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NAREIM dialogues

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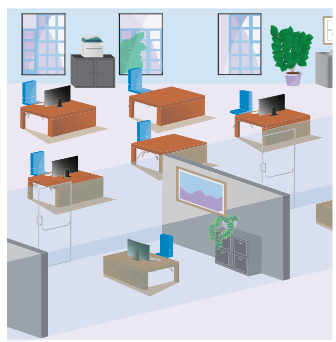
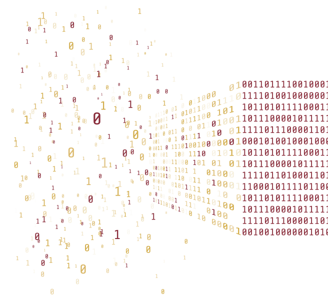




Zoe Hughes, CEO

Today, we say thank you to all of our Inclusion & Diversity committee members, including committee chair, **Kristin Renaudin** of Stockbridge, and vice chair, **Reisa Bryan** of Nuveen Real Estate. Thanks also to: **Anne Peck,** AEW Capital Management; **Alexandra Williams,** Barings Real Estate; **Justinn Wheatley-West,** BentallGreenOak; **Jennifer Licciardi,** Berkshire Residential; **Erick Harris,** Blue Vista; **Stuart Bernstein,** CapRidge Partners; **Dave Kutayiah,** Clarion Partners; **Kathy Briscoe,** Dermody Property; **Tyler Scheppman,** Dermody Property; **Helen Rivero,** Gemini Rosemont Commercial Real Estate; **Sally Stocks,** Invesco Real Estate; **Deena Goodman,** PGIM Real Estate; **Ken Dubas,** Principal Real Estate Investors; and **Corey Turner,** Waterton Associates. Thank you.

"Real change, enduring change, happens one step at a time." In 2018, during the filming of the documentary, *Notorious RBG,* Ruth Bader Ginsburg argued that societal change — "enduring change" — takes time, with many steps along the way.

It was a philosophy that Ginsburg embodied every day of her life. Despite knock backs and outright rejections, she persevered, taking one step at a time until she made it to the Supreme Court of the United States.

Achieving diversity is also about taking one step at a time.

As an industry, real estate investment management is not diverse. In 2019, NAREIM data showed 16% of executive management were women while just 4% of men and 2% of women at executive leadership levels were Asian-American or African-American.

We have certainly improved. In 2017, just 12% of executive management were women. That's a 33% increase in two years.

Is it good enough? No. Is it a step in the right direction? Absolutely.

Today, there are powerful initiatives — including work by associations such as PREA and SEO, as well as among investment managers themselves — focused on building diverse pipelines of talent. We all need to support these efforts and collaborate together to spread the word about the opportunities this industry can provide to people who don't even know it exists.

But we also need equal focus on inclusion.

There is little point spending time and valuable capital finding and hiring diverse talent if you then fail to retain them because they don't feel included, heard, or worse, valuable to your organization.

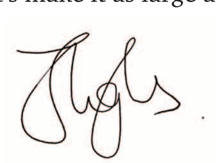
That makes inclusion paramount. It's one reason institutional investors are increasingly asking to see data on turnover of diverse professionals within organizations.

Inclusion is about the embrace of diverse perspectives or, as CalSTRS' Mike DiRé and The World Bank Pension Fund's Christina Scarlato describe in this issue of Dialogues, diversity of thought. Having diversity of thought in the investment process makes you a better manager, fiduciary partner and investor of LP capital, they said. It makes the team better able to respond to the evolution of, and revolution in, commercial real estate property types and markets.

The added benefit of a focus on inclusion is that it doesn't just benefit diverse professionals. It benefits everyone within a firm. Who doesn't want to be listened to and engaged with? It is one reason why, from today onwards, NAREIM is calling its work and committee on the issue 'Inclusion & Diversity.'

Of course, there's a lot of work still to do and many steps to take in the months and years ahead. NAREIM would not be able to do this without the expertise and time of the members helping shape its strategy now and for the coming years on inclusion and diversity.

And to all reading this column, remember that while Ginsburg said enduring change requires one step at a time, she never said what size the step had to be. Let's make it as large as we dare.



Change *is* coming

To bring about real and lasting changes, efforts need to be purposeful and happen not only inside the firm, but also within the industry. **Reisa Bryan** *of Nuveen Real Estate and* **Kristin Renaudin** *of Stockbridge speak with NAREIM about the need for diversity and inclusion in the industry, how to improve recruitment and retention, changing investor attitudes, and what steps organizations can take to move forward.*

By Zoe Hughes

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Reisa Bryan
Managing Director,
Global Chief Operating Officer
Nuveen Real Estate

In her current role, Reisa Bryan leads all business planning, business management and business project coordination globally. She is a member of the Global Executive Leadership and the Americas Executive Leadership teams, serves as the Chief of Staff to the Global Head of Nuveen Real Estate, and is the central point of contact for senior leaders. She began her career at TIAA 20+ years ago where she became a Director of the national contact center overseeing a team of 400+ registered representatives across the US.

Kristin Renaudin
Chief Financial Officer
Stockbridge

Kristin Renaudin is responsible for directing Stockbridge's finance and operations activities, as well as having active involvement in the overall strategic planning and direction for the firm. During her 22 years with Stockbridge and its predecessor firm, she has held various responsibilities across departments, including acquisitions, client relations, capital markets and portfolio management. She has been involved with the underwriting, evaluation and structuring of numerous real estate acquisitions and capital markets transactions.

Why is D&I so important to you? Why do we need to change?

Reisa Bryan, Nuveen Real Estate: I'm a black woman, I'm a mother and I'm a daughter. As I've been reflecting on the last few months of going through this social unrest, what continues to resonate for me is, I have two children. I have a 14-year-old daughter and an 11-year-old son. I think that they both deserve a society that will give them a fair chance. That's why I fight for this. I am giving them all of the tools and resources they need to be successful and all I ask of society is to give them a fair chance. Additionally, I'm also cognizant of the fact that others may not have access to similar resources, but still deserve a fair chance at success as well.

Kristin Renaudin, Stockbridge: I couldn't say it better than Reisa did. I have two girls and a boy ages 11, nine and seven. As much for the boy's perspective as the girls', I want our kids to understand the importance of diversity and the impact of opportunity. I hope they mature into a world without preset barriers.

As our industry becomes increasingly global, the ability to connect with people from different backgrounds, geographies and perspectives is fundamentally important to success. How do you measure success? I measure success primarily based on relationships and connectivity to those around me. I think that will be increasingly important to our children.

ORGANIZATIONAL EFFORTS

Where does your firm stand with D&I?

KR: At the start of the year, we discussed the steps we were hoping to take both internally and as an industry — to reinforce why diversity is important, what steps we can take to advance our efforts and how to measure our success over time. Consistent with our peers, our efforts have accelerated over the last few months with the BLM movement and social unrest. The circumstances have pushed diversity and inclusion to the forefront of discussion. As an industry, it's important to turn this energy into more than a passing moment.

As a firm, we're focusing on what we can do in the near term to educate ourselves and take action. This includes formalizing our diversity and inclusion policy, facilitating unconscious bias training for our workforce, and broadening our recruiting efforts.

From a long-term standpoint, we have to think about, first, how to bring diversity into the workplace, and second, how to motivate and retain diverse talent. If we look at gender, socioeconomic or racial diversity, oftentimes there is a tremendous lack of candidates across the already established talent pool in our industry. In this unfamiliar Covid-19 environment, it may seem easier to prioritize candidates with the greatest experience or most similar background given the potential challenges with virtual onboarding. But, as an industry, we need to prioritize efforts to recruit, train and retain the next generation of talent from among more broadly represented populations that have been traditionally underserved in real estate.

Alongside our broader ESG efforts, we've established an internal diversity taskforce which is evolving into a formal D&I committee. Our diversity task force is led by one of our partners, working with a senior vice president and four to six other professionals. The D&I committee will have broad representation from all of our functional areas and offices, with strong support from our senior management.

We are also doing specific outreach on direct initiatives. For instance, our Atlanta office is working to develop a pilot initiative with a local organization to help reach kids at the high school level. We hope to attract new talent to real estate at this early age and provide a foundation to allow individuals to stay within the industry as they develop their careers.

Reisa, where is Nuveen with D&I?

RB: There's a lot of overlap with Kristin in terms of what our organizations are doing. Compared to our peers, I'd say we're ahead of the curve with 45% of our leadership team represented by females and 11% ethnically diverse. At Nuveen and TIAA we have a diverse CEO and leadership team, which is pretty impressive for a Fortune 100 company. However, there are still areas of opportunity. I would say from a female perspective we're doing exceptionally well, but in terms of ethnic diversity there's room for growth.

Within Nuveen Real Estate, we have formed a task force similar to what you're doing, Kristin, focused on organically growing diverse talent. We've identified four areas of focus. We're creating a professional development platform/pipeline for high school students. We're targeting recruitment at HBCUs [historically black colleges and universities]. We're leveraging some of the real estate specific affinity groups and organizations like SEO and REAP. And lastly, we're exploring mobility programs for our existing employees, beginning with understanding what are their career aspirations.

One of the areas of focus for us at TIAA and subsequently Nuveen Real Estate is unconscious bias training. We are being deliberate about implementing accountability measures around hiring and retaining diverse talent.

How can we do better when it comes to retaining talent?

KR: Retention is about making sure people can 'see what they want to be' and that they have mentorship to bridge the gap from here to there. In order to have diverse leadership, we have to offer opportunities to diverse candidates across all levels of the organization and demonstrate that a path is available for them to advance. Mentorship at smaller and even midsize firms can be challenging in this regard; not all organizations can provide the appropriate mentorship support. This is where I think working together across the industry can be very valuable.

I think it's important to have flexibility when it comes to how to measure success in today's unprecedented environment. Can someone be successful in a remote work environment? What does a flexible schedule look like? It's not our preference or tendency to test the norms in these areas.

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The environment is stretching our preconceived notions of what it means to be successful — and the residual of this shift may allow greater acceptance of inclusion and diversity efforts going forward.

RB: What has been really successful for us is frequent employee sentiment surveys. Understanding where people are in their journey across all levels of the organization is critical. Oftentimes where organizations go wrong is they don't understand what's going on at the lowest levels. In an effort to have a holistic picture of what's happening throughout the organization, more frequent employee engagement, such as sentiment surveys, roundtable discussions and fireside chats, asking the tough questions and encouraging your employees to speak up is necessary.

Are people happy? Why aren't people happy? Do people see themselves here three years from now, five years from now? Do people have career profiles so that leaders understand what their perceived trajectory needs to look like? Are we using mentorship and coaching to allow them to either attain those goals or to close those gaps? Too often, we assume that somebody wants to be the next MD or wants to be the next VP when they may have a totally different direction they'd like to go in.

What's the next step for you?

RB: It's about the exposure to the industry. If you interviewed 10 African-Americans today, nine out of 10 of them would not know what commercial real estate is, and more importantly, the vast number of career opportunities in this field. So I would start with the exposure to our industry. Partnership with larger organizations that provide mentorship for diverse talent, like the SEOs and REAPs of the world, and where it makes sense partnership with larger real estate shops, again allowing us to reach across and bring others in. The only way to change the narrative is to organically grow talent and be deliberate about hiring and retention practices.

I would like to see us be more intentional about bringing our industry to light in the longer term. I think mentorship dovetails nicely to the extent that we can be mentors in diverse communities. We could target magnet programs or STEM programs where we partner with high schools. We could also partner with organizations that are not specifically focused on commercial real estate; there could be talented, diverse candidates within those organizations that we could reach in and mentor and start to expose them to our industry.

KR: It's making sure that companies, not just the larger ones with significant resources, prioritize and work together to develop pipelines of diverse candidates and cross-industry opportunities. Real estate is something everyone can relate to — you've lived in an apartment building, worked in an office building and/or been to a store. It's a tangible asset class with understandable characteristics.

RB: I agree. It's such a tangible asset class yet it's so foreign to many. I'll share a quick story. I sit on a board of a predominantly African-American organization. I gave them an overview on commercial real estate, and I got probably about 10 or 12 calls afterwards saying, "Wow, thank you for that. I had no idea and oh, by the way, I'm interested." These are not inner-city kids. These are kids whose parents are saying, "You need to be the next doctor. You need to be the next lawyer." But here's yet another profession that they would have never known about. Discovering these types of organizations to partner with is something that I think we can do as an industry.

KR: We have to combine those recruitment efforts with an industry acknowledgement that diversity of background and thought ultimately leads to better results for our people, businesses and clients. Without a willingness to really adopt that thinking, recruitment ultimately won't lead to long-term success.

[1] Erik Larson, New Research: Diversity + Inclusion = Better Decision Making at Work, *Forbes*, September 21, 2017.

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RB: As the former head of diversity hiring for TIAA, this is tried and true. In fact, Forbes published an article a few years ago that showed a direct link between inclusive decision-making and better performance. The exact stat was "inclusive teams make better business decisions up to 87% of the time."[1]

INVESTOR FOCUS

When investors say they want diversity, what they mean is diversity of thought. It's not necessarily about gender or ethnicity. Do you see diversity leading to better performance?

KR: I'd love to be able to tell you that the returns across the real estate industry for non-diverse firms are X basis points on average below what they are for diverse firms. To my knowledge, we don't have that kind of data available in real estate. I believe the private equity industry has more statistics available with respect to superior performance across minority and women-owned businesses.

Our firm founder, and my boss of 23 years, is known to canvass opinions up and down the hall before making major decisions. We've joked about it over the years, but his willingness to listen to feedback from anyone at any time sets a tremendous example of openness. An environment where positive, negative and neutral comments can be discussed freely from all sides has to lead to better results. I hope that the nascent data collection efforts across the real estate industry will serve to definitively demonstrate the power of diverse thought.

While LPs may not hold a commitment back because of D&I, they are pushing where they feel they can. Have you seen an uptick on the D&I front on reporting?

KR: Absolutely. Overall, we've seen an increased focus on ESG, and D&I is included in the social and governance aspects of ESG. This includes greater scrutiny on D&I during upfront due diligence efforts and ongoing reporting requirements. For some of our separate account relationships, we've received specific questionnaires and minimum requirements. ILPA's standard due diligence questionnaire now includes a D&I reporting template. It's not universal across our investor base, but it has become more and more prevalent, particularly over the last few months.

RB: Our investors are very focused on the social aspects of ESG. I would say it's still early days and I would expect that we'll see an uptick in more intentional questions. They have been asking us about our diversity makeup and our diversity attrition: "Do you have adequate representation at the leadership table?"

KR: What you pointed to, Reisa, is increasingly important. Diversity is no longer looked at from a blanket perspective, but is evaluated across different departments and across seniority levels. During my early years in the industry, diversity was more often seen across the back of house functions within an organization rather than on the investment side. Now, investors might ask specifically how our diversity breaks down across the departments and positions within our organization. We've seen questionnaires inquire about promotion ratios for diverse professionals relative to our overall firm. I think for smaller firms to really see progress, we're going to need several years or cycles of measurement.

RB: Vendor diversity is starting to bubble up as well. Again, going back to Kristin's earlier point around ESG, investors are also trying to understand how many of us are actually leaders in this space.

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ON GETTING THERE

Are there any key thoughts or ideas that you really want to get across?

RB: If we want to create change in our industry, we have to be purposeful. And the only way to do that is to measure our successes at our individual organizations. One might say, “Well, it’s not really that easy.” And I would agree it’s not easy at all, but we have to start somewhere.

We should create minimum measurements around what we can hold ourselves accountable for. We can be intentional about targeting diverse organizations for recruitment purposes. We can create tracking systems where we’re keeping candidates warm even if they’re not offered the job. I want to also add a caveat to the notion of hiring diverse candidates. I’m not a proponent of hiring just to check a box; if you’re going to hire diverse candidates, do so because they are qualified for the role. Instituting management accountability measures is a must. It’s the only way it’s going to get done.

Also use your existing employees. Create a referral program where they’re bringing you candidates that we can’t find on LinkedIn. Training is so important in this journey. People don’t know what they don’t know. Everybody has unconscious biases and to the extent we bring that to the forefront and help individuals identify those biases and course correct, we would be much better off as an industry.

KR: I certainly agree with everything Reisa just said. For me, it comes back to the why, the what and the how. It’s important for the ‘why’ not to be pushed to the side because people assume there is broad support. We have to continually come back to educating our leadership and all levels of our organizations about why diversity is important. It’s of course wonderful to see diverse values rise in importance for the investor community. Ultimately though, our efforts must inspire an intrinsic commitment to diversity in our own organization’s culture as the only path to sustaining real change across the industry. ◆

3 steps *to creating a* D&I strategy

Erin Green, Managing Director at FPL Associates speaks with NAREIM about the steps needed to create a diversity and inclusion roadmap for organizations: identify the goals, think about tactics and ensure there's accountability.

