CONTRARIAN REAL ESTATE INVESTING PART II

A road map for underwriting investments that cut against conventional wisdom

Adam Ducker, Managing Director
Taylor Mammen, Managing Director

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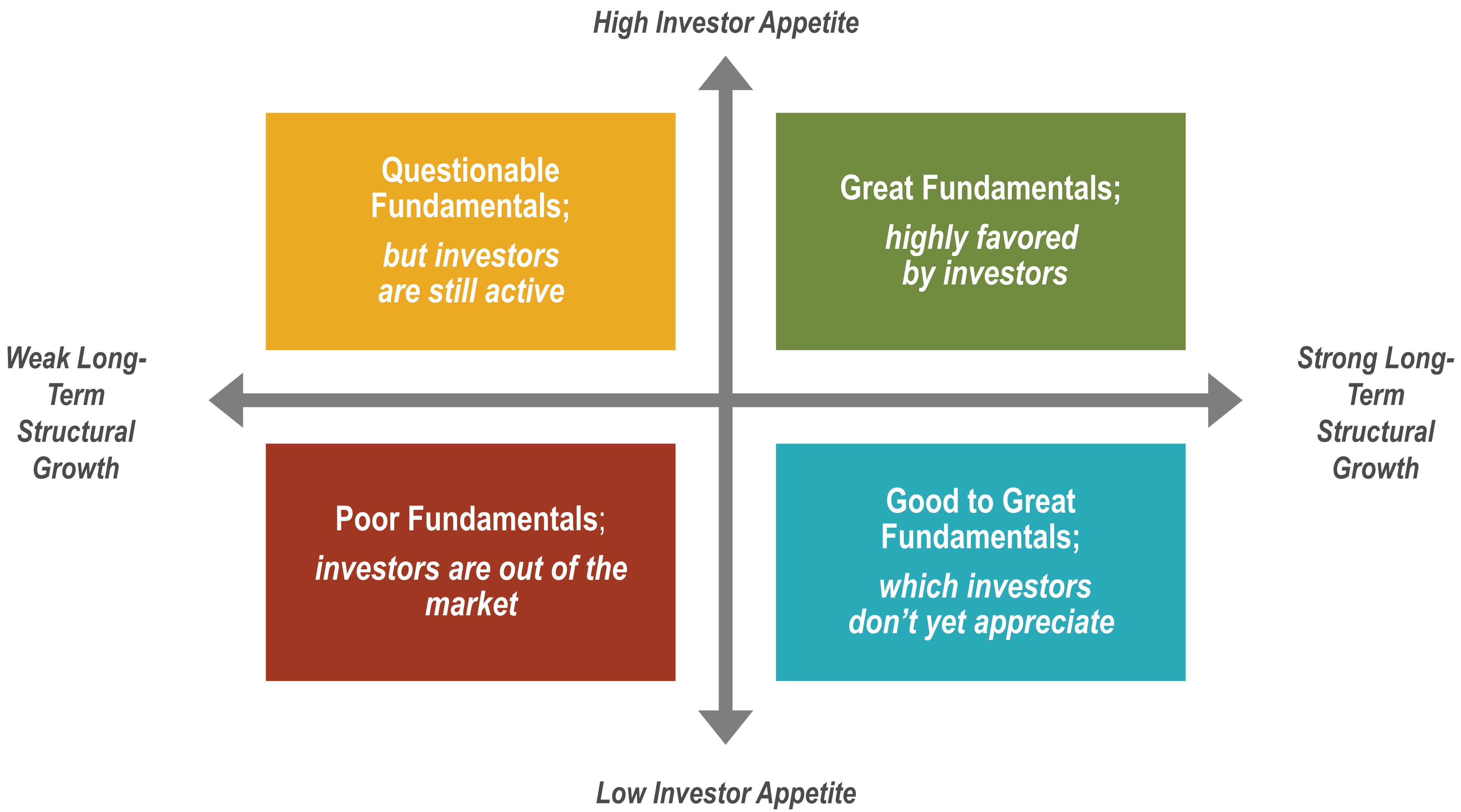
ABOUT RCLCO

