in the uncertain future, if at all."

Steve Pack
Director of Commercial Real Estate, Deutsche Bank Securities, Inc



"Real Estate prices really flattened 18 months ago, but most people just didn't see it."

Mark Gibson
CEO & Executive Managing Director, HFF

"We are hearing that a lot of the equity guys are reevaluating how to effectively put out the last portions of a given fund," commented Steve Pack, Director of Commercial Real Estate for Deutsche Bank Securities, Inc. "They are weighing how heavily to invest in the uncertain future, if at all." This is not to say that everyone is pulling back immediately. "There are still great opportunities out there," but they are being vetted with cautious optimism, to put it optimistically.

"In 2017 there should be ample liquidity," said Mark Gibson, CEO & Executive Managing Director of HFF. "Real Estate prices really flattened 18 months ago, but most people just didn't see it." So if a deal was on the table for $100 million a year ago it was probably priced above its actual worth and wouldn't close. "We'd get brokers calling back to check in and sure enough, it would come down." This is what's known as a rebound call. "Rebound calls started in mid 2015 and escalated throughout 2016." This doesn't mean that prices are falling per say, just that they are plateauing. "But it still effects the psychology: Why would I bid now if I know you're going to call me back?" Alarmingly, there were no palpable price increases in 2015. "Come the beginning of 2016 a lot of people thought the recession had started." But it hadn't yet. "We are in a period of price discovery right now."

Future technology might already be here. What do we do about it?

"There is a resurgence of domestic manufacturing going on and that is having a profound effect on commercial real estate," claims Michael Brennan, Co-Founder and Chairman of Brennan Investment Group. But this is not the manufacturing of the past. Robots are already taking over. "We are now living in the 'Third Industrial Revolution.'"

"I own 225 industrial buildings. I have walked the floors of every one and every tenant is automating. This is eating into China's competitive advantage and has already caused 300+ companies to re-shore." Another implication of this robotic advancement is, "mass customization." The first industrial revolution was the advent of machines "this was hand and machine, cotton mills for example." The second was the mass synchronization of machines, "think Henry Ford and the assembly line." The Third, and current, revolution is based on mass customization, "It's the antithesis of Henry Ford. Now you can have anything you want." All revolutions are bloody but "this one will not be bloody in a classic sense, the blood spilled here will be jobs."

“I own 225 industrial buildings... every tenant is automating.”

Michael Brennan
Co-Founder and Chairman,
Brennan Investment Group

“Manufacturers have always moved to the lowest cost area.” Any city you look at has rings of old industrial space starting close in then moving farther and farther out of the city center to the suburbs then the exurbs as manufactures moved out to less expensive areas over time. “China is just the most recent ring.” Recently the lower-cost advantage of a manufacturing center on the other side of the globe has evaporated. Accelerating the pull back, consumer and business trust of China and their manufacturing culture is quite low. Their apparent disregard for consumer, worker safety, and IP laws adds to the risk, and ultimately the cost of staying there.

So if the cost of Chinese manufacturing keeps going up, trust keeps going down, and thousands of unskilled workers are replaced by robots and a few highly skilled technicians, it becomes more efficient to locate manufacturing as close as possible to the consumers in cities. There may be quite a bit of demand for new and old industrial space in the US – developers may even wonder some day why so much good industrial space in Brooklyn was converted to high-priced housing and retail.

So what will happen with our current economic cycle? How much time is left? What will happen to interest rates? Capitalization rates? Demand for space? Technology? Regulations?

At the moment, the only certainty is continued uncertainty and change. We don’t know what will happen next, but it will undoubtedly be interesting.

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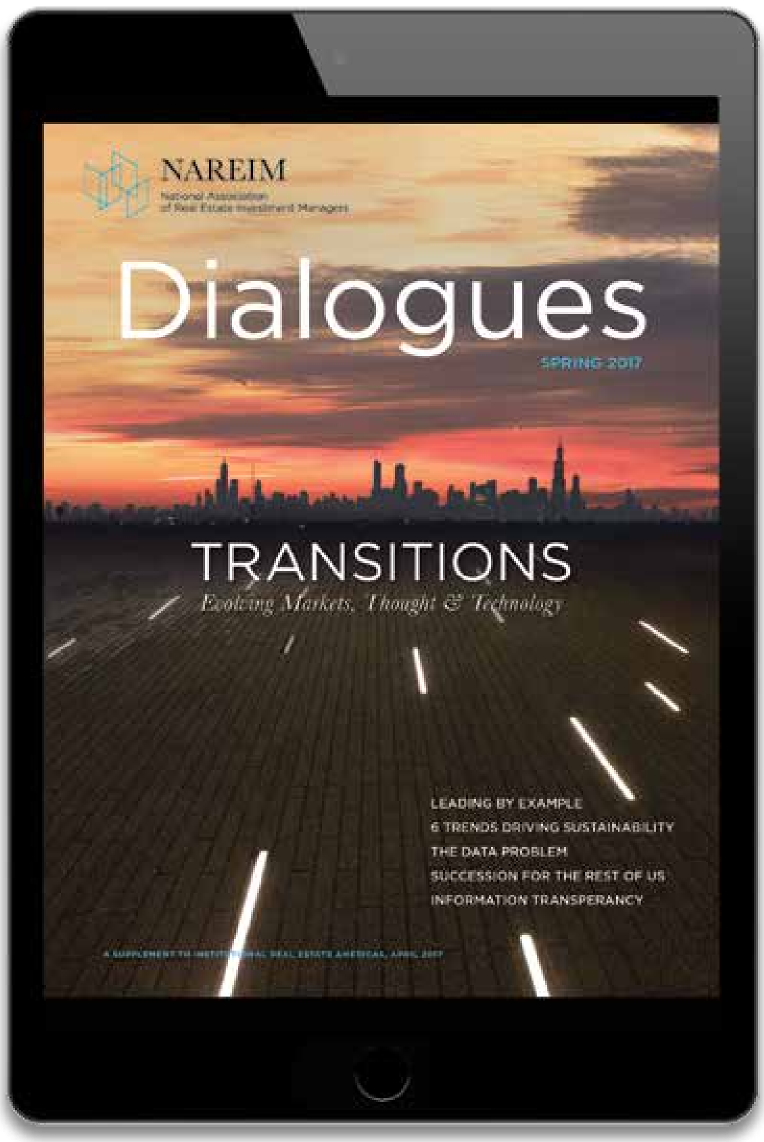

ABOUT NAREIM

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.

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