What are some strategies firms are doing well when it comes to inclusivity?

When sourcing talent, firms have been identifying a greater pool and removing bias. They have diverse hiring panels, blind resume screenings and removed potentially biased language from job descriptions.

Candidates want a clear career path. They want to understand what it takes to move through the organization and so feedback is crucial. Mentorship can be very helpful.

Simple things can be very impactful in terms of encouraging inclusivity, such as team events and social outings that bring people together and allow them to interact with one another on a human level.

Key components of an effective D&I policy

1. ***Identify objectives.*** What are our objectives? What are we trying to achieve? Five years from now, where do we want to be? What do we need to be able to achieve having quantifiable and qualitative metrics for what we want the organization to look like? Set realistic goals.

2. ***Establish specific strategies and tactics of how we're going to get there.*** Where are we going to recruit talent from? Who are we going to partner with to identify a more diverse talent base? How are we going to effectively attract those individuals to our platform? And then once they're here, how are we going to develop and retain them and help them to progress through our organization so they do reach the senior levels of the organization over time?

3. ***Establish accountability.*** Who is responsible? It has to be a defined individual or group of people, like a D&I committee. There should be senior-level involvement on the D&I committee. Ideally, link compensation to some metrics. There should be clear KPIs in terms of how we are progressing. With new hires made over the past 12 months, what is the composition of the group? Looking at departures over the past 12 to 24 months, are there trends we should be concerned about? Have we lost half of our diverse employee base? Who have we promoted through the organization? Do we need to be mindful about ensuring we're creating an equal playing field for everyone?

Intent, traction *and* asset-level DIVERSITY

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The desire to change is critical when it comes to improving diversity in private real estate. **Mike DiRé** *of CalSTRS and* **Christina Scarlato** *of The World Bank Pension Fund speak with* **Suzanne West** *of The CenterCap Group, about how their position as investors advocating for diversity have worked with managers to encourage and enact change, and how managers can communicate better with their investors about how they're focusing on diversity at the corporate, as well as asset management, level.*

Mike DiRé is the Director of Real Estate Investments at the California State Teachers' Retirement System (CalSTRS). He leads a staff of 25 and a portfolio of approximately $35 billion, including both discretionary and non-discretionary investments. He joined CalSTRS in July 2000 and has expanded the CalSTRS Real Estate program into joint ventures, international investments and real estate debt. Prior to joining CalSTRS, he worked as a real estate investment specialist for the California Public Employees Retirement System (CalPERS). Prior to joining CalPERS, he worked for Deloitte & Touche Real Estate Consulting Group and Liquidity Fund Financial Corporation. Mike holds a Bachelor's degree in Real Estate and Finance from California State University — Sacramento, and is a member of PREA, NAREIT and ICSC.

Christina Scarlato is Principal Portfolio Manager for real asset investments at the World Bank Pension Fund. She is responsible for strategic planning, monitoring existing managers and evaluating prospective managers across real assets both domestically and abroad. She has worked with the World Bank Pension Fund since 2007, and previously worked for several years in various departments across the Treasury Department of the World Bank. She was past Chairman of the Pension Real Association Board, where she still serves on the Board. Christina received a B.A. in Mathematics and Spanish from Seton Hall University and an MBA from George Washington University.

Suzanne West is a Senior Advisor to The CenterCap Group. She is also Founder and President of Epic Advisory LLC. West draws upon her 30 years of experience across the real estate industry to provide clients with capital raising and strategic consulting services. Previously, she was involved in the formation of Belay Investment Group which invests capital on behalf of the California State Teachers' Retirement System (CalSTRS) alongside emerging managers that she helped source and mentor. Prior to Belay, she was a Co-Founder of Park Madison Partners (PMP), a New York-based real estate advisory and placement firm which she helped grow over her eight-year tenure. Suzanne received a B.S. in Finance from the University of Connecticut.

Suzanne West, The CenterCap Group: I would like to focus our conversation on the true diversity of organizations and the cultural shift towards inclusivity necessary to effectuate meaningful change within our industry. Supporting the growth in number and scale of firms owned or led by women and people of color continues to be a priority, but it takes time. Can you each share your perspectives and how your organizations are trying to promote positive change?

Mike DiRé, California State Teachers' Retirement System (CalSTRS): I have been with CalSTRS Investments for about 20 years now and the lack of diversification among our investment managers across the entire investment portfolio has been a concern throughout that time. However, it should be noted that the State of California has had rules in place for decades explicitly stating that you cannot discriminate by gender, race, age or sexual orientation. Ironically, those rules actually work against some of these diversity and inclusion goals since we, CalSTRS, can't effectively make diversification a selection criteria even though our board members and our senior staff recognize the need as well as the benefits.

Historically, we've tried to lean in by looking for ways to make allocations of capital that would lead to more diverse management teams while also achieving strong financial

> "We've tried to lean in by looking for ways to make allocations of capital that would lead to more diverse management teams while also achieving strong financial returns."

> It would be awkward to sit in the chairs we're in, and for me in particular as a white male, to direct people to do better if we didn't look at ourselves first.

returns. A good and ongoing example has been our urban investment strategies. Real estate is local and so to be most effective, the groups executing urban renewal strategies are advantaged if their teams reflect the communities in which they operate. Because we have the flexibility to invest through joint ventures and separate accounts, CalSTRS is able to form some investment relationships with diverse managers. We've had success and honestly some challenges with that approach. It is time-intensive and we have been challenged to get meaningful amounts of capital out.

The bottom line is, there's engagement at multiple levels. CalSTRS believes that the diversity of ideas is important to achieve top-tier returns. In the course of our ongoing investment activities with our current managers, we raise the subject and try to learn what they are doing to tackle the issues. We can quickly assess the importance to their organizations while also finding new approaches or, hopefully, best practices.

It would be awkward to sit in the chairs we're in, and for me in particular as a white male, to direct people to do better if we didn't look at ourselves first.

We have struggled to get women in senior positions in real estate. At CalSTRS Investments, it has taken time to achieve results but we can now say that 46% of our investment directors are women and more than 50% of CalSTRS' staff self-identify as other than white. We didn't have a female portfolio manager on our team until six months ago, which wasn't on purpose, but simply a function of how long the team has been in place with minimal turnover.

Clearly the events of 2020 relating to racial inequality is a subject that is difficult to address for all parties. I personally have wondered if my perspective is relevant. However, as leaders in our organization and industry, we have to find a path to engage whether or not it's uncomfortable.

SW: You're right. Real estate is local with properties serving a diverse tenant, resident or consumer base. Thus, to be most effective, management firms should broaden their perspective by seeking input from team members representing differing age, gender and cultural backgrounds when making strategic decisions about their assets.

Christina, you have also been a long-time advocate for greater diversification across our industry. What has been the World Bank's impetus for change?

Christina Scarlato, World Bank Pension Fund: The World Bank is super diverse and, as an American citizen, I am actually in the minority. The Bank has been focused on diversity and inclusion for a long time and women make up over 40% of senior management, with a goal of reaching 50%.

Starting at least seven years ago, the Pension Fund started pushing ESG initiatives that led to building a dedicated three-person team and signing onto the United Nations Principles for Responsible Investment. Ironically, the Pension Fund is a signatory but the Bank is not. The real assets team has focused more on governance issues, including diversification, where others have focused more on environmental issues. Unfortunately, educating the ESG people about what it is that we do as real estate investment professionals has been challenging. Coming up with a due diligence questionnaire that's relevant to real estate is not as easy as one would think. But we're getting there.

It's interesting what you said, Mike, and I've heard other investors say the same thing that, "as a group of white men, who are we to tell a manager that it needs to be more diverse?"

Ironically, in the past, I have felt the same awkwardness but from a different perspective, where my push for increased diversity is somehow diminished as being self-serving. But with more LPs talking about it, I feel less awkward asking those types of questions. There was certainly a time when I

> You're not going to, all of a sudden, create a field of female and diverse middle or senior management. You've got to start at the bottom, at the analyst level, and grow them internally.

felt like I was the token female asking the token female questions on maternity policy. At the end of the day, the reason firms have more diversity is because of policies that support maternity leave and a better work-life balance for families raising children.

As an industry, I think we're making strides in the right direction. When I attended PREA for the first time 12 years ago, there were still relatively few women attending. That has improved dramatically. What PREA is doing with Sponsors for Educational Opportunity is awesome. The key is starting from the ground up, bringing young people into this industry, teaching them about it and getting them excited to pursue a career in real estate. You're not going to, all of a sudden, create a field of female and diverse middle or senior management. You've got to start at the bottom, at the analyst level, and grow them internally.

SW: What measures have worked for you, whether making selection decisions based on a firm's commitment to diversity or having candid conversations with your partners around the importance of diversifying away from traditionally homogenous management teams? Is diversity a key component of your management selection process?

CS: It helps, but it's not a must. Our goal is to find interesting, high caliber groups pursuing unique and compelling strategies that fit within our portfolio. Diversity is certainly a differentiator, but I don't think we can make it a criteria until we have more diversity within our field.

MD: We are addressing the issue by trying to find the alignment of what makes good investments. Is it racial or gender diversity? We have also discovered the importance of incorporating the views of younger generations when making strategic, sector-specific investment decisions as millennials have become a driving force on office. We are making selections to get an appropriate risk-adjusted return.

We are also focused on how we, as the people putting out the capital, can take additional steps to effectuate change. For us, there are some simple things we do that help. We ask for pictures of the management and investment teams when they come and present to us, whether an existing or a potential relationship. We ask them to lay out, not only who works directly on our investments, but also to show us pictures of the management team members not represented in the room. It helps us identify the people who work on our account, which was the original goal; however, we have now found that it also lays out for all to see the diversity of the team — or lack thereof. Managers now often acknowledge upfront when they need to improve the diversity of their teams.

> “It is with our existing relationships where we believe we have influence. We are in it together and can exchange ideas with the acknowledgement that we all have room to improve the diversity of our teams.”

It is with our existing relationships where we believe we have influence. We are in it together and can exchange ideas with the acknowledgement that we all have room to improve the diversity of our teams. Another typical way we raise the subject is to ask about the customer base of assets they manage. Back to what I mentioned earlier, the management of the assets should benefit by having those managers be relatable and in tune with the customers.

SW: How have you managed situations where you liked the team and the strategy, but were disappointed by the firm's lack of diversity?

CS: We have never told a manager “we're not going to hire you because you're not diverse enough.” We're not there yet. However, we have talked to our managers about ways to become more diverse and we routinely share examples from our other managers. One firm we're invested with has spent a lot of time on this, including hiring a consultant who pointed out to them that their applications were male-focused. They have since improved their hiring process and started identifying and recruiting diverse talent early through internships.

MD: Similar to Christina, we haven't said it's a threshold you have to get over. But the conversations are a lot easier to bring up now as with my earlier example of our urban strategies. While it doesn't come up as much with firms presenting lending strategies because it's more of a numbers game, there are plenty of opportunities in between to have the

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conversation. Again, real estate is a customer business. How are you addressing your customers?

Let's take a simple and arguably extreme example — retail. I hope it's not sexist to say that the majority of consumer purchasing decisions are made by women. If a team came in and presented a retail strategy where only men were part of the investment and management team, it would raise a question whether they were fully equipped to relate to all of their customers. These are fair questions and have become more commonplace. You can find a way into the dialogue about how firms are managing this, what they are doing that's unique to address what's happening in America today, and how they are going to make us more money and generate a better risk-adjusted return. I think that's the most effective path that we have found that addresses the issues.

We can tell whether a management team genuinely wants to make improvements in any area of their business by their responses to tough questions. For example, have they already taken the initiative by setting up a diversity outreach program and hiring senior women or people of color that are helping them in every conversation to make sure unseen biases are addressed? To me, anyone who is thoughtful about any issue is ultimately a better manager and investor. CalSTRS wants partners who are attentive and forward-thinking to invest our money.

> “To me, anyone who's thoughtful about any issue is ultimately a better manager and investor. CalSTRS wants partners who are attentive and forward-thinking to invest our money.”

> “Social progress is difficult to track, but it's not difficult to show traction.”

SW: Historically, the culture of many real estate firms was a reflection of a single person, or personality, at the top and generally deal-driven. Today, more and more firms are recognizing the importance of human capital and diversity as drivers of a long-term, viable business. For our industry, we need to think outside the box and broaden our recruitment efforts to make it happen. What's going to motivate these firms to put in the extra effort it might take to build out diverse teams?

CS: I think it's us; it's the LPs' responsibility. I don't think the managers would make the effort, without a push by the money that keeps them in the business. Of course, some have made progress but it is on the margins. As uncomfortable as the conversations are, we have them because they are important and they have to happen. If they don't happen, nothing changes.

The reality is, across ESG, we have had to work closely with our managers on their responses to unveil what they are actually doing. With respect to environmental, as it turns out, some of them are doing all the right things but just haven't had the experience of putting it to paper. We have felt like pioneers on this front and recognize that the LPs have to just keep pushing the managers to continue making progress on the social issues.

MD: I agree. LPs may not be able to speak with one voice, but the conversation is going to happen if we are collectively raising

> “The best ideas on ESG should always be shared. GPs may feel they cannot give away their best ideas but, on the ESG front, people should work together and not fight one another.”

the same issues. People have been talking about environmental and sustainability initiatives long enough that it is an easier conversation to have now. However, the social portion of ESG is hard. How do you track progress? Social progress is difficult to track, but it's not difficult to show traction. That said, CalSTRS is finding that managers are being proactive in this area and we have gained recruitment ideas from them.

SW: How can managers show traction?

MD: Initial traction is just that they're engaged on the subject matter. The numbers come later. Every company's basic goal is to attract and retain the best employees available. Attracting new people of color or more women into management will come from engagement. It shouldn't come from the law of large numbers. There will naturally be more diversity and more women for larger firms, but managers shouldn't get credit for that. The more progressive companies that have a plan and process will be ahead of the curve.

SW: Christina, you mentioned a firm that you're invested with that hired a consulting firm to review and assess their business practices in terms of diversity and inclusion. What was the outcome?

CS: The manager, which is a smaller firm, now recruits SEO interns where they previously focused on students from Ivy League universities. As the firm's strategy is centered on workforce housing, they've also partnered with not-for-profits to create afterschool programs for children at their assets. It's a huge value-add to the asset; it helps immensely with retention of tenants and it doesn't cost a lot.

To Mike's point, it's less about the statistics than actually being able to say, “We're doing these things to be better.” And it's not just at the manager level; it's at the asset level as well. You're not going to change it today or tomorrow, but what actions are you taking to get there? That's a big piece of enacting change.

I will add that the best ideas on ESG should always be shared. GPs may feel they cannot give away their best ideas but, on the ESG front, people should work together and not fight one another.

MD: I think that what Christina just said is really important. I fear ESG will come down to checking some boxes. It's pretty expensive to hire someone to run your ESG program. I think there should be an emphasis on ways to do ESG without having to check the corporate boxes. LPs are impressed when people think outside the box — it's impactful and what you want them to do with your investments.

SW: Is there a way to capture the momentum?

MD: It's articulating questions that you utilize for due diligence or periodic reviews that eventually become a shared value. If you spend a significant amount of time with your GP partners across the organization, from top to bottom, you will see and hear if there is momentum.

CS: At the end of the day, things come out through conversation since some of our managers are already doing a lot of the right things. With our encouragement and that of other LPs, we are seeing progress on diversity and ESG. The more that GPs are asked to report annually on ESG, either in writing or at the annual meeting or both, the more progress we will continue to make as an industry.

What's critical is to know that it's not about checking the boxes — it's about intent and actual desire to do better. I do believe our industry is moving in the right direction. ◆

> “Things come out through conversation since some of our managers are already doing a lot of the right things... What's critical is to know that it's not about checking the boxes — it's about intent and actual desire to do better.”

30 BEST Pieces of ADVICE PART 2

Real estate leaders share the best pieces of advice they have received, how it influenced them personally and professionally, and what advice they offer their teams today.

BRANDON SEDLOFF

Managing Director, VP — Sales, Juniper Square

Figure out what your 'personal genius' is and **track the things that give you energy and suck your energy**. Use that as the basis for identifying the right career path. Print your calendar from last week and circle everything that you loved in one color and dreaded/hated in another and think about how you can do less of things you don't like and more of things you do like. Steve LeBlanc of CapRidge Partners offered me this advice when he was with Texas TRS on a bus ride to a Council Meeting at the ULI San Diego Spring Meeting. **It allowed me to expand my perspective and see my other strengths**. Specifically, it enabled me to divorce my functional expertise (i.e. personal genius), which is building and maintaining deep professional relationships, from my subject matter expertise (i.e. real estate). This realization was what led to me taking my first meeting with the founders of Juniper Square.