RCLCO is the leading knowledge solutions provider to the real estate industry

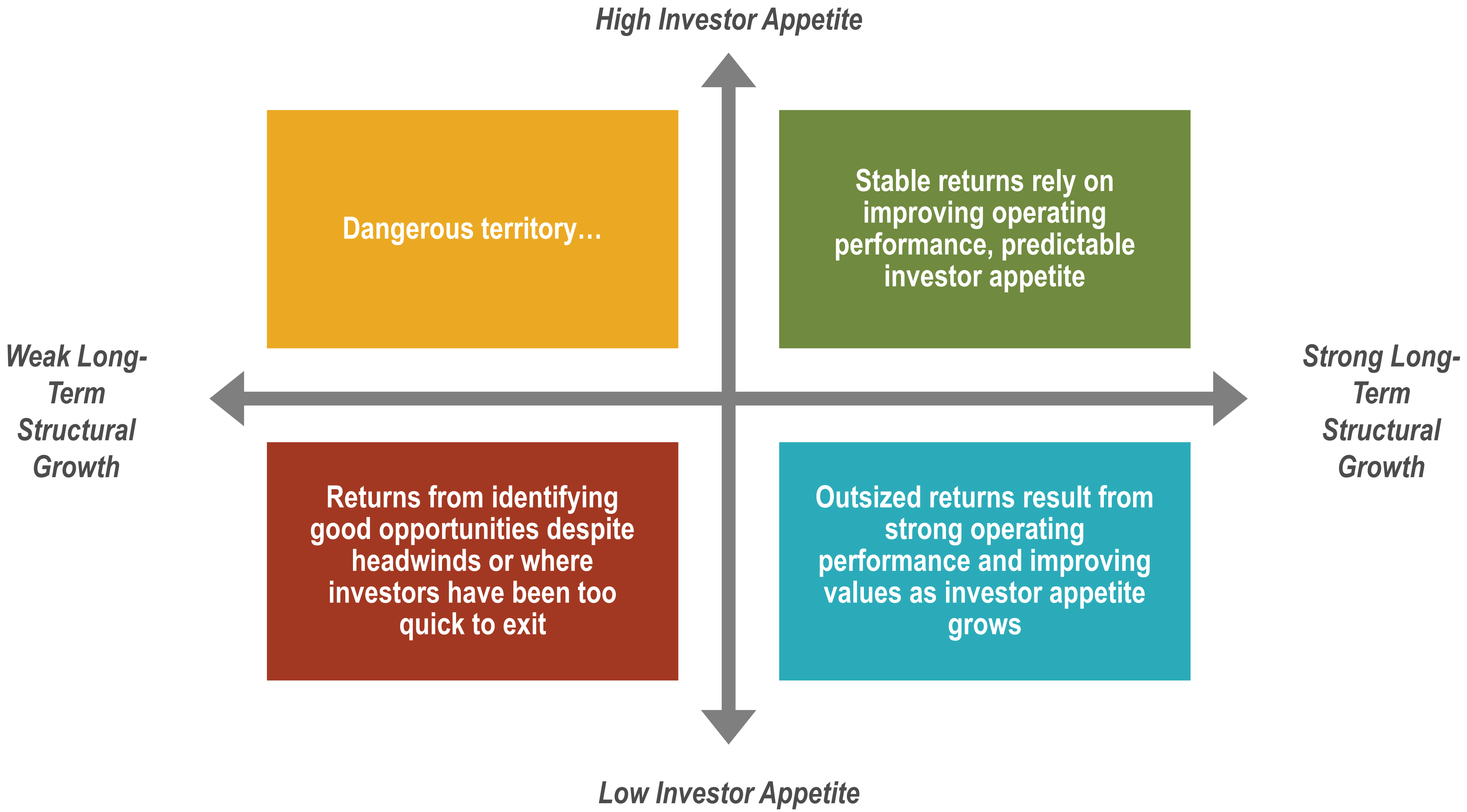
- "First call" for those seeking strategic and tactical advice regarding property investment, planning, and development
- We provide end-to-end advisory and implementation solutions at an entity, portfolio, or project level

- Engaged on ~500 projects annually touching more than $5B in real estate
- Affiliated with more than 25 leading industry associations, including ULI, PREA, NMHC, etc.
- **Office Locations**: Los Angeles, CA; Austin, TX; Orlando, FL; Washington, DC
- **Mission**: To help our clients make strategic, effective, and enduring decisions about real estate
- **Advisory Groups**: Institutional, Urban Real Estate, Public Strategies, Community & Resort, Strategic Planning & Litigation Support