- **Find a great mentor or set of mentors**. People won't say, "Can I be your mentor?" You need to ask them for help.
- Second, **add value and punch above your weight**. Always strive to be the least qualified person with a seat at the table.
- Third, follow up. **If you say you will do something, do it**.
- Fourth, put your head down and focus. **Causing problems doesn't get you ahead; delivering results does**.
- Fifth, **find your personal genius and double down**.
- Sixth, you can't create industry experience so **find other ways to relate to people you want to do business with**. For me, travel was the great equalizer. I have been to 50+ countries and could always relate to an executive and their travels when I was earlier in my career.

JULIE WONG

Managing Partner, Co-Head of Capital Raising and Investor Relations, BentallGreenOak

My mother may not have gone to business school or even had a chance to finish her own schooling — but she started a business and ran it for over 25 years. Ever since the days I worked in our family restaurant during the summers, she has taught me that **it is better to give and treat people well**. She lived by that maxim and managed a staff that have worked alongside her through grueling hours for over two decades.

Her advice to be kind and to focus first on treating others well has been a guiding principle throughout my own career in finance and real estate. This is a message I pass on because **having this perspective has made the journey more gratifying and the possibilities more expansive by lifting others**.

CHRIS HOLTVED

Senior Portfolio Manager, Real Estate, Healthcare of Ontario Pension Plan

Never fall in love with the real estate. It's an asset meant to deliver a return. My first boss on my first day on the job. Never forgot it.

PAMELA BONEHAM

Managing Director, Head of Capital Strategies, Barings

The concept of networking sometimes sounds and feels forced. Yet, many of us have found that **friendships in the business and within our organizations have provided us with unexpected personal and business opportunities**. It can also provide better insights into ourselves and the companies we work for and work with. Networking was the avenue for most of the major moves in my career and many of the professional opportunities that have come my way. It has also been the source of a number of lasting and treasured friendships.

Consider building relationships within your organization and in the industry, as much a part of your job as running numbers or creating PowerPoint presentations. During my first eight months at Barings, I lived on the East Coast so I could be close to the majority of my colleagues. Today, I draw on the trusted relationships that developed then to help me navigate challenges large and small, as well as to share a laugh when it's most needed. When I had young children at home finding time for networking could be especially vexing, yet I relied on the advice of a colleague, who is now the CEO of a major investment advisor. He encouraged me to **develop a strong network not only for myself, but also for my family**. When times become challenging, it is your network and your friends in the organization and in the industry, that will help you find the next path or the next assignment. In other words, **the best job security in this business is your network**.

Pursue networking in all forms, whether via Zoom or at a Starbucks, as we navigate the current environment and beyond. However, **I still believe strong personal connections are best created face to face**, and I wish you friendships as supportive as I have found in this pursuit!

PRESTON SARGENT

EVP, Bailard, Inc

Always choose the most challenging path. It's the one that will test your mettle. **It's the one that will teach you the most**. It's the one that you will remember. And it's the one that will build character and confidence and provide the greatest opportunity for growth. **Endeavors that are easy, by definition, have very little value**. Elmer W. Johnson, Managing Partner at the law firm of Kirkland & Ellis in Chicago, gave me this advice in the late 1970s. It profoundly influenced my post-college academic pursuits, my career path, and my professional activities and business practices.

It is somewhat akin to that wonderful Fredrich Nietzsche quote: "That which does not kill us makes us stronger"... and better and smarter and more resilient!

STUART BERNSTEIN

Partner, CapRidge Partners

A platoon can only move as fast as its slowest solider. **Make sure your slowest members of your team are on board**. It made me more conscious of working with many people of different skills and to overcommunicate.

Overcommunicate just to break even. You can say something three times and someone still might not have heard you.

TIFFANY GHERLONE

Head of Real Estate Research and Strategy — US, UBS

Speak up! I didn't apply to roles unless I felt I was 100% qualified. I kept quiet in meetings when people outranked me. I didn't share my goals out loud or ask for critique.

Actively challenging myself to say at least one thing — a question, clarification or comment — **during and after meetings supercharged my career**, increased my comfort level and changed the way my coworkers perceived me. **It took about 18 months of constant effort**. I hope you're a faster learner!

FRANK GARCIA

Managing Director, PGIM Real Estate

The best and most memorable piece of advice that I've received is to **think of work-life balance as a tripod — you have work, family and yourself**. If any one of those are out of balance for too long, it can be difficult to be a productive long-term employee or to be happy personally or with your family life. This came from Ned Spieker when I worked at Spieker Properties, a West Coast public REIT, in the late 1990s.

It always sounded like good advice, but I didn't have as much perspective earlier on in my career. Once I had kids and more responsibilities and pressures — for example, when work became very intense or a family member had health issues — I began to realize that **it's easy to become intensely focused on one of the three aspects**. But you need to **pay attention and get back to a balanced state**. I've been lucky to work for organizations that recognize and allow this kind of flexibility.

I've seen that the workaholic often turns into a shooting star that eventually burns out. As a manager, it's important to realize that **a long-term employee will go through various stages of life that will require support and flexibility at times**. Employees appreciate that and it ultimately creates strong ties and loyalty.

PETER DiCORPO

Chief Operating Officer, Allen Morris

Treat the janitor in the same way you treat the CEO — and it should mirror the way you want to be treated! One of my first bosses and mentors, Gary Kleinman, gave me that piece of advice when I was a year or so into my tenure at AIG Global Real Estate and about to accept a promotion into a financial analyst role. This approach was always central to my personality, but it was reassuring to have someone who had been successful in business reaffirm this core value.

Raise your hand for a variety of projects: both large and small, important and minor. You will learn immensely from each, and you will establish yourself and your dependability in front of your work community.

JEREMY ROGERS

Managing Partner, Montana Avenue Capital Partners

Try to avoid working with capital partners who wouldn't be thrilled that you could buy the house next to them. If they can't see that your success means that they have done as well or even better, you don't want to partner with them. Dave Brown at Somera Capital Management in Santa Barbara gave me this advice in early 2010, right as I was starting my company. The Firestone family had been a fantastic partner and he encouraged me to look for something similar. I took the advice to heart and have **worked hard to find — and work repeatedly with — partners who are cheering for my success**.

Don't ask for more on your plate if you can't take care of what's already on it. When you're ready for more load/responsibilities, we'll both know. So **slow down and just take care of what's right in front of you** to the absolute best of your abilities.

PATRICIA GIBSON

CEO, Banner Oak Capital Partners

- Early in your career, **become technically proficient** so you can be the go-to person on a subject matter or in a particular area.
- Continually **work on soft skills** — communication, networking and presentation skills.
- **Having P&L responsibility and a strong understanding of finance is important** if you want to lead an organization.
- Don't lose sight of the fact that **your integrity is one of your most important assets**.
- **Build teams that share your values** and then fiercely protect the culture of your organization.
- Careers are long and **don't expect everything to happen all at once**. Play for the long run, **be the type of person others want to be around** and have fun along the way.

BLEECKER SEAMAN

Co-CEO, Broadshore Capital Partners

I have had this advice in different forms, but it is summed up in the oft-referenced statement: "Perfect is the enemy of done." While I have been guilty of wordsmithing and other fine-tuning, with limited value-add, it has taken time to realize that **getting things done with reasonable quality and moving on to the next task is better than obsessing over getting it exactly right**. More subtly, it is also about having conviction over what you are doing so that you don't let doubts creep into your decisions or how you are presenting them.

It probably took longer than it should, but I have learned to let go and recognize there is more than one way to get things done. While I may have approached things differently or said it in a different way, **empowering people and letting them find their way is rewarding in its own right**.

While much of what we do is all about the numbers, I try and remind our teams that the only thing we know about a pro forma is that it will be wrong. **The focus has to be on having conviction about the investment strategy** and make sure you are comfortable about the macro themes and not get overly focused on the micro.

STEVE LEBLANC

Founding Partner, CapRidge Partners

When you have made the sale, stop talking. This taught me to actively focus and listen, and to stop talking once you have a yes.

Know yourself and improve your listening skills.

JEFF GILLER

Partner, Head of StepStone Real Estate

Joe Robert, sometime back in the late 1990s, said: "**If you focus on what's good for the investor, good results all will follow all around**." And the GEICO Gecko said: "**If you love what you do, you'll never have to work a day in your life**." I've tried to lead our business with both pieces of advice in mind. In my personal life this has translated into a belief that **good things will follow by acting well and always trying to do the right thing**.

Take charge of your career and don't depend on others. A long time ago, I had the revelation that my bosses were not dedicating a lot of their mind share toward thinking about my accomplishments or losing sleep over whether or not I was being fairly compensated or promoted. So, around performance review season each year, I always made sure they knew what good I'd done for the firm and how I thought I should be compensated. Although it may work against me now, I share this advice with all of our team members.

It's about the investor, stupid… **work hard, work smart, work efficiently**, be a perfectionist, make great investments, and never forget to focus on your families, friends, health and exercise.

HELEN RIVERO

Chief Operating Officer, Gemini Rosemont Commercial Real Estate

Passion for the job is infectious. As a leader, when I get passionate about an initiative, no matter how big or small, the whole team gets passionate. It's the most important advice I've gotten and given.

To create that passion, leading by example is critical. **Leaders have to demonstrate the passion and work ethic that they want their team to replicate, and to actually do the real work**. That's how your team recognizes that you're willing to do whatever it takes to get the job done. **When your team sees that you believe in the work the company is doing, they will believe in it**. I've learned firsthand that when you treat your team fairly and with respect, you can create a team that is not only loyal to you, but most importantly, loyal to the company.

Servant leadership helps create this environment by giving the team what they need to be successful and crediting them for the success. **Success breeds passion**.

Q&A

The STATE of the office

NAREIM speaks with Preston Sargent, Executive Vice President at Bailard, about office opportunities amidst changing work trends in the post-Covid-19 world.

We're in the middle of a pandemic and some headlines say office is dead. What are you seeing with demand?
Office is definitely not dead. But because the economy is contracting, demand for office space is negative for the first time since the first quarter of 2010. Negative absorption during Q2 2020 was approximately 20 million square feet (msf). In the context of an 8 billion sf market, 20 msf is fairly inconsequential. However, if negative absorption persists while new space is being delivered, vacancies will tick-up and rents will be under pressure.

Previous recessions are not particularly helpful in understanding the contours of this current contraction, its impact on real estate fundamentals, and the timing and trajectory of a recovery. However, the recession triggered by the 2008 Global Financial Crisis (GFC) is a useful benchmark. Over a seven-quarter period during the GFC, there was 56 msf of negative absorption, an average of 8 msf per quarter. The highest quarterly negative absorption during the GFC was Q2 2009, when it hit 20 msf.

We believe the economic recovery from this pandemic will be slow, halting, and muted, and for that reason anticipate several more quarters of negative absorption before positive demand returns. Many companies, large and small, public and private, are looking to save money. This could translate into looking for ways to lower occupancy costs by shrinking their office space footprint by allowing employees to work from home, moving to less expensive space in lower quality buildings, and/or relocating to a different submarket in a metro area or an entirely different market altogether. All of this will take time to play out.

Although we don't foresee wholesale migrations from central business districts (CBDs) to suburbs, or from expensive global gateways to more economical metro areas, on the margin there are several pro-suburb and non-global gateway favoring trends which will impact where and how office workers live, work, commute, and shop.

A 'shock absorber' for office, in general, is in-place leasing. The national vacancy rate when the pandemic hit in March was 9.9%, well below the 10-year average of 11.2%. As long as the tenants obligated on those

[1] CBRE, 2020 Global Occupier Sentiment Survey, The Future of the Office.

iStock.com/SDI Productions

leases remain financially viable and continue to pay rent, whether or not they occupy their space, the landlords of those buildings will have steady cash flow. The rubber will meet the road as leases mature and the tenants subject to those leases make decisions about how much space they need and where that space will be. The typical suburban office lease is 5 to 7 years, meaning 15% to 20% of the rent roll expires every year. CBD office leases are generally 7 to 10 years, resulting in 10% to 15% of 'roll' every year.

Changing work trends

What do you make of the trend of flexibility in allowing a portion of the workforce to work from home?

The forced work-from-home experiment for office workers has worked quite well. We believe that remote work, along with shift-working, will have some durability. In a June 2020 occupier-sentiment study conducted by CBRE,[1] 70% of all respondents indicated that some portion of their workforce will be allowed to work from home permanently, while 61% of respondents indicated that all of their employees will be allowed to work remotely at least part-time. Companies and their employees are going to be finding their right balance to remain productive and effective.

Companies will have to reimagine how their office space is laid-out and utilized over the coming quarters and years. For businesses that value company culture and thrive on creativity and innovation to design, produce, and deliver best-in-class products and services, in-office collaboration is still the best and most efficient way to achieve that. Having said that, we

> “We believe the economic recovery from this pandemic will be slow, halting, and muted, and for that reason anticipate several more quarters of negative absorption before positive demand returns.”

> “ Office space is going to de-densify. The de-densification will be necessary to enhance employees’ safety and health, and to make them feel safe and secure while in the office. ”

believe that the levels of positive absorption that office markets enjoyed post-GFC will not be repeated during the next economic expansion.

De-densification was already happening even before the pandemic hit. What has Covid-19 shown us about the importance of the office?
Since the mid-1980s, the average space per person has dropped from about 250 sf to approximately 190 sf; a 24% decrease. This trend allowed companies to grow without leasing more space.

In the post-Covid-19 world, office space is going to de-densify. The de-densification will be necessary to enhance employees’ safety and health, and to make them *feel* safe and secure while in the office. Even after there’s a widely available and reliable vaccine, most office workers will want more space and distance between themselves and their colleagues.

Effective mentoring, on-boarding, and collaboration cannot be done remotely. Serendipitous meetings that lead to creative breakthroughs, enhance camaraderie, and promote innovation happen in the hallway, kitchen, and around the office lunch table; those are impossible in a remote-working construct.

This is an opportunity for firms to reassess what they need and what they want as they look forward. Who are the winners and who are the losers?
The thesis for trophy high-rise office properties in CBDs served by mass transit that has captivated most large institutional investors the past 20 years is going to be tested. Metropolitan areas enjoyed a long run of urbanization as millennials and others flocked to the urban cores to avail themselves of employment opportunities, cultural offerings, and entertainment. Many companies relocated to, or grew their footprints in, CBDs in order to tap into the deep pool of highly educated and talented employees residing there. The pandemic has upended that trend and the consequent sheltering-in-place has dimmed the allure of the city center for many.

Moreover, major cities are facing political and social challenges linked to recent unrest. Fairly or unfairly, urban dwellers are feeling less safe in many CBDs. In addition, those cities are confronting massive fiscal problems as a result of the economic downturn. The only way for them to plug their budget gaps is to increase taxes and/or decrease services, at a time they can least afford to do either.

Employers and workers are going to need a high level of certainty that the pandemic is over before we’ll see people congregating in crowded offices in large numbers. In the meantime, people and businesses may decide to move outside of the urban core where they feel safer and fiscal health is the norm. After the economy turns around, we expect that CBD office demand will be muted for the next cycle.

Suburban properties that are conveniently located, boast ample parking, and are easy to navigate will gain at the expense of CBD competitors. Interestingly, even before the pandemic there were some nascent trends pointing toward a ‘return to the suburbs.’ That shift will accelerate over the next few years.

Valuing the office

What do you see for office valuations?
It depends. Some markets will suffer growing vacancy while others will skate by relatively unscathed. Markets with the most pronounced supply/demand imbalances will see the largest decreases in rents and biggest diminution in values. It’s impossible to know which markets will fare best because it all depends on the economic drivers in individual metros and the depth and duration of the contraction.

It’s imprudent to try to predict where values are going, but there are some important considerations. Because transaction volume has fallen precipitously since March, appraisers have very few comps to consider. Instead, they’re leaning heavily on discounted cash flow (DCF) models to discern values. In Q2, appraisers of office properties generally lowered rental growth rates, increased vacancy and credit loss factors, and lengthened lease-up/re-leasing periods. Those adjustments drove office property values down by approximately 2% to 5% from Q1 to Q2. Appraisers generally did not lower market rents or tack-on concessions, or adjust residual cap or discount rates. If market fundamentals weaken further, appraisers will further adjust leasing market assumptions which will, in the absence of countervailing changes to cap and discount rates, put further downward pressure on values.