"CONTRARIAN" = IDENTIFYING UNDERAPPRECIATED OR MISPRICED OPPORTUNITIES



INVESTMENT OPPORTUNITIES PRESENT THEMSELVES IN EACH QUADRANT



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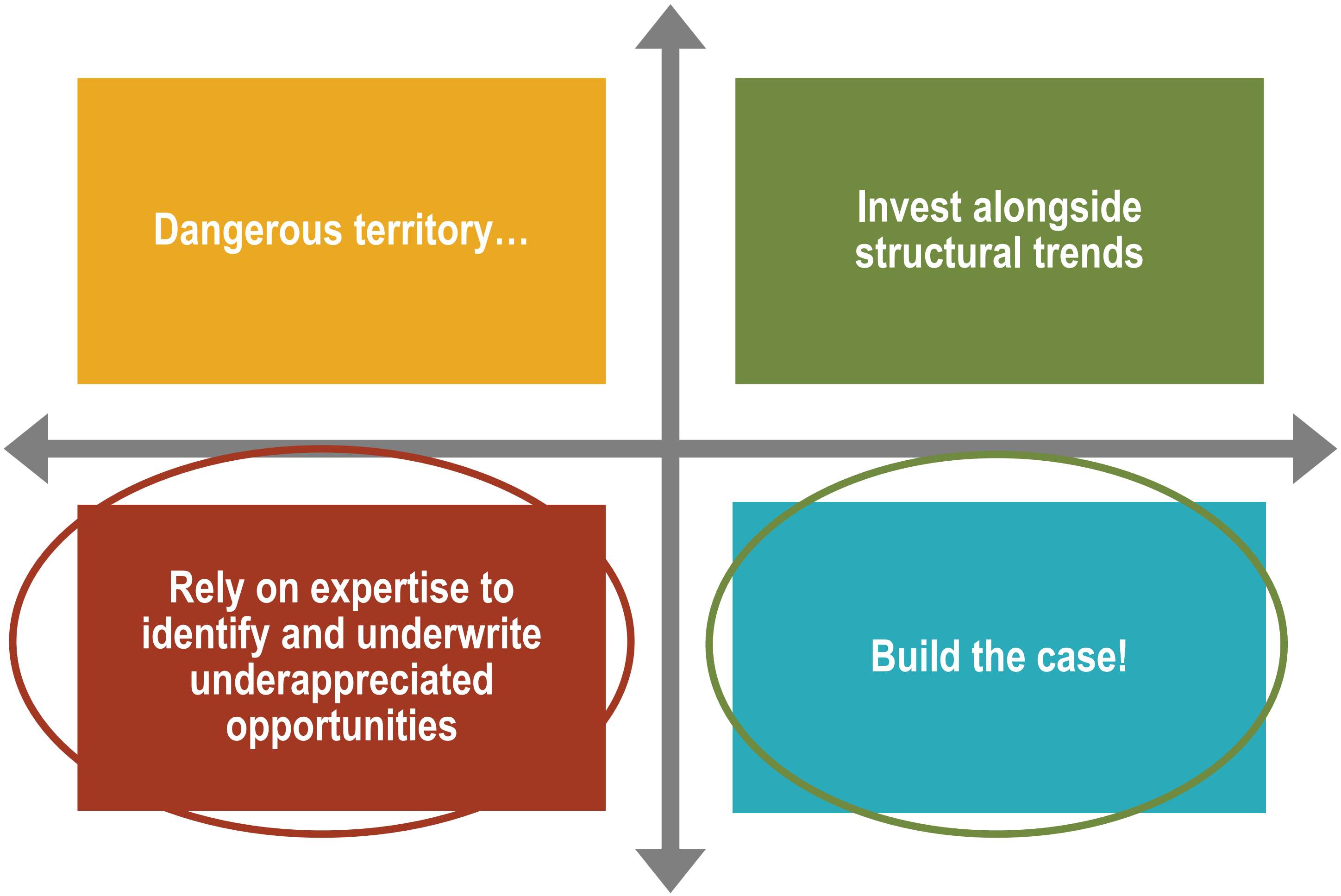
FOCUS FOR TODAY: UNDERWRITING INVESTMENTS IN THE SECTORS WHERE RISK APPEARS MIS-PRICED

Examples:

- Suburban Office
- Retail
- (Upscale/ Luxury) Hotels



Examples:

- For-Sale Housing
- Suburban Apartments
- Multitenant Industrial
- Hybridized Product Types

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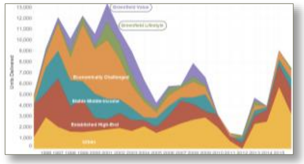
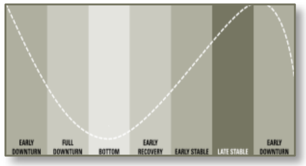
QUESTIONS FOR TODAY



How does contrarian investing fit within a portfolio of real estate investments?



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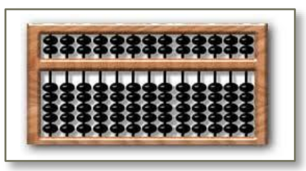
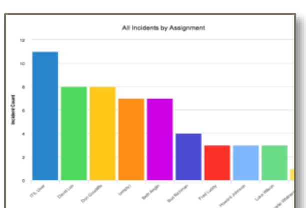
How might we think about debt or capital stack formation in pursuing investments that are harder to price?



How do you underwrite a contrarian strategy?

How do you vet a manager's ability to execute an unproven investment hypothesis?



What monitoring and asset management complications does this investment style create?

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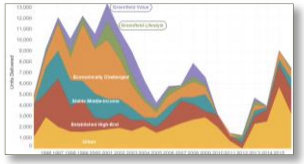

How does contrarian investing fit within a portfolio of real estate investments?

PORTFOLIO APPROACH OVERVIEW

Portfolio Role of Contrarian Investments:

- Continuous introduction of risk (and higher returns) an essential component of a portfolio
- “Contrarian” investments allow investors to further diversify their risks
- “Contrarian” risks are different, but manageable

Specific Risks to Quantify:

- Macroeconomic
- Interest Rate
- Inflation
- Market
- Execution
- Financing
- Liquidity

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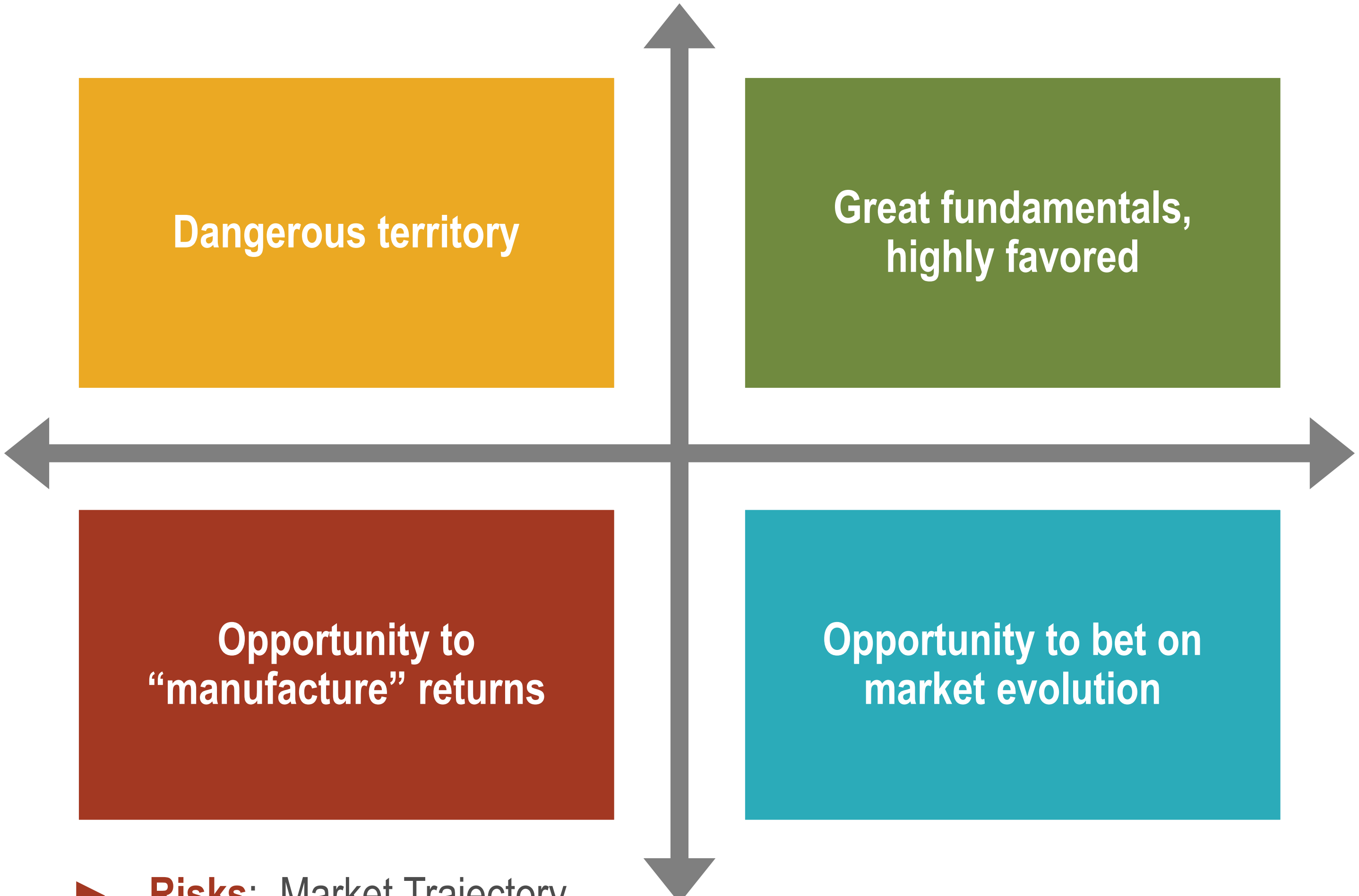
RISK LAYERING COMPONENTS