During past recessions, increased uncertainty dictated a need for higher returns for investors. That would generally mean an increase in both residual cap rates and DCF discount rates. The downward move in 10-year Treasuries since the beginning of 2020 from about 2% to 0.6% widened the spread for investors by about 140 basis points. This 'extra cushion' seems to be adequate compensation in the eyes of the appraisal community. As long as that relationship holds up, we do not expect material adjustments to either cap or discount rates. Any changes to office values will be the result of leasing market assumption changes dictated by supply/demand fundamentals.

For context, during the GFC, office property valuations declined by 30% or more in some cases because the appraisers made material adjustments to both leasing and capital market assumptions. This 'turbo-charged' the negative impact on values. We do not anticipate the same thing happening this time around.

There is a lot of dry powder. If office values are not coming down, is there a buying opportunity? Is there a play for distressed assets?
We do not see any distress out there right now. The recession might be lengthy, but there is so much capital eager to get into any kind of real estate. This will dampen buying opportunities. We have seen some good deals, but we have not seen anything that we would characterize as a great deal. I think this will continue to be the case. Since there is so much uncertainty, we are going to guard our liquidity very carefully. We want to make sure we've got plenty to last through the duration of this downturn and then have enough to make some attractive buys once the worst of the storm passes and the view ahead is a little clearer. We don't know whether that will be 6 months or 16 months from now, but for the time being we'll remain patient and cautious.

For the past several years high quality suburban office properties traded in the 7% to 8% capitalization rate range, at substantial discounts to replacement cost, while premium CBD office buildings were transacting at 4% to 5% cap rates, at material premiums to replacement cost. For us, that 300 to 400 basis point arbitrage between the two alternatives dramatically favored the suburban office investment play. In light of the pandemic and the knock-on effects on office dynamics, we feel even stronger about that argument.

Over the past five years Bailard has purchased nine offices with a total aggregate square footage of 1.5 msf. All nine properties are located in suburban nodes around major metropolitan areas like Los Angeles, Denver, Chicago, Minneapolis, Columbus, and Washington, DC. Our average basis in those properties is less than $175 per sf, a substantial discount to replacement cost. This is an important metric for Bailard.

> “The recession might be lengthy, but there is so much capital eager to get into any kind of real estate. This will dampen buying opportunities.”

Looking ahead

Do you see capex increasing now that offices have to be cleaner, safer and more secure?
Definitely, and it will modestly dampen the value of office real estate. If those costs are increasing, landlords will try to pass those costs back to their tenants. But if tenants are forced to pay the higher operating costs, they will insist on lower rents. Alternatively, landlords can eat the additional costs which will simply lower the net operating income. Regardless, the net negative impact on office landlords will be about the same.

Are we pricing risk into the market?
In my mind, not in the equities markets. Admittedly, I'm not an expert on the public equities markets, but there's a disconnect between what's going on in the stock markets and what's going on in the real world. We believe that real estate is still relatively fairly priced because of where the 10-year Treasury sits. However, the ultimate arbiter of value is an asset's intrinsic value or replacement cost. Investors who, in the pre-Covid-19 cycle, bought assets at premiums to replacement cost are likely to experience material value declines. During recessions, values tend to regress back toward replacement cost (or below) as capital sorts out risk and reward in the effort to discover proper pricing. As the economy stumbles back to its feet, we expect a similar scenario to play out. ◆

Modernizing *your* PORTFOLIO *for long-term* CRE *resilience*

When it comes to future-proofing your assets, using AI-based systems and modernizing buildings can help keep portfolios optimized for years to come.

By Matt Ganser,
Carbon Lighthouse

The Covid-19 pandemic has created a crisis unlike any commercial real estate executive has faced before.

In addition to the standard features of a downcycle, office lease rates have fallen[1] as companies mandate work-from-home policies. Business and leisure travel ceased, leading hotels to close or drop to single-digit occupancy. As many as 8,000 hotels may close for good by October.[2] Additionally, consumer fear coupled with shelter-in-place mandates may lead to the closing of as many as 25,000 retail stores by the end of the year.[3]

The financial repercussions cannot be understated, and the ongoing uncertainty is exacerbating the problem. This, unfortunately, is the new normal.

The pandemic and the ensuing economic crisis have highlighted what those who work closely with commercial buildings have long known. Having been built before the end of the Cold War, many buildings in the US are long overdue for equipment and technology upgrades. These buildings often are unable to make the quick changes needed to meet the requirements of planned business disruptions, much less unexpected external disruptions such as a pandemic or a natural disaster.

Simply put, US commercial real estate is in need of modernization.

On-site teams managing low- to zero-occupancy buildings are challenged with numerous technological limitations. Notably, these teams struggle with a lack of visibility into HVAC operations

1 Greg Cornfield, Leases are Getting Shorter and Rents are Dropping with US Market in Turmoil, *Commercial Observer*, July 16, 2020.
2 Dees Stribling, As Many As 8,000 American Hotels Might Be Gone By October, *Bisnow*, July 27, 2020.
3 Dees Stribling, 25,000 Stores Might End 2020 in Dustbin of Retail History, *Bisnow*, June 9, 2020.

and don't have a means of establishing remote building access, which is crucial for implementing measures amidst Covid-19 shelter-in-place restrictions. Even before the pandemic, buildings suffered from operational inefficiencies caused by deferred maintenance and lacked important updates needed to accommodate higher or varied occupancy. This means CRE portfolios are not well-positioned to navigate the uncertainties that lie ahead.

Fortunately, portfolio and asset managers can take three important steps to prepare their portfolios for long-term resilience: (i) gain strategic insights by collecting and leveraging artificial intelligence (AI)-based systems and data; (ii) modernize building equipment; and (iii) build and maintain a resilient partner ecosystem.

i Gain strategic insights with data

Commercial assets are, in some ways, like human beings — they have unique characteristics and should be approached on an individual basis. Discerning, optimizing and monitoring the operational signature of each asset requires the collection of actionable data. Investing in advanced controls, sensors and AI-enabled data analytics can inform operational inefficiencies and optimization strategies across the portfolio.

The first step in data collection is to evaluate each asset's building management system (BMS). Is it modernized with AI capabilities? Can it provide the data needed to ensure adaptability to future systems or constraints?

There is a very clear distinction between having a BMS and equipment that merely work, and having a system that is optimized to function together. Optimization allows for adaptation to any fluctuations in occupancy or health and safety regulations as efficiently as possible. Many BMSes and dashboards provide superficial data that does not provide a holistic view of the building. Often, building data is not stored or collected in a uniform manner, with varying levels of accuracy, inconsistent naming conventions, and lacking useful meta data and descriptions. This makes the data impossible to process in a standardized way.

Further, many BMSes rely on interval meter data provided by the utility company, which doesn't truly capture the many factors impacting how a building operates throughout the day (outside air temperature, humidity and occupancy to name a few). Advanced sensors can capture a much deeper set of real-time data to better inform how the building systems should respond throughout the day to these dynamic shifts. Data analytics, after all, are only as good as the data being collected.

Once the data is in hand, advanced analytics can help uncover hidden inefficiencies and start working on behalf of building operators. AI-driven analytics translate data points into actionable recommendations for operators who can then focus more time on tenant needs.

For example, using AI technology at the Montage Beverly Hills' central plant led to the optimization of its chilled water plant and implementation of sequences to make its three cooling towers work in sync. The optimization resulted in significant first-year savings and improved NOI. Instead of just collecting data about how a piece of equipment performed or flagging issues, the right AI-enabled technologies can help determine why the issue occurred, how to fix it, and can even predict or prevent similar issues in the future. The hotel was later acquired for a record-breaking per key price.

AI-based technologies not only provide asset-level granularity, but if rolled out across the portfolio, can also have significant operational and financial benefits for investors. Energy savings of $0.30 per square foot across a portfolio of 1 million square feet can

> " There is a very clear distinction between having a BMS and equipment that merely work, and having a system that is optimized to function together. "

Buildings aren't static. Here's a list of data beyond your BMS you should be collecting:

- Occupancy rates
- Lighting levels
- Daily air temperature fluctuation
- Fan power
- Supply and return air humidity
- Variable air volume (VAV) reheat valve and damper positions
- Cooling and heating load
- Plug load
- Regional weather data
- Demand spikes

[4] Centers for Disease Control and Prevention, Covid-19 Employer Information for Office Buildings, July 9, 2020.
[5] ASHRAE, ASHRAE Offers Covid-19 Building Readiness/Reopening Guidance, May 7, 2020.
[6] Carbon Lighthouse, Without Proper Visibility, Covid HVAC Safety Measures Could Raise Energy Spend by 70%, August 11, 2020.
[7] Carbon Lighthouse, How CRE is Listening to Data, Science and Tenants to Navigate Covid-19, July 2, 2020.

quickly turn into $300,000 a year in savings. The investment can be even more meaningful if the value is capped at disposition, creating millions of dollars in new revenue for sellers.

Analyzing each asset's energy usage data and establishing baselines are important steps to take in order to position the building for modernization. Implementing energy efficiency measures can also offset the cost of any capital expenditures related to building modernization, which is the next step towards positioning a portfolio for long-term resilience.

ii Modernize your equipment

The second step is to seize the opportunity that lower occupancy provides and address assets' deferred maintenance or necessary upgrades.

Rather than running through a regular checklist, asset managers should leverage the data they've collected to guide the smart upgrades that provide an asset- and portfolio-level return on each and every measure implemented.

Work with property teams to determine the status of previously deferred projects, whether any equipment replacements are necessary, what key tenants are demanding from a health and safety perspective and, finally, if there are any carbon emissions regulations coming into effect in the next few years, such as New York's Local Law 97.

Having an AI-driven system can help with overall optimization and prioritization in terms of identifying shortcomings, the solutions to address them, and then cost reduction measures to help finance any heavy capital expenditures.

> “It ultimately comes down to addressing tenant concerns while balancing efficiency.”

One system to pay close attention to is the HVAC, the bedrock of a building's energy system. An inefficient HVAC system can drive up utility costs significantly. That's true in standard operating times; in the age of Covid-19, with so much focus on the safety of indoor spaces, it's even more critical. Government and industry bodies like the CDC[4] and ASHRAE[5] have issued highly conservative guidance on outside air and HVAC filters. These measures could increase energy spend by one to three times for a single building.

Portfolio and asset managers should work with their operators to consider whether implementing industry guidelines make sense for their buildings, such as running outside air into the building 24/7.

If following all the recommendations made by the CDC and ASHRAE, a more modernized building equipment system can, to an extent, help offset the resulting increase in energy usage. In fact, by our calculations, taking a ‘kitchen sink’ approach to implementing all of the CDC and ASHRAE measures could cause energy bills to spike by 70%.[6] One approach would be to leverage the data to identify the smartest HVAC strategies that do not jeopardize occupant safety. These may include:

- Setting HVAC systems to circulate two to four air changes per hour, which provides the same health benefits as 24/7 ventilation.
- Replace MERV 8 air filters with MERV 13 filters, the same kind used in hospitals and other healthcare facilities. Using HEPA and MERV 16 filters together is not necessary as the virus particles are small. However, the particles they transmit on are generally larger, so the MERV 13 filter provides the same health benefit without a dramatic increase in cost.

However, it ultimately comes down to addressing tenant concerns while balancing efficiency. As Deborah Boyer, The Swig Company's EVP of Innovation & Community Impact, recently said:[7] “There were times when we chose to do things that a mechanical engineer may have refuted, but at a certain point, if a measure creates the perception of safety for a tenant, we might still implement it.”

Evaluating back-end operations is also a key component in modernizing equipment. This could come in the form of setting visual controls, performing preventative maintenance to help keep costs low, and updating procedures to ensure the site team is staying on top of it. At a Class A office tower in Miami with 674,000 square feet of rentable space, L&B Realty leveraged AI technology to gather over 34 million data points, leading to energy-saving measures that make the building more efficient and alleviate maintenance for the site team. These steps included isolating energy zones during evening hours and installing LED lighting retrofits in common areas with controls.

iii Build a resilient partner ecosystem

A real estate portfolio is only as modern as its partner ecosystem. Portfolio managers should take a step back and assess their partners; specifically, property managers, on-site teams, vendors, service providers, equipment providers, consultants and contractors. Are they all aligned with a modern, sustainable and scalable approach that will be just as resilient and long-lasting as the portfolio itself? Are they using the latest technologies?

Additionally, portfolio and asset managers should consider their partners' ability to support the portfolio for climate resilience. Modernization cannot be fully achieved without equipping assets across the portfolio with solutions that reduce carbon emissions and ensure a positive contribution to the environment. As LPs are increasingly prioritizing funds that are committed to ESG, funds with portfolios that have data-backed climate solutions will be primed for investment.

Partners should be able to scale, grow and adapt to the business's evolving needs, keeping their portfolio cutting-edge and continuously modernizing for a brighter, more sustainable future. They must be resilient, versatile, technologically savvy and have a predisposition towards proactive problem-solving.

Conclusion

In a rapidly changing and uncertain environment, portfolio managers can ensure adaptability and long-term resilience by modernizing their portfolios using AI-driven technologies to identify strategies with the best returns, to optimize their assets, and to maintain the right partner ecosystems to ensure efficiencies gained are not lost. Taking these important steps can give managers a competitive advantage in pursuing investors and tenants alike. ◆

Matt Ganser is EVP of Technology & Engineering at Carbon Lighthouse.

Working the middle: Opportunities in ESSENTIAL housing

With investors increasingly focused on the positive societal impacts of their investments, manager strategies centered around solving housing-related issues are gaining momentum.

By Sabrina Unger,
American Realty Advisors

Cities across the United States have long grappled with how best to tackle increasing housing unaffordability for many of their residents, to varying degrees of success. The ensuing economic fallout from the coronavirus and wider discussions on equality have brought back into focus the critical importance of equitable policies for all sociodemographic groups in providing basic necessities, including quality housing.

Much of the existing commentary on the affordable housing space has been centered around the potential investment opportunities arising from coordination with state and local municipalities to leverage tax credits or subsidies to supply much-needed low-cost housing to the community; significantly less has been dedicated to addressing and solving for what some have coined the 'missing middle' — that is, those renters who can neither qualify for affordable or subsidized housing in the traditional sense, nor afford the

[1] Chris Salviati, 2019 Cost Burden Report: Half of Renter Households Struggle with Affordability, *Apartment List*, October 8, 2019.
[2] Severely burdened households are households paying in excess of 50% of income to housing as defined by the Department of Housing and Urban Development (HUD).

luxury housing that has represented the majority of new projects that have been delivered during the most recent economic cycle (after the 2009 Global Financial Crisis).

What is essential housing?

There is a myriad of labels used to describe any housing that is not 'market rate.' These descriptors — affordable, attainable, low income, workforce, Section 8, rent protected, essential — are often used interchangeably, muddling the nuances of the sector. So, what do we mean when we talk about essential housing, and how does it differ from some of the more well-known housing types?

Perhaps the best way to contextualize the gamut of for-rent housing in the United States is to think of it as a spectrum, moving from those properties owned and operated by governmental housing authorities and fully subsidized on the left, to the most expensive Class A+ market-rate apartments on the right (see Exhibit 1). Units that cater to households making more than 80% of an area's median income (AMI) that are above the cutoff for governmental subsidy, but do not qualify for or cannot reasonably afford the new luxury product, are what we've designated as the 'essential gap.' It is this gap that has, and continues to be, woefully undersupplied, but also creates an opportunity for the socially minded investment manager.

Demand and (lack of) supply

Data from Apartment List[1] suggests that there are over 9.3 million households nationwide moderately rent burdened (with an equally large number considered to be severely rent burdened[2]) that need more affordable and accessible housing relative to their incomes. The next logical question might then be, 'why isn't there enough housing that is within reach for these households?'

The short answer is that the demolition of outdated units to make way for new luxury multifamily construction or different uses entirely, value-add repositioning of older product to drive rents that are no longer attainable, and lack of purpose-built attainable housing all contribute to the shortage of available housing for this cohort. By rough estimates, nearly 200,000 Class B/C apartments have been demolished in the last 20 years. At the same time, the ability for investors to earn a sufficient return on development of buildings with lower per-unit rents has been increasingly challenged given rising land and construction costs, discouraging much new supply.

Challenges for investment managers

The lack of suitable supply represents both the opportunity and the challenge of essential housing for investors. From a fundamentals' perspective, the combination of limited supply and elevated demand is the basis of any compelling investment thesis. But how does one go about acquiring or building this type of product at sufficient scale to justify a targeted product offering?