- **Risks**: Mostly Macro
- **Expectation**: Lower Volatility
- **Contrarian Bet**: Returns are higher / volatility lower than the market expects
- **Example**: Seniors Housing

- **Risk**: Misunderstood Market
- **Expectation**: Growth Trajectory
- **Contrarian Bet**: Market has it wrong, execution not so complicated
- **Example**: Suburban Apartments

- **Risks**: Market Trajectory
- **Expectation**: Value Pop
- **Contrarian Bet**: Execution capability trumps fundamentals
- **Example**: Suburban Office

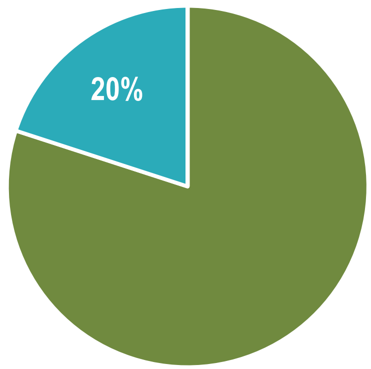
POTENTIAL PORTFOLIO STRATEGIES

Core of Core

***Upside**: Predictable Returns*

***Downside**: Never meets required returns because of imbalance between downside and upside risk*

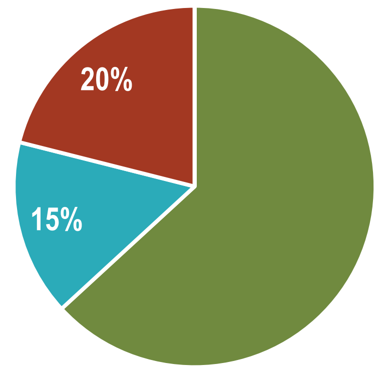
Growth Upside



***Upside**: Enhanced long-term income growth*

***Downside**: Contrarian bets become a distraction; performance hard to assess*

Broader Risk



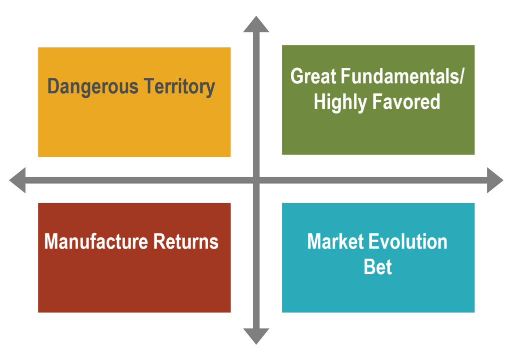
***Upside**: Total returns are compelling with less than expected volatility*