As we alluded to, many 'obvious' candidates for such a strategy are also prime targets for value-add capital that can afford to pay more on the expectation of higher returns post-renovation, handily beating out a core-like, income-oriented essential housing

Exhibit 1: For-rent housing spectrum

Public housing	Low-income housing tax credits	Essential gap	Class A+
Characteristics: • Owned & operated by government agencies • Limited to low-income families & individuals, the elderly and persons with disabilities • Properties range from single-family houses to high-rise apartment complexes	*Characteristics:* • In exchange for tax credits, properties must meet affordable rent requirements for at least 30 years • Typically privately owned • Can apply to mixed-income housing or 100% affordable	*What is it?* • Units that are financially viable for households making between 80%–120% of AMI, usually market-rate Class A-/B/C properties *Why is it missing?* • These units are prime targets for value-add renovations, pushing rents into unaffordable ranges for these tenants	*Characteristics:* • Highest absolute per-month rent costs • Not subsidized • Typically privately owned • May require tenants to make 40x the rent

Greatest household economic burden ⟷ Least household economic burden

Source: American Realty Advisors based on data from Cushman and Wakefield's Global Occupier Metrics Dashboard as of May 2020.

Case study: Dissecting the lack of supply

At first glance, imagining that a household making 80%–120% of AMI would have difficulty finding housing in a reasonably affordable place to live, like Miami, is hard to fathom. Yet the aggregate figures mask the true lack of supply.

According to the recently revised HUD Income Limits for fiscal year 2020, the median income for Miami-Dade County was $59,100. This means a household making between $47,280 and $70,920 fall within our 80%–120% of AMI range. At the 30% rent-to-income ratio, this means households can afford to pay between $1,180 and $1,800 in rent monthly.

There are approximately 101,000 market-rate multifamily units in Miami-Dade County whose effective rents fall within $1,180–$1,800 to service the approximately 202,000 households whose incomes align with the 80%–120% parameters.

Yet this 2:1 household-to-unit ratio doesn't account for other factors that further reduce the amount of supply, namely:

1. ***The number of units vacant at any given time in this price range.*** There have been, on average, less than 4% of these units vacant in any given quarter over the last 20 years.
2. ***The distance to primary employment nodes.*** The units that are vacant and available for occupancy are strewn across the county. While many are within driving distance to major employment nodes, nearly 20% are in locationally disadvantaged areas. According to the Center for Neighborhood Technology, a more comprehensive view of affordability combines both the cost of housing and cost of transportation, suggesting properties that are geographically further out actually exacerbate affordability pressure. And this says nothing as to the availability of other essential amenities such as grocery stores, childcare and the like.
3. ***The propensity for rents to rise.*** The units identified reflect a pool of accessible apartments to the households making 80% of AMI today and reflects a moment in time. A change in ownership strategy that results in a value-add renovation program with the objective of increasing rents could bring these rents to an unattainable level, thus reducing the amount of available options even further.

program whose strategy is to maintain the existing affordability profile of the asset.

Thus, investment managers may need to go beyond the most obvious markets or locations within primary markets to offset some of these pressures and create a viable pipeline. Because there is virtually no metro in the country that isn't faced with affordability concerns, managers may be compelled to venture into secondary and tertiary markets to find suitable opportunities with better going-in yields. Moreover, because essential housing assets tend to stay well-leased throughout economic cycles and offer a stable, income-oriented return profile, there is less exit liquidity risk venturing beyond primary markets for this type of strategy than perhaps for other property types. This is particularly true for open-end essential housing structures whose modus operandi is to acquire and hold long term.

There is also the operational element to consider. One of the reasons institutional managers have not, to date, ventured into the essential- or middle-income housing segment with the same gusto as other opportunities is the inefficiencies of scale. Existing properties that fit the bill are generally smaller in size (100 to 200 units, with average per-unit costs of +/–$150,000 per unit compared to +/–$250,000 per unit for Class A), requiring a measured aggregation strategy in order to compile sizable enough portfolios to really achieve operational efficiencies. The upside, of course, is that there tends to be lesser competition for these smaller deals.

Strategies that elect to leverage a development component may also be viable, though will require creative approaches to cost management, floor plan and space optimization, and amenities. This could include the use of modular or prefab construction, standardized and re-usable building plans, and pared-back amenities to offset hard construction costs. Moreover, with a lower turnover ratio from longer-tenured residents, future capex needs may be reduced, serving to at least partially offset higher initial costs to develop.

Investor expectations of an essential housing allocation

Because a commitment to essential housing is a commitment to conserving the affordability of units, investment managers should position their offerings

Exhibit 2: Class B return profile

Total returns, Class A and Class B apartments, national, 2001–19

Income component of Class B total returns, 2001–19

Note: CoStar's total teturn data is a proprietary estimate of the total nominal return on unleveraged property investments and is based on derived transaction returns. Income returns are calculated based on the change in average cap rates for actual sale transactions, while appreciation returns reflect the percent change in price value net of capital expenditures.
Source: American Realty Advisors based on data from CoStar as of August 2020.

to potential investors as having core-like returns with added upside through higher going-in yields. According to data from CoStar, cap rates for Class B properties nationally (a frequently used and appropriate proxy for essential housing) as of Q2 2020 offered a 120-basis point spread above Class A, and have achieved stronger total returns over the last seven years (see Exhibit 2).

Over the last 19 years, 64% of Class B multifamily returns have been derived from income, with the remainder attributed to appreciation. What's even more impressive is that despite representing the lion's share of the total returns, the income component is responsible for just 8% of annualized volatility — this suggests that a focus on the resilient and stable nature of the income returns is a prudent one for fundraising.

Conclusion

With individuals' homes currently serving as their residence, their workplace and their social sphere, the coronavirus has re-emphasized the necessity of accessible housing for all. Yet to date, the availability of appropriately priced housing for middle-income renters has been woefully inadequate to satisfy the level of demand.

Part of the reason there has been limited inertia in solving for this segment is the challenges associated with acquiring it — simply put, it is harder to compete on pricing for marketed opportunities against buyers whose strategies envision higher rental rates after a renovation program.

Yet given the increasing appetite from institutional capital for strategies that allow them to do well by doing good, forward-focused institutional managers who endeavor to navigate the complexities and answer the call have an opportunity to do both.

For those investors to whom achieving a stable, income-oriented return while simultaneously satisfying their ESG agenda is appealing, an essential housing strategy may be best suited to achieve those goals. It requires adopting an approach with a long-term view dedicated to maintaining affordability of market-rate essential housing across the country. ◆

Sabrina Unger is Managing Director, Head of Research & Strategy at American Realty Advisors.

Climate PRESCRIPTIONS *for mitigating climate risks*

Developing tools for property manager education about the impact of climate-related risks on their properties is the first step towards climate risk mitigation.

By Jennifer McConkey,
Principal Real Estate Investors

Climate risks are an increasing concern for investment managers. In 2018 and 2019, natural disasters resulted in over $136 billion worth of damage in the United States alone.[1] We saw historic flooding rage the Midwest, wildfires consume the West Coast, and hurricanes batter the South and East Coast. It doesn't stop there — climate change is expected to cause an increase in frequency and severity of natural disasters, resulting in additional property and infrastructure damage, disruption to businesses, and loss of human life.

The real estate industry is beginning to recognize the increasing materiality of climate risks to investment performance and so is seeking better ways to assess and disclose those risks to stakeholders. For example, the Task Force on Climate-related Financial Disclosures (TCFD) is pushing to stimulate market dialogue and increase transparency on climate-related risk disclosure to investors, lenders and other stakeholders. The recent inclusion of TCFD-aligned questions on the United Nations Principles of Responsible Investment annual survey demonstrates the market's growing awareness of climate risk issues.[2]

As part of our fiduciary responsibility to our clients and investors, we sought to understand the impact of climate risks within our investment management practices. With assets located all over the United States subject to a wide variety of climate-related risks, there is significant concern about investment performance, as well as the safety of our property teams, employees, tenants, residents and the communities in which we do business. By incorporating the findings of our study into our portfolio and building capacity for addressing current and future climate risks, we produced a series of documents called the 'climate prescriptions' aimed at decreasing our aggregate risk exposure and reducing potential mitigation costs.

[1] Weather Disasters and Costs, Office for Coastal Management.
[2] UN Principles for Responsible Investment, TCFD-based Reporting to Become Mandatory for PRI Signatories in 2020, February 18, 2019.

Climate risk assessment pilot

As a first step to understanding the impact of climate risk, we worked with a leading climate risk modeling firm to secure climate risk exposure data for assets in one of our funds. Our goals were to identify and characterize emerging property and fund allocation risks, and to build institutional knowledge and expertise. These were necessary in order to understand and address climate risk factors as part of investment management.

We quickly realized that there were several key lessons that would inform our future work in this area:

- **Property team education is key.** Climate risk is a new emerging issue for our industry, requiring new knowledge and capabilities for our property teams.
- **Climate impacts are connected, which means that climate risk mitigation strategies are also interconnected.** A strategy that decreases a property's risk for major storm damage may also increase the property's resilience to flooding and to the long-term impact of sea level rise. This encouraged us to take a holistic view of capital improvement projects and mitigation strategies.
- **Climate risk mitigation strategies will depend on the specific property type.** Property type will determine the amount of landlord involvement in property operations, the number of residents or tenants present at the property in the event of a natural disaster, and the most effective approaches for stakeholder engagement.

For our climate risk assessment pilot, our data partner used historical and modeled climate data to give each asset a risk score for the identified climate risk categories (see Exhibit 1). The scores were based on each asset's geographic location, ranging from 0 to 100. A higher score represents a higher risk. An important limitation of the climate risk assessment is that the score only depicts the potential exposure of a particular physical risk; it does not indicate the possibility of that risk occurring. The data utilized was derived using Representative Concentration Pathways emissions scenario 4.5, which represents a moderate carbon emissions reduction scenario.

The pilot and climate risk scores primarily focused on the climate-related physical risks (i.e. risks concerned with the impact on property physical conditions, infrastructure, operations, systems and equipment). We also examined transition risks (i.e. risks associated with movement to a low-carbon economy) by completing an internal review of existing climate action plans, renewable energy portfolio standards, and other environmental regulations targeting greater energy efficiency and reduced carbon emissions associated with commercial buildings across the United States.

TCFD

The Task Force on Climate-related Financial Disclosures (TCFD)'s mission is to "develop voluntary and consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers and other stakeholders." Increased transparency and access to climate-related risk data will enable companies to more holistically measure and evaluate their own risks. TCFD signatories include over 160 financial firms responsible for over $86.2 trillion of assets.

Exhibit 1: Climate risk categories

Risk	Definition
Flooding	The submerging of normally dry land. Flooding can be linked to a major storm, excessive precipitation, sea level rise, or damage at nearby dams or levees. Floods can cause significant physical damage to properties, infrastructure and disrupt normal property operations.
Heat stress	Increased exposure to high temperatures, above what previous averages and historical records would indicate. This can often result in more frequent heat waves and prolonged higher than normal temperature events.
Major storms	Includes hurricanes, blizzards and tornadoes. These storms can cause significant physical damage to properties and infrastructure, as well as disrupt normal property operations. Major storms can also cause another climate risk — flooding.
Sea level rise	Long-term, global rise in sea level. This is a particular concern for properties in coastal regions. Unlike other climate risks, sea level rise is not associated with an acute disaster event. Rather, the consequences of sea level rise occur slowly over time and creates a new normal.
Water stress	The lack of ability to meet human and environmental water needs. Water stress could be caused by a prolonged period with little to no precipitation, a diminished water supply and/or an increased demand for water. Climate change increases the possibility of water stress in many parts of the world by changing rainfall patterns and increasing average temperatures.
Wildfires	Unplanned fires. Wildfires are increasingly occurring in or near densely populated areas, parks, green belts and other areas that have combustible landscaping. These can be caused by humans, equipment, transportation and/or electrical/gas utility systems. The risk of wildfires increases during periods of little precipitation and/or strong winds.

Birth of the climate prescriptions

Once every property was scored for each climate risk by our climate risk data partner, we created a tool to disseminate this information to property management teams at the affected properties. This tool is the climate prescriptions, a series of documents to inform property management teams of the consequences of the risk and next steps to help remedy the risk.

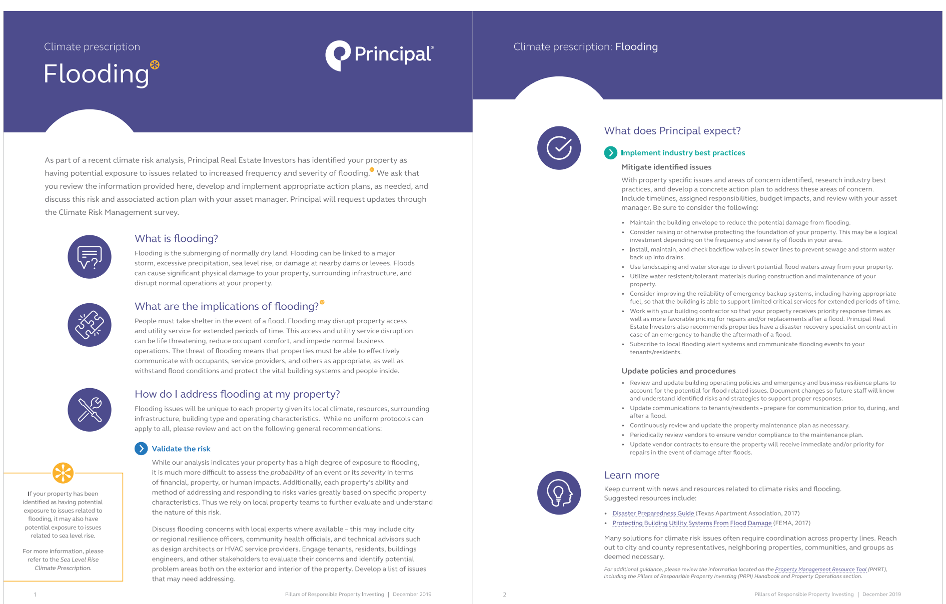
To develop the climate prescriptions, we conducted secondary research on disaster preparedness best practices and consulted with leading experts on property operations, including Brenna Walraven of Corporate Sustainability Solutions and John Scott of Colliers International. They shared their perspectives on the most important items to share with property teams, as well as insights into how to make the climate prescriptions actionable. Both stressed the importance of using local climate resilience resources, such as government task forces and contacting local utilities.

When we created this tool, we distributed a follow-up survey to ensure that each property team read the climate prescriptions and, if required, took appropriate action at their property. This also enabled us to support property teams if they had additional questions about climate risks, as well as to understand and gather property-level mitigation strategies. The findings from the climate risk assessment pilot will be integrated into Principal Real Estate Investors' ESG platform and used to refine the expansion of the climate risk assessment to other portfolios.

Our goal with these resources was to give property teams an introduction to the different physical climate risks that might impact their properties and provide actionable next steps to protect the asset, residents/tenants and property team from adverse events. As we gathered research, we realized there was a plethora of complicated information that could easily overwhelm even industry experts. We knew we needed to keep each climate prescription short, informative and actionable. This meant striking a balance between keeping the climate prescriptions applicable to all property types, but specific enough to drive meaningful property-level action.

The final climate prescriptions is a series of two-page documents, each dedicated to a specific climate risk category. The content is organized as follows:

- **Introduction:** Overview of the property's climate risk and its implications.
- **Risk validation:** We asked property managers to validate the risk, since historical and modeled data may not be indicative of a specific's property's risk, or may miss 'ground-level' factors that could exacerbate or mitigate the risk.
- **Industry best practices:** Actionable next steps for property teams. This may include outreach to local experts and government resources.
- **Additional resources:** Articles for property teams to continue learning about climate risks.



Climate prescription

Flooding

As part of a recent climate risk analysis, Principal Real Estate Investors has identified your property as having potential exposure to issues related to increased frequency and severity of flooding. We ask that you review the information provided here, develop and implement appropriate action plans, as needed, and discuss this risk and associated action plan with your asset manager. Principal will request updates through the Climate Risk Management survey.

What is flooding?

Flooding is the submerging of normally dry land. Flooding can be linked to a major storm, excessive precipitation, sea level rise, or damage at nearby dams or levees. Floods can cause significant physical damage to your property, surrounding infrastructure, and disrupt normal operations at your property.

What are the implications of flooding?

People must take shelter in the event of a flood. Flooding may disrupt property access and utility service for extended periods of time. This access and utility service disruption can be life threatening, reduce occupant comfort, and impede normal business operations. The threat of flooding means that properties must be able to effectively communicate with occupants, service providers, and others as appropriate, as well as withstand flood conditions and protect the vital building systems and people inside.

How do I address flooding at my property?

Flooding issues will be unique to each property given its local climate, resources, surrounding infrastructure, building type and operating characteristics. While no uniform protocols can apply to all, please review and act on the following general recommendations:

Validate the risk

While our analysis indicates your property has a high degree of exposure to flooding, it is much more difficult to assess the *probability* of an event or its *severity* in terms of financial, property, or human impacts. Additionally, each property's ability and method of addressing and responding to risks varies greatly based on specific property characteristics. Thus we rely on local property teams to further evaluate and understand the nature of this risk.

Discuss flooding concerns with local experts where available – this may include city or regional resilience officers, community health officials, and technical advisors such as design architects or HVAC service providers. Engage tenants, residents, buildings engineers, and other stakeholders to evaluate their concerns and identify potential problem areas both on the exterior and interior of the property. Develop a list of issues that may need addressing.

If your property has been identified as having potential exposure to issues related to flooding, it may also have potential exposure to issues related to sea level rise.

For more information, please refer to the *Sea Level Rise Climate Prescription*.

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Climate prescription: Flooding

What does Principal expect?

Implement industry best practices

Mitigate identified issues

With property specific issues and areas of concern identified, research industry best practices, and develop a concrete action plan to address these areas of concern. Include timelines, assigned responsibilities, budget impacts, and review with your asset manager. Be sure to consider the following:

- Maintain the building envelope to reduce the potential damage from flooding.
- Consider raising or otherwise protecting the foundation of your property. This may be a logical investment depending on the frequency and severity of floods in your area.
- Install, maintain, and check backflow valves in sewer lines to prevent sewage and storm water back up into drains.
- Use landscaping and water storage to divert potential flood waters away from your property.
- Utilize water resistent/tolerant materials during construction and maintenance of your property.
- Consider improving the reliability of emergency backup systems, including having appropriate fuel, so that the building is able to support limited critical services for extended periods of time.
- Work with your building contractor so that your property receives priority response times as well as more favorable pricing for repairs and/or replacements after a flood. Principal Real Estate Investors also recommends properties have a disaster recovery specialist on contract in case of an emergency to handle the aftermath of a flood.
- Subscribe to local flooding alert systems and communicate flooding events to your tenants/residents.

Update policies and procedures

- Review and update building operating policies and emergency and business resilience plans to account for the potential for flood related issues. Document changes so future staff will know and understand identified risks and strategies to support proper responses.
- Update communications to tenants/residents - prepare for communication prior to, during, and after a flood.
- Continuously review and update the property maintenance plan as necessary.
- Periodically review vendors to ensure vendor compliance to the maintenance plan.
- Update vendor contracts to ensure the property will receive immediate and/or priority for repairs in the event of damage after floods.

Learn more

Keep current with news and resources related to climate risks and flooding. Suggested resources include:

- Disaster Preparedness Guide (Texas Apartment Association, 2017)
- Protecting Building Utility Systems From Flood Damage (FEMA, 2017)

Many solutions for climate risk issues often require coordination across property lines. Reach out to city and county representatives, neighboring properties, communities, and groups as deemed necessary.

For additional guidance, please review the information located on the Property Management Resource Tool (PMRT), including the Pillars of Responsible Property Investing (PRPI) Handbook and Property Operations section.

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Distribution and follow-up

Once the climate prescriptions were finalized, we distributed them to each affected asset manager and property team. We asked them to document their validation, research and proposed actions. After a couple of months, we surveyed 37 properties that were flagged for climate risks to collect information and assess progress. The purpose of the climate prescriptions survey was to:

- **Gather feedback** about the climate prescriptions;
- **Ensure** property teams received *and* reviewed the climate prescriptions; and

- **Facilitate discussions** for how property teams will increase their property's resilience to identified risks.

We found that 54% of property teams stated they already had existing procedures to mitigate the risk, 35% of property teams implemented new procedures in response to the climate prescriptions, and 11% of property teams were still developing new climate risk mitigation strategies for their properties. We were impressed by the variety of climate risk mitigation strategies being implemented, including:

- One property team that manages an office in Colorado plans to add the phone system, card reader system and garage door operator to open circuits on the emergency generator to ensure that tenants have access to the building even when the electricity is out.
- A property team that manages a multifamily property in Florida already disseminates hurricane preparedness information to tenants and has procedures in place for property protection.
- One retail property team in Texas solicited bids for improving roof drainage and obtaining hurricane shutters to mitigate effects of downpours and flooding.
- An industrial property team in Tennessee has an emergency preparedness manual for precautionary measures and an emergency preparedness first responder assessment for evaluating damage after significant weather events.

Challenges and next steps

The climate risk assessment and resulting climate prescriptions were some of our first steps in a comprehensive climate-related risk mitigation program. Throughout this process, we identified several challenges:

- Property teams have full workloads, especially with unforeseen circumstances like Covid-19.
- It is also possible that property teams may not be familiar with climate risks and their materiality, or not understand the operational impacts of long-term climate issues like heat or water stress.
- There is a wide variety of climate-related risks based on the geographic location of each property. This also means that there are many possible mitigation strategies. It will take time to determine the most appropriate mitigation strategy for a specific property situation.

It is critical for property teams to understand climate risks and their potential impacts. By establishing plans of action to mitigate climate-related risks, we are taking steps to ensure the physical and financial stability of our investments now and into the future as climate-related risks become more frequent and intense.

The climate risk assessment and development of the climate prescriptions was a significant learning opportunity for myself, the Pillars of Responsible Property Investing team and property managers. Our initial pilot, which occurred over several months, solidified our approach and understanding of the materiality of climate risk to investment performance. We are working to incorporate the findings from the assessment into additional ESG initiatives.

We are also exploring the development of an ESG scorecard, a tool that will provide a snapshot of ESG information for our standing investments and potential acquisitions including climate risk. Additionally, we are forming an internal climate risk committee to continue planning for climate risk mitigation strategies, including integrating climate risk factors into the acquisitions process and performing climate risk assessments on additional funds. Through this exploratory pilot, we have gained a greater understanding of the ramifications of climate change to our investment management practices and are better prepared to address them going forward. ◆

Jennifer McConkey is Senior Director — Operations and Sustainability at Principal Real Estate Investors.

Plan B: How firms are adapting in the pandemic

Communications, technology and company culture are crucial to manage the fallout from Covid-19.

By Matt Hooper, Pereview Software

As the commercial real estate industry continues to navigate the fallout from the coronavirus pandemic, firms have begun piecing together lessons learned and planning for the next disruption, whatever and whenever it may be.

To learn how some players are navigating this new terrain, the team at Pereview Software spoke with firms that either manage commercial real estate directly or work with the commercial real estate industry. We asked three simple questions: Did you have a plan in place for the kind of disruption wrought by the pandemic, how were you able to adapt your business practices to the situation, and what tactics or strategies have been most valuable thus far?

Their answers illustrate the range of impact that Covid-19 has had on the industry and how CRE leaders are responding.

Communication, technology and culture

When Covid-19 first forced staff to shelter in place, Austin, Texas-based Pennybacker Capital had a unique opportunity to stress-test the firm's internal passion project — their robust company culture.

Since their founding in 2006, Pennybacker has worked to build and nurture the firm's culture, which revolves around what CEO and President Timothy Berry calls the 'three Ts' (3Ts): teachers, tenants and team.

Teachers refers to the pensions and endowments whose assets the firm manages. Pennybacker is focused on growing those funds; working to ensure that each teacher they represent has a comfortable retirement nest egg. For tenants, the focus is on improving the experience of those who live and work in the buildings Pennybacker manages and owns. Finally, working as a team, Pennybacker employees strive to help


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one another achieve their personal and professional goals.

For Pennybacker — which invests in a variety of commercial real estate properties, including multifamily, office and retail — the 3Ts serve as a compass for all functions of the business. In the context of Covid-19, this has delivered two positive impacts.

First, employees remained focused on the same goals, even while working independently at home. Employees instinctively knew that whatever they did and whatever decisions they made had to deliver value on behalf of the 3Ts.

Second, in order to deliver maximum value on behalf of the 3Ts, Pennybacker had long invested in innovative technologies and business practices, including platforms that aggregate, model, visualize and report on real estate asset data. These technologies have proven their value during the pandemic because they allowed remote employees to have fast access to trustworthy data, facilitated opportunities for process automation, and provided visibility into operations and investment performance during a time of economic uncertainty.

These strategic investments in culture and technology have reduced worries related to business continuity, at least to this point. As a result, Pennybacker was able to direct more energy to serving the needs of their tenants as the pandemic's impact deepened. Teams reached out directly and frequently to residential and commercial tenants to inform them of latest developments — as well as to listen, understand tenants' pain points and brainstorm solutions.

By communicating frequently with both property-level teams and Pennybacker's tenant base, Berry and his team were able to provide both information and inspiration.

In the short term, Pennybacker is focused on ensuring the health and safety of property managers and tenants across their portfolio. That includes health screenings, sanitation, installing anti-germ surfaces, imagining lower-density office layouts, and creating safer pathways of ingress and egress. This is in addition to Pennybacker's longtime focus on environmental hygiene — high-quality lighting, air and water, as well as lower carbon footprints — for the properties they manage.

Above all, Berry attributes the firm's handling of the pandemic to its compass — the company's culture. When employees instinctively know what's most important for the company and what's expected of them, they will deliver even during a massive disruption.

Flexibility and adaptability

About 1,500 miles west of Pennybacker headquarters is the Los Angeles home office of RCLCO, a real estate advisory group founded in 1967 (as Robert Charles Lesser & Company). RCLCO's leaders realized that, though they didn't have a plan specifically tailored for a global pandemic, they did have contingency plans available to address disruption of property operations or asset performance based on external events and market forces. Leadership immediately began modifying those existing plans to fit the coronavirus shutdown.

At the onset of the crisis, RCLCO's leadership identified two high priorities: clear and consistent communication, and asset performance visibility.

Mostly utilizing video conferencing apps, like Zoom, the leadership and staff at RCLCO increased both the frequency and the intentionality of their communication. Because no one had the luxury of physically popping into an office or cubicle to ask a question of a colleague, Zoom calls were carefully structured and aligned to strict agendas to ensure that key information and questions were conveyed and addressed.

Jomar Ereso, one of the firm's managing directors responsible for the entire asset management process believes that, if anything, the internal teams at RCLCO probably overcommunicated with each other — and that such a strategy served them well during the crisis. That consistent flow of information from leadership to direct reports, and back again, has kept productivity as high as it was pre-pandemic. Tools like Microsoft Teams fostered collaboration as stay-at-home orders took effect.

Video and messaging apps addressed gaps related to internal and external communications, while data warehouses and visualization tools provided increased visibility into how the company's assets were performing as the world economy stumbled.

In order to stay on top of operations and portfolio performance, the team at RCLCO leveraged their technology stack — including data warehousing, dynamic modeling, visualization and reporting — to gain visibility into how the economy was impacting their assets. They augmented these digital tools by adding escalation features that would trigger alerts based on leading indicators and risk metrics. Like Pennybacker, having access to data while staff was largely remote allowed them to make data-driven decisions at a time when such accuracy was greatly needed.

As of time of writing in August 2020, Ereso maintains that the keys to managing this crisis — and whatever the next one will be — are flexibility and an abundance of intentional communication and technological tools. The team at RCLCO proved that you don't necessarily need a pre-made plan for every possible contingency, as long as you have a solid, base-level crisis plan that can be adapted to meet the moment. ◆

Takeaways for other firms

Leaders at Pennybacker and RCLCO think that they are navigating the pandemic as well as could be expected. Across the industry, there's a more diverse spectrum of corporate health. Some companies are thriving, others holding their own and others still are in varying degrees of trouble. Wherever you are on that spectrum, there are two key takeaways that any firm can use.

First, communicate. Clear, frequent, honest and purposeful communication benefits employees and clients by inspiring confidence, providing opportunities for collaboration and fostering engagement.

If you have an internal communications team, empower them to take charge and arm them with information they need from leadership to keep employees informed. Provide your external communications team with helpful messaging for clients/tenants regarding building safety, distancing and masking requirements, as well as tips for office layouts and flexible work arrangements. Company leadership should ensure that investors and other stakeholders are updated with new information regarding investment performance and outlooks whenever it becomes available. Making a deliberate effort to check in with those stakeholders, as well as tenants and other clients, will inspire confidence during uncertain times.

There's no firm rule on how often you should initiate communication during a crisis, but RCLCO's Ereso says that, based on his team's experience, over-communication is better than under-communication.

Second, don't panic — adapt. Fans of the novel *The Hitchhikers Guide to the Galaxy* are well aware of the importance of the phrase 'don't panic.' As an homage to the book, Elon Musk had the words 'DON'T PANIC' displayed on the screen of the Tesla Roadster he sent into orbit in 2018. That piece of advice is perfectly suited to the age of coronavirus.

If you didn't have a pandemic plan, join the crowd. Few people can honestly say they foresaw anything like Covid-19 on the horizon. But chances are you have a business continuity plan of some sort to carry your firm in case of economic disruption. Break the glass and put what you have in front of your leaders. Identify gaps and determine how to adapt what you have to meet the challenges you're facing.

We cannot now predict how or when things will get back to normal — or even how we will define normal moving forward. But chances are good that companies with a strong corporate culture, an intentional communications strategy and a flexible business plan will emerge from this crisis stronger than their peers.

Matt Hooper is Director of Marketing and Communication at Pereview Software.

MANAGING tenant risk *in* dynamic *markets*

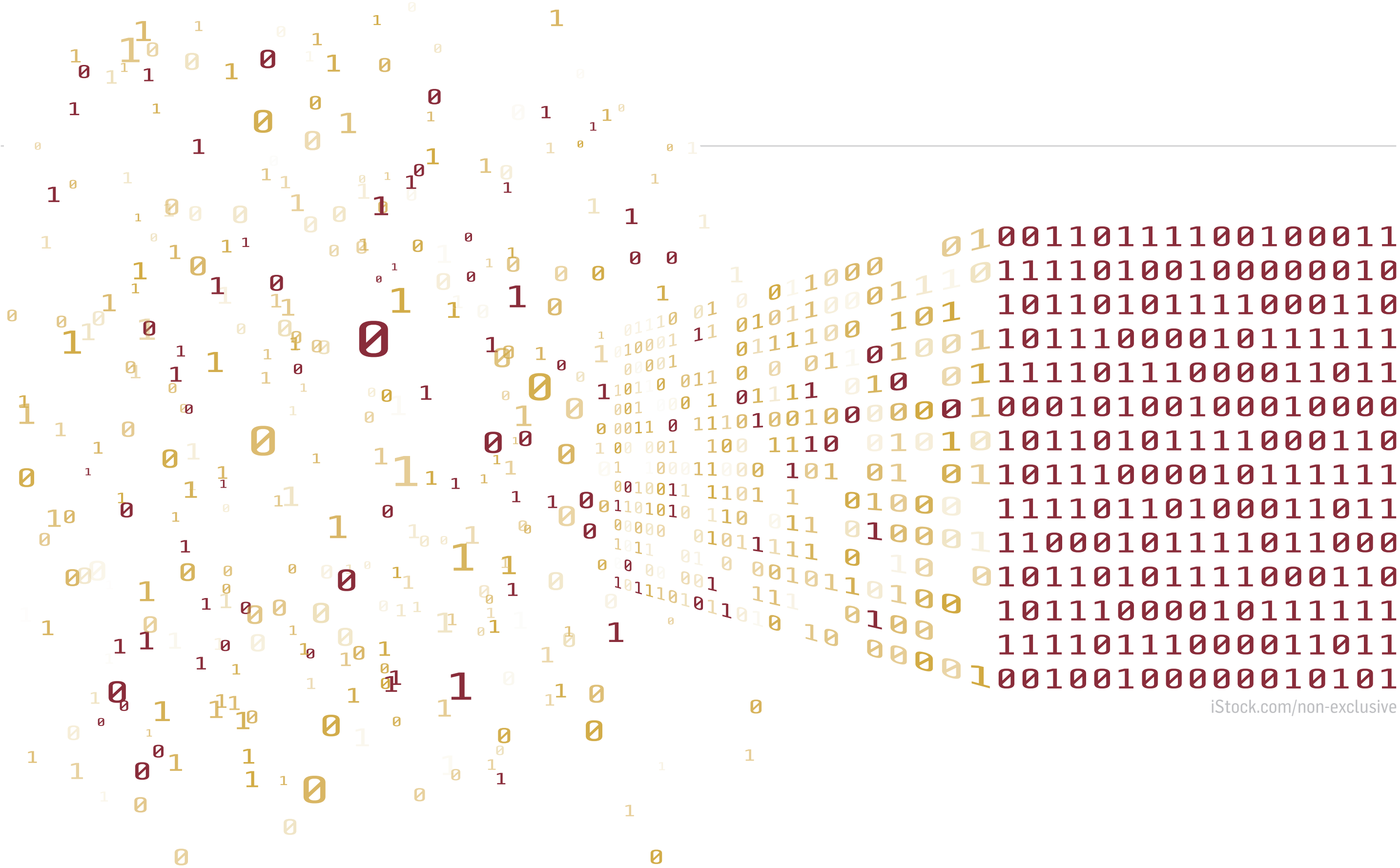
Tenant risk can be understood and managed by having systems and processes to collect and analyze data.

By Damien Georges,
RealPage

Understanding exposures and managing risk is at the core of what investors do. For real estate investors, the stability of their tenant bases is an important measure in judging portfolio health.

The current market, however, is unique in the extent to which tenant status has been shaken up. More than ever, information on tenant exposure across portfolios, financial risk of the underlying companies and the corresponding ability to get paid are central to the day-to-day operations of investment management firms and their investors.

A challenge to working with good tenant data is that managers must harvest it from a diverse and sometimes complex portfolio that spans multiple property types in multiple regions. For most, this still means dozens of hours consolidating, validating and aggregating the data into a useful format that can be stored in a single repository.



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The data spread across a real estate organization generally comes from disparate systems including ERPs, property management systems and Excel spreadsheets. This data generally isn't standardized in a consistent format, meaning someone has to normalize it to make it usable. And while investment managers are scrambling to transform the data into actionable information, their investors are seeking to mitigate risks across their portfolios before they become reality.

Having systems and processes in place to collect, aggregate and normalize data in a single and easily accessible location is the fastest and easiest way to leverage the data and be proactive instead of reactive.

The numbers that matter

Traditionally, risk management in real estate has involved looking at tenants, expertise and credit ratings. But the Covid-19 pandemic has changed how risk is managed across the portfolio. Stay-at-home orders, travel restrictions and government subsidies have modified the universe of data essential for managing risk.

Today's essential data points include:

- ***Tenant industry classification.*** Grouping tenants by classification allows investors and managers to understand exposure by segment. For example, bars, restaurants, movie theaters and other retail businesses have been shuttered or compromised due to the pandemic.
- ***Tenant credit rating.*** While individual credit ratings are important, understanding credit trends across industry classifications allows managers to work with larger datasets to gain a richer understanding of risk.
- ***Government subsidies.*** Federal, state and local governments are offering significant subsidies and loans to all businesses in an effort to limit bankruptcies and keep unemployment low. Understanding which tenants are receiving government subsidies, and which are not, can help predict which firms may be under the most pressure when these subsidies end.
- ***Options and break clauses.*** Understanding which of your tenants has the ability to either not

> "Understanding which of your tenants has the ability to either not pay or walk away from a lease is critical to assessing your level of risk."

pay or walk away from a lease is critical to assessing your level of risk.
- ***Receivables.*** Understanding which tenants are paying and which tenants are delinquent is central to asset and risk management. Aged receivables reporting across individual properties, portfolios and industry classifications, when married with market data, enables asset managers and investors to understand which companies are most at risk and which properties need the most attention.

Now that you know what data to collect, the question becomes how to collect it and where to store it so it can be analyzed. While the industry relies heavily on Excel, there are other tools and systems that make data aggregation and analysis easier and more reliable. While certainly not a requirement for understanding and managing tenant risk in your portfolio, leveraging a system that incorporates data governance, data validations and embedded analytics enables managers to curate data, develop complex risk management models and store that information to be used in the future. While the platforms are complex, the implementations do not need to overwhelm an organization.

Putting a platform in place

Where do you start with a project like this? Here are some pointers:
- First, ***don't boil the ocean***. Data management initiatives are large, transformative projects. Creating reasonable scope with the right partners is critical.
- ***Enlist the executive team.*** Having senior leadership support will help drive adoption; adoption is key.

“ Having all your data in one place, easily accessible and in the forms various stakeholders need, will reduce response times, increase accuracy and free up your people to focus on decisions that help the bottom line. ”

- ***Identify specific business challenges you are trying to address; don't leave your goals vague.*** Documenting the business issues, challenges and gaps will help to ensure your data project is on-task and will deliver for the enterprise.
- ***Understand your constraints.*** Every organization is different, but almost all will have constraints on personnel. Obstacles might include the bustling quarter-end for the finance team or a parallel project the IT team is working on. Knowing and documenting these constraints at the beginning will allow you to build realistic plans.
- ***Understand your data requirements.*** This is arguably the most important step. We like to either build out or enhance a 'data dictionary.' The data dictionary is the fabric or DNA of your entire organization. It ensures that everyone is looking at your data the same way.
- ***Understand your outputs.*** What do you intend to *do* with your data? This step usually identifies some missing data points you can layer back into your data requirements.

Once you have pinned down your objectives and understood what data you need to collect and how you would use it, you can start to layer in systems and processes, and begin to build realistic project plans, timelines and expectations for delivery.

After the storm

Now that you understand your tenants and their risk to your portfolio performance, you need to capitalize on this knowledge. The result will be that your organization is better informed and better prepared to weather not just the current crisis, but future ones as well. Your team will become more proactive in protecting existing assets and better positioned to execute on accretive transactions. I firmly believe that this distinction will become a defining factor in determining which real estate investment managers experience the most success in attracting investors over the coming months and years.

Having all your data in one place, easily accessible and in the forms various stakeholders need, will reduce response times, increase accuracy and free up your people to focus on decisions that help the bottom line. Instead of wrangling data, asset managers can focus on pinpointing opportunities for improvement and addressing issues before they become problems. ◆

Damien Georges is SVP of Investment Management at RealPage.

CMBS market shrugs *as critics* TAKE AIM

Amid allegations of loan origination impropriety that coincided with the onset of the Covid-19 pandemic, the CMBS industry sees little to worry about.

By Paul Fiorilla, Yardi Matrix

Dealing with the growing number of delinquencies and trying to drum up loans in the time of Covid-19 is a tall order for the commercial mortgage-backed securities (CMBS) market. But the industry is waging war on another front: a small but dogged group of critics has emerged to allege widespread impropriety in the loan origination process.

Charges that CMBS issuers embellish loan documents to exaggerate the performance of underlying properties are strongly denied throughout the industry. Indeed, transparency has been a top theme of the industry post-Global Financial Crisis. Collateral properties in CMBS deals, pandemic or otherwise, are subject to voluminous disclosure of information.

Industry players say that lessons were taken to heart after the financial crisis, the evidence being that loan performance since the chastened market reformed a decade ago — dubbed CMBS

1 Heather Vogell, WhistleBlower: Wall Street Has Engaged in Widespread Manipulation of Mortgage Funds, *ProPublica*, May 15, 2020.
2 Cezary Podkul, Commercial Properties' Ability to Repay Mortgages Was Overstated, Study Finds, *Wall Street Journal*, August 11, 2020.

2.0 — was nothing short of stellar for a long time. As of Q1 2020, only 1.8% of CMBS loans were 30 days or more delinquent, the lowest level since Q4 2008, per Wells Fargo and Intex.

Whether through luck or design, the reports alleging malfeasance came just as the impact of Covid-19 hit and loan defaults suddenly shot up (see Exhibit 1). The CMBS delinquency rate spiked to 9.6% as of July, according to Trepp, almost entirely because of sharp increases in hotel and retail loans. Depending on one's vantage point, that either supports the claims or gives credence to questions about whether they are being promoted to help industry litigation consultants gin up business as loan defaults increase.

Studies allege improprieties in underwriting

The first shot came in May from an article in ProPublica[1] that outlined allegations made in a whistleblower complaint filed with the Securities and Exchange Commission by John Flynn, the chief executive of CRE Loan Advisors, a consulting firm for distressed commercial borrowers. In the article, Flynn alleged that CMBS loan originators commonly erased past expenses or inflated income to enable properties to qualify for more loan proceeds.

That means not only that borrowers have less chance of repaying loans, but also the severity of losses on loans that default is higher than expected based on the official documentation. Flynn claimed in the article to have found inflated numbers on $150 billion of CMBS loans securitized between 2013 and 2019.

The Wall Street Journal[2] published an article in mid-August that highlighted the results of a survey produced by John Griffin and Alex Priest, professors at the McCombs School of Business at the University of Texas at Austin. The professors looked at $650 billion of CMBS securitized between 2013 and 2019 and found that net operating income fell short of underwritten income by 5% or more in 28% of loans. The paper alleged that loan appraisers use artificially low capitalization rates to inflate values that allows properties to qualify for larger loans.

Griffin and Priest also identified banks that had "sizeable and persistent differences in income overstatement… with some large and leading originators having over 40% of their loans exhibit 5% or greater income overstatement." The study contended that 29.8% of loans originated by originators with a history of high-income overstatement were on a rating agency watchlist in May 2020, relative to only 10.9% of loans by originators with low levels of past income overstatement.

"Originators have financial and reputational incentives to originate high quality loans, but they also profit from passing along lower quality loans that appear to be of higher quality," the study noted.

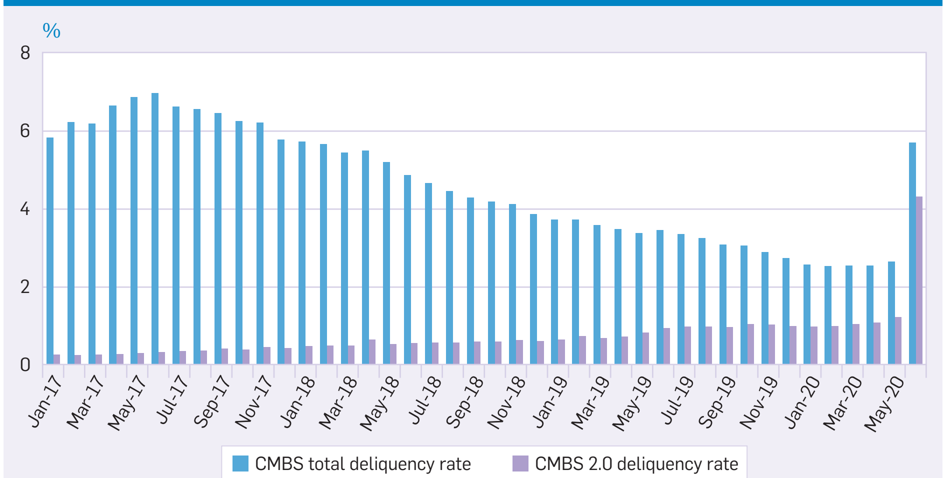
The industry fires back

The industry responded swiftly to the Wall Street Journal piece. "As a transparent, well reported market, we believe the claims about the CMBS industry in this document are baseless and misinformed," said Lisa Pendergast, executive director of the industry trade group CRE Finance Council.

Rebuttals to the claims that CMBS programs inflate financial performance of properties fall into several categories.

"Whether through luck or design, the reports alleging malfeasance came just as the impact of Covid-19 hit and loan defaults suddenly shot up."

Exhibit 1: CMBS delinquency rate



Source: Moody's Investors Service, Trepp.

One is that property income and expenses naturally fluctuate from year-to-year, especially among property types that have shorter-term leases such as hotels and apartments. The UT study did not measure positive changes in underwritten income, so it's not clear whether there is systematic bias to understate revenue or if income is just hard to forecast. In any event, a 5% loss of income is not enough to put many loans in danger of default. Moreover, ebbs and flows at a property level are an accepted characteristic of CRE lending.

A second rebuttal is that the CMBS market is set up with layers of checks and balances that were acknowledged but given short shrift in the two studies. Once CMBS pools are set, individual loans are re-underwritten by rating agencies and the investors who purchase the first-loss classes, which are known as B-piece buyers. Rating agencies underwrite individual loans to stressed scenarios and assign ratings to the securities that are sold to investors, usually after imposing significant haircuts on a property's net operating income.

B-piece investors have a major role in scrubbing pools because they bear the loss of income if loans default. Issuers at various times have complained that B-piece buyers are too strict in their refusal to buy bonds unless loans not deemed of high enough quality are removed. A major reason loan quality deteriorated in the run-up to the 2008 market meltdown was that the B-piece buyers re-securitized their holdings, reducing the incentive to perform proper due diligence and transferring the risk on the buyers of collateralized loan obligations they issued. One of the important Dodd-Frank Act reforms addresses this phenomenon by requiring CMBS B-piece buyers (or deal sponsors) to hold bonds for five years without hedging or financing.

A third avenue of rebuttal of the UT study is the reliance on a watchlist, which is not a meaningful predictor of default. Servicers put loans on a watchlist when property performance deteriorates from prior periods but that does not mean a property is in danger of imminent default.

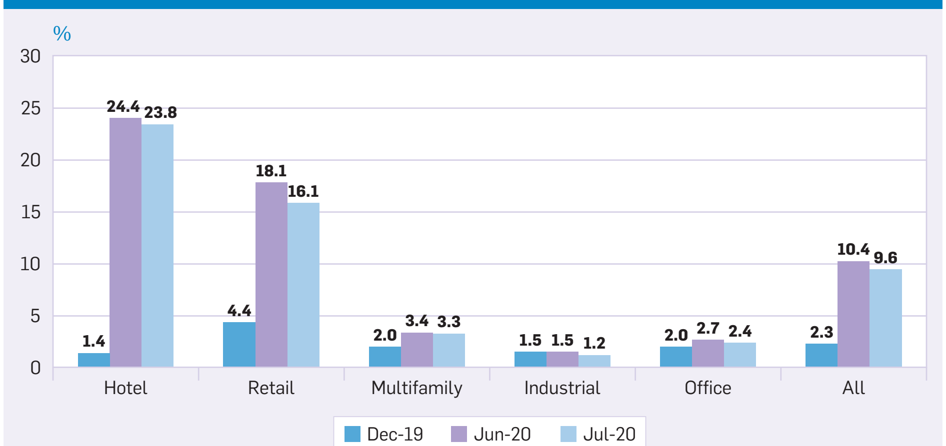
Perhaps the most pertinent rebuttal is CMBS performance over the last decade. By any standard, the market has not exhibited the frothiness of the 2005–07 era, when loans were underwritten 'pro-forma,' or with assumptions that property income would grow during the life of the loan. In the early 2000s, underwriting became progressively more aggressive until the market collapsed. Lenders have remained disciplined in this cycle. In 2019, according to CREFC, the average issuer loan-to-value ratio was 58.4% and debt service coverage was a conservative 2.25. That means net income was more than twice the average mortgage payment, giving most loans a cushion in the event income deteriorates.

Covid-19 has prompted default rates to shoot up but limited almost entirely to hotels (23.8% as of July, according to Trepp) and retail (16.1%) (see Exhibit 2). Default rates of multifamily (3.3%), office (2.4%) and industrial (1.2%) remain low. Industry proponents say the pandemic was impossible to plan for. "The pandemic has forced many commercial real estate owners to shutter their businesses, resulting in property owners experiencing dramatic declines in property-level cash flow," Pendergast said.

Critics of the study also suggest that selecting May as the measurement date obscures rather than clarifies the quality of loan underwriting. "If debt service coverage of a conference hotel is underwritten at 2 times and somehow research suggests that a 'true' debt service should have been 1.9 times, that has no direct impact on the hotel's performance

> "Covid-19 has prompted default rates to shoot up but limited almost entirely to hotels and retail."

Exhibit 2: CMBS loan delinquency rates by property type



Source: Trepp.

when occupancy is at 15%," says Brian Olasov, executive director of financial services consulting at Carlton Fields. "The pandemic reveals little about property performance other than that properties with limited revenue don't perform well."

Griffin and Priest say that the pandemic demonstrates the underlying issues they discuss in their report.

"Although modelers design securities to withstand distress, crises often provide substantial information regarding security quality, as they provide an actual stress test for evaluation," the UT study said.

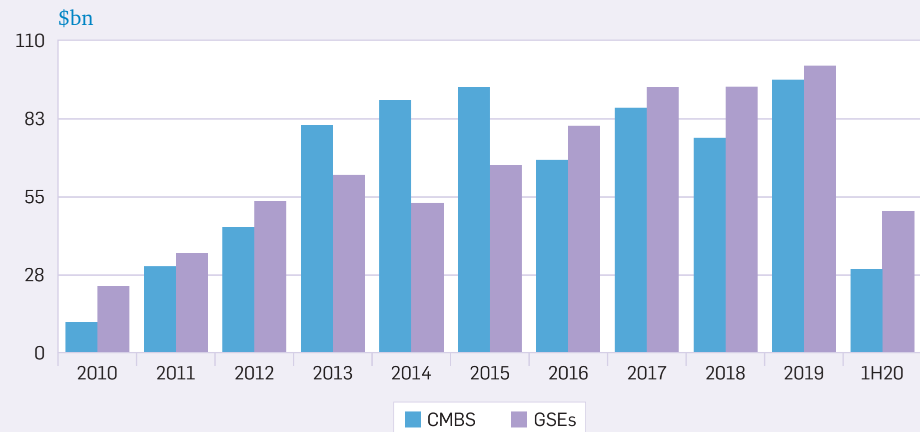
Bigger problems in the Covid-19 era

The industry has largely shrugged off the reports. Some of the indifference could stem from having larger problems as a result of the pandemic. CMBS is dealing with a spike in delinquencies, while bracing for more impact from the weak economy and focusing on lobbying federal and state governments to boost aid packages for tenants and to shape policies such as foreclosure and eviction moratoriums.

Meanwhile questions arise about forbearance and the impact of social distancing on demand for space. These questions include: Which retail properties will survive? Will corporations cut back on office needs? Will demand for urban apartments weaken?

CMBS loan originations slowed to a crawl when major metros shut down in March and bond spreads blew out (see Exhibit 3). Triple-A conduit CMBS, which jumped from 77 basis points over swaps pre-Covid to 330 basis points in late March, has fallen to 97 basis points, per CREFC. With Treasury rates so low, CMBS borrowing rates are once again attractive, but most new business is refinancing since transaction activity is tepid.

Exhibit 3: Securitization volume



Source: Commercial Mortgage Alert.

Aside from the focus on Covid-related issues, few are shocked at the studies. Some investors say they expect issuers to present loans in the most favorable manner, and that if the systematic overstatements were severe it would have manifested in higher default rates leading up to Covid-19.

There's also a sense that the industry has been discussing these issues for more than a decade and has taken steps to address them. In recent years, regulators have imposed a stricter framework that includes requiring banks to hold 5% of bonds they issue, while industry trade groups such as CREFC have overseen the implementation of an expansive infrastructure to prevent the type of documentary embellishment alleged. For example, when the SEC implemented reforms to the sweeping regulation covering securitized asset types as diverse as car loans, credit cards and commercial mortgages, they required a new asset schedule incorporating 140 separate data fields on the underlying loans. Under a CREFC framework, CMBS captures more than 800 fields for each loan.

> "CMBS loan originations slowed to a crawl when major metros shut down in March and bond spreads blew out."

Olasov notes: "CMBS is one of the most poked, prodded and probed of all credit risk products going through the hands of professional skeptics including auditors, investors, site inspectors, appraisers and rating agencies, each of which can make downward adjustments to borrower-provided financial information. This list doesn't include the underwriters. Moreover, borrowers' insatiable appetite for leverage that drove deal sizes in CMBS 1.0 is a relic from a bygone era now that LTVs persistently hover below 60%." ◆

Paul Fiorilla is Director of Research at Yardi Matrix.

Stuck with the bill:

CMBS financing's incompatibility with an unpredictable world

As hotel revenues evaporated, owners were forced into protection mode. For most, loan forbearance and federal stimulus became the critical tools to stay afloat, but many CMBS sponsors were left to fend for themselves.

By Peter Laskey, Barclay Fellow

Almost one year ago, I attended NAREIM's Executive Officer Meeting in Newport Beach, California, as a Barclay Fellow. The opportunity for an MBA student like myself to converse with industry leaders was incredibly valuable for my young career. Over the course of the three-day conference, both small discussions and formal presentations were consistent in their message: lots of "dry powder," "late-inning" stage of the cycle, and "it won't be 2008 again." I am sure you might have heard similar outlooks.

I took the knowledge I learned at the conference and applied it to my previous column for the Spring 2020 issue of Dialogues: a glimpse into the current state and future trends for lodging. In short, I predicted that in 2020, the development lag would approach plateauing demand levels, resulting in a slight downtrend in RevPAR. However, I promoted the premium-brand, select-service hotel as a relatively recession-proof asset with a high upside on the back end.

My first foray into making predictions for the real estate industry did not age gracefully. Instead of my previous claim that "the days of a -16% RevPAR decline like in 2009 are long in the rearview mirror," we are faced with a "new reality" that dawned with the onset of the Covid-19 pandemic: according to CBRE,[1] US hotels had a -75% RevPAR decrease versus the prior year in Q2. Occupancy tumbled to 28.3% in the quarter, forcing the temporary closure of many assets. At the drop of a hat, hotel owners and operators were forced to go into protection mode: responsive asset management and loan forbearance became the top concern.

Fortunately, according to a recent survey by the AHLA,[2] about 90% of hotel investors who hold traditional bank debt have received relief, primarily in the

1 CBRE, US Hotel Outlook: Recovery Under Threat? July 30, 2020.
2 Ben Eisen, Hotel Owner Seeking Mortgage Relief? Not If Wall Street Owns Your Loan, *Wall Street Journal*, June 4, 2020.
3 Trepp, CMBS Special Servicing Rate Continues Upward Trend in August, September 2020.

form of three- or six-month payment deferrals. However, investors holding commercial mortgage-backed securities (CMBS) or other securitized debt have not been as lucky — they face many barriers when receiving relief.

Hotel CMBS market

Of the $550 billion US CMBS market, about $86 billion is secured by hotel or lodging assets, ranging from large, 'big box' convention hotels as 'single asset, single borrower' to smaller hotels packaged in a portfolio. Many investors are attracted to securitized debt's low-interest rate and non-recourse nature to finance new deals. However, the pandemic has shined a bright light on one major downside of CMBS loans: when a loan is packaged and sold to other investors, there is a much higher degree of difficulty in receiving any restructuring. According to the same AHLA survey, only about 20% of owners with securitized loans have received any form of relief.

During the Covid-19 era, it is common for CMBS borrowers to run into dead-ends or long delays when reaching a restructuring agreement with their servicers. CMBS loan documents are complex, and servicers claim it takes time to pare through each contract to reach an agreement. Understandably, servicing agencies were neither adequately staffed nor had any warnings of such a sudden blitz of servicing requests.

According to Trepp data,[3] the average special servicing rate for lodging was about 2% in the 12 months leading to March 2020 (see Exhibit 1). That number skyrocketed to 11.4% in April, then 16.2% in May, and continued to climb to 20.5% by June and a staggering 24.99% in August. The same rate for retail CMBS loans grew from 6.1% in April to 17.3% in August, indeed a large number and scary increase, but still a much tamer increase in servicing rate than witnessed in the lodging sector. Office, multifamily and industrial special servicing rates have consistently stayed low throughout the pandemic. Therefore, lodging and retail are responsible for the spike in the total special servicing rate: 10.04% in August versus 2.8% heading into 2020.

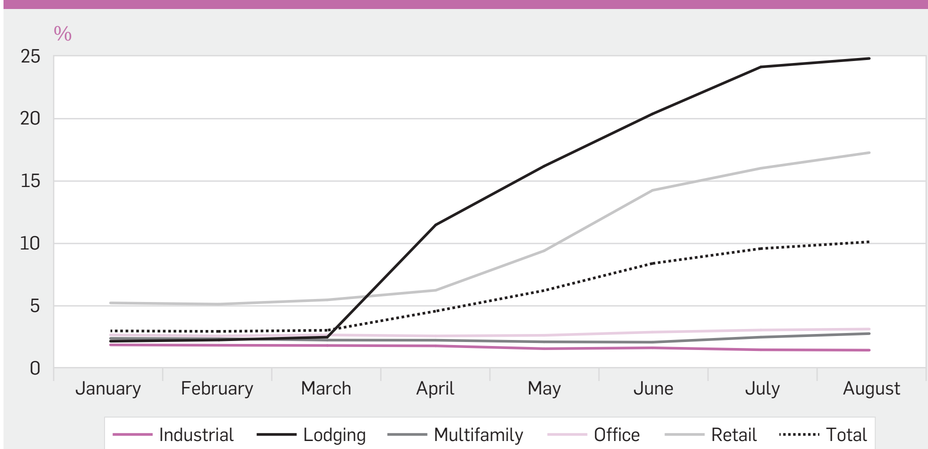
Trepp also reports that the CMBS delinquency rate for hotels spiked to 24.3% in June while retail clocked in at 18.1%. The total delinquency rate for June was 10.32%, just 2 basis points short of Trepp's all-time high of 10.34% recorded in July of 2012. Interestingly, the peak delinquency rate in the wake of the Global Financial Crisis occurred more than three years after the crash of 2009. Meanwhile, it took Covid-19 only three months to reach the same level — another sign of the incredibly unique and swift toll of the pandemic.

Fortunately, unlike the virus itself, the delinquency rate hit 'terminal velocity' in July — meaning that if borrowers have not requested relief in April through June, they probably never will. If this theory proves true, the month-over-month increase in delinquency should diminish as time goes on. In fact, after its peak in June, the delinquency rate decreased 78 basis points in July and another 58 basis points in August after a large chunk of loans were 'cured' by way of maturity extension or reserve relief. However, the delinquency rate is expected to increase again in Q3 after the temporary relief window closes.

Searching for relief

Due to the nature of their loans, CMBS borrowers have struggled to find relief. Unfortunately, their headaches do not stop there: CMBS loan structures also prohibit borrowers from taking on any 'additional indebtedness' without approval from their servicer. Borrowers who take on unapproved debt are massively penalized, including the possibility of the loan becoming fully recourse. Therefore, most federal programs designed to keep businesses open during the pandemic lockdowns,

Exhibit 1: CMBS special servicing rate by sector



Source: Trepp. Data as of September 3, 2020.

4 Asian American Hotel Owners Association, Hotel Owners Call for Additional Congressional Action to Stave Off Catastrophic Collapse of Hospitality Industry, July 23, 2020.
5 CBRE, US Hotel Outlook: Recovery Under Threat? July 30, 2020.
6 Jay Singh, Plateauing US Passenger Numbers Show Evidence of Choppy Recovery, *Simple Flying*, July 28, 2020.
7 Peter Grant, Cash Pours Into Distressed Real Estate Funds as Investors Aim to Play Offense, *Wall Street Journal*, April 21, 2020.

such as the Payment Protection Program (PPP) rolled out in April, were out of reach for CMBS borrowers; taking on these federal loans could breach their contracts. Even if their servicers do approve additional debt like the PPP, the added complexity and red tape for borrowers desperately searching for cash inflows may be too high a hurdle to clear.

There is a silver lining that might backstop some of the borrower's losses. As previously mentioned, many servicers were not prepared for the influx of servicing requests and therefore may be reluctant to foreclose on assets. From the servicer's perspective, the sponsors are still best suited to continue to manage the asset, as courts are clogged and appraisals are difficult. Foreclosure seems to be the last resort for servicers, especially for well-capitalized and name-brand sponsors. The foreclosure process might be prohibitively difficult to the already overwhelmed servicers, and some borrowers might squeak with a few missed payments while cash is low.

With an industry back on its heels and in dire need of support, lobby groups such as the AHLA and the Asian American Hotel Owners Association, which represent about 55,000 of the nation's hotels, have stepped up their lobbying efforts. On July 23, 2020, the AHLA penned a letter to lawmakers to "establish a CMBS market relief fund, with a specific focus on the hotel industry." In this letter, the AHLA warned that "pervasive default and foreclosure on hotel CMBS debt would be disastrous for the commercial real estate market at large, as well as the holders of that debt, including pension plans and other investors."[4] Thus far, federal resources have supported mainly agency and multifamily CMBS distressed debt.

For those investors who did receive deferrals, the three- or six-month forbearance period will quickly recede, and unfortunately, it will not take the virus with it. While the deferrals are crucial to maintain liquidity and keep people employed, the US's uncontrolled Covid-19 spread means it is more and more likely that six months is not long enough of a runway to get most hotels back to profitability. When these deferrals expire in about Q4 of this year, travel demand will still be severely depressed; Q3 and Q4 skew heavily toward group and convention business, which will surely be near nonexistent. As with all things Covid-19, it is too early to tell how agreeable banks will be in their restructuring come winter, but it will likely be less than the 90% of bank debt holders who received relief the first go-around.

(New) Outlook for hotels

So, what does this mean for the near future of hotels? Indeed, it is a different world than my prior prediction made in February of a slight downturn. After a predicted -52.8% RevPAR decrease in 2020, CBRE forecasts[5] that US hotel revenues will not fully recover until 2024.

The United States' lack of control of the Covid-19 viral spread through the summer, as compared to other countries with high testing rates, has undoubtedly hampered our recovery. According to Transportation Security Administration (TSA) data,[6] week-over-week air travelers decreased in late July, generally peak summer travel season, after consistent favorable green shoots since mid-April. Better control of the spread is necessary for economic recovery. Domestically, travelers will not gain the confidence to travel until they feel safe, and inbound international travel will be restricted until we can prove that the US's Covid-19 spread is under control.

Surely this will not be the death blow to the lodging industry. While cultural changes due to Covid-related work-from-home policies could cause irreversible damage to the business and convention sectors, many Americans like myself are longing to travel again. With all the dry powder sitting on the sidelines from the eight-year expansion, many investors are gearing up for a surge of 'Covid discount' lodging assets to become available. While the transaction market is currently pretty quiet, banks might be forced to sell off the loans when loan forbearance expires in Q4. We have already witnessed many funds raised specifically for distressed assets and non-performing debt.[7]

Alas, hotel investors encumbered with CMBS debt have endured the long road, and they are not anywhere close to being out of the woods. The AHLA is correct when they say that such a massive surge in hotel delinquency will haunt the entire CRE industry, not just lodging. And while we should put more resources towards helping these assets stay afloat, the lesson is clear: our world has become increasingly unpredictable, and rigid financing options, like CMBS, have been exposed in their instrumentality in an already unpredictable sector. ◆

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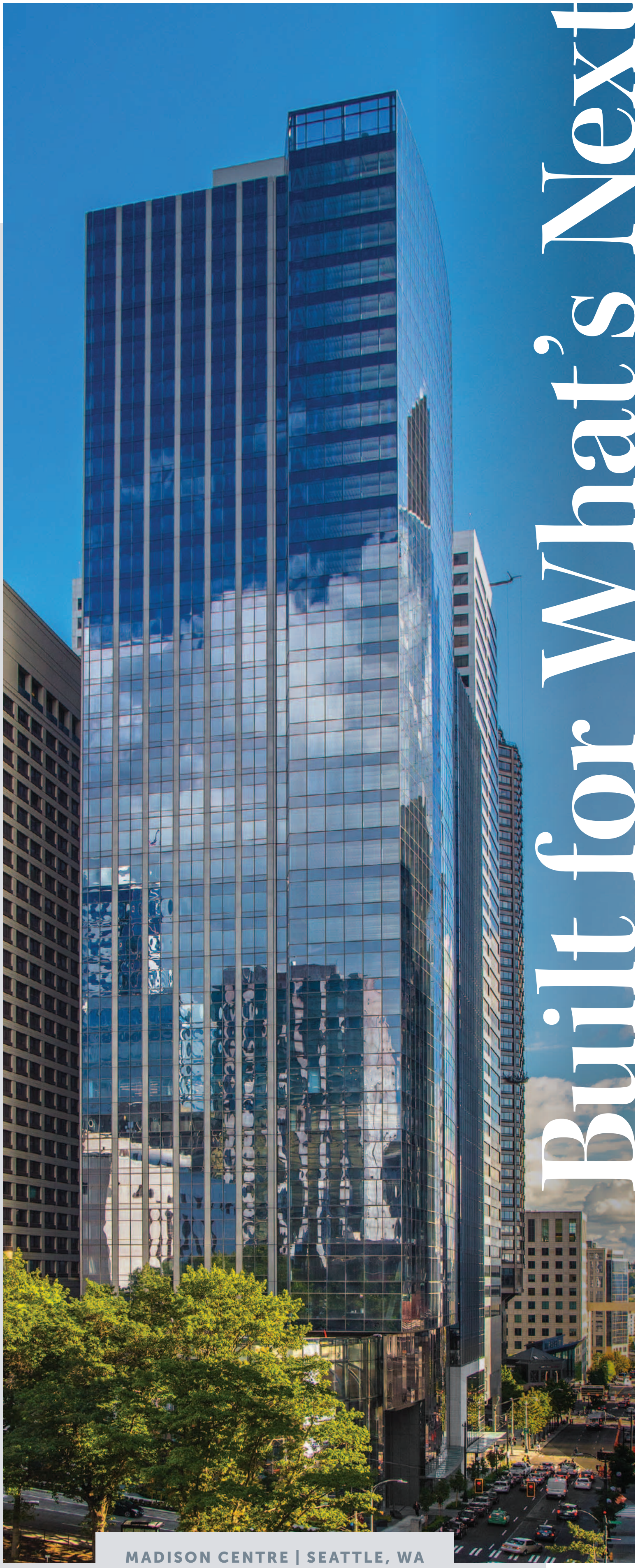

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