***Downside**: Unsuccessful bets jeopardize ability to carefully manage strategy*

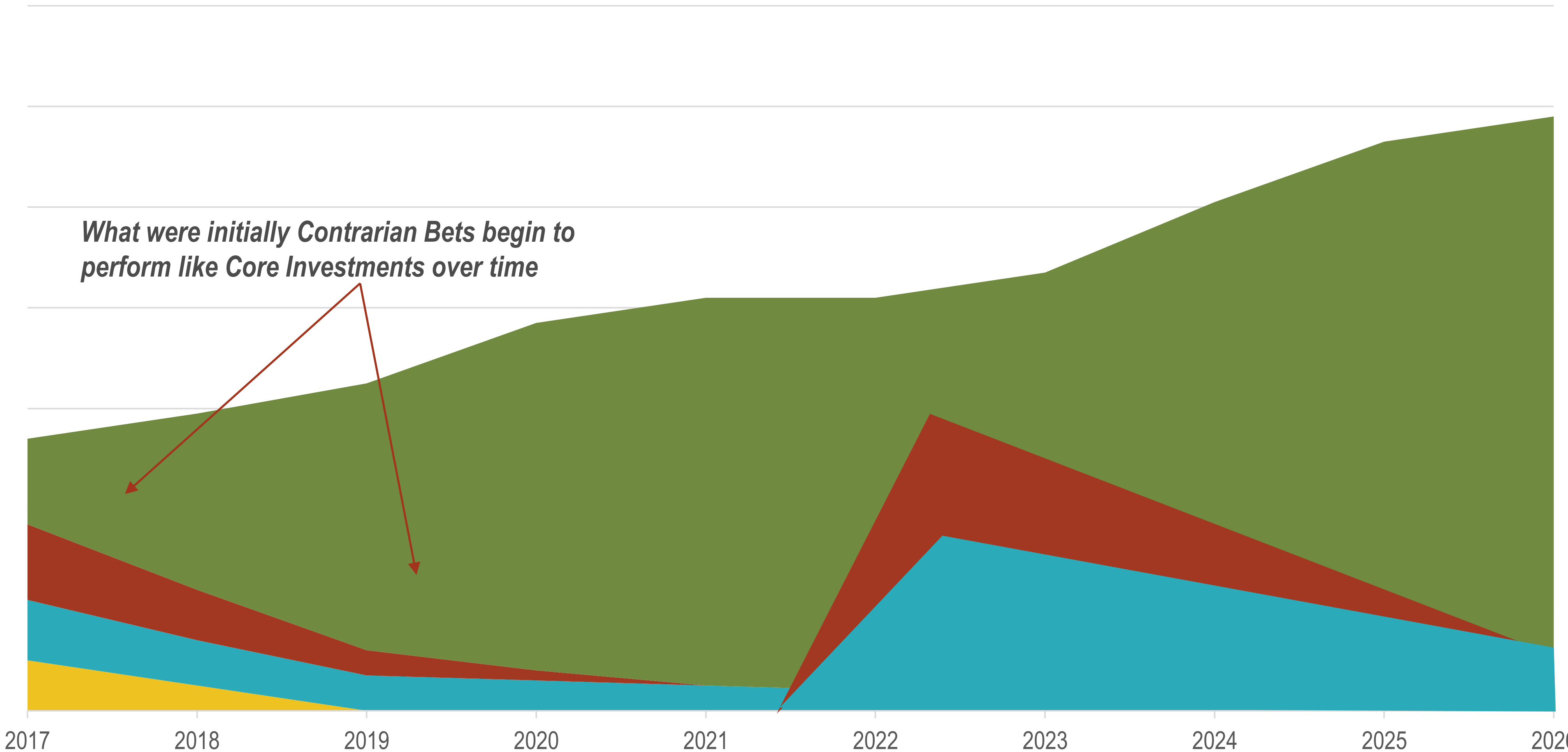
Opportunity Fund

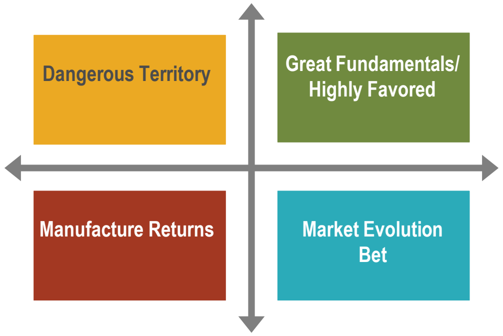
***Upside**: Outsized returns over shorter period of time*

***Downside**: High volatility and invested capital at greater risk; too much trading*



IDEAL PORTFOLIO OUTCOME





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How does contrarian investing change the way we think about real estate cycles?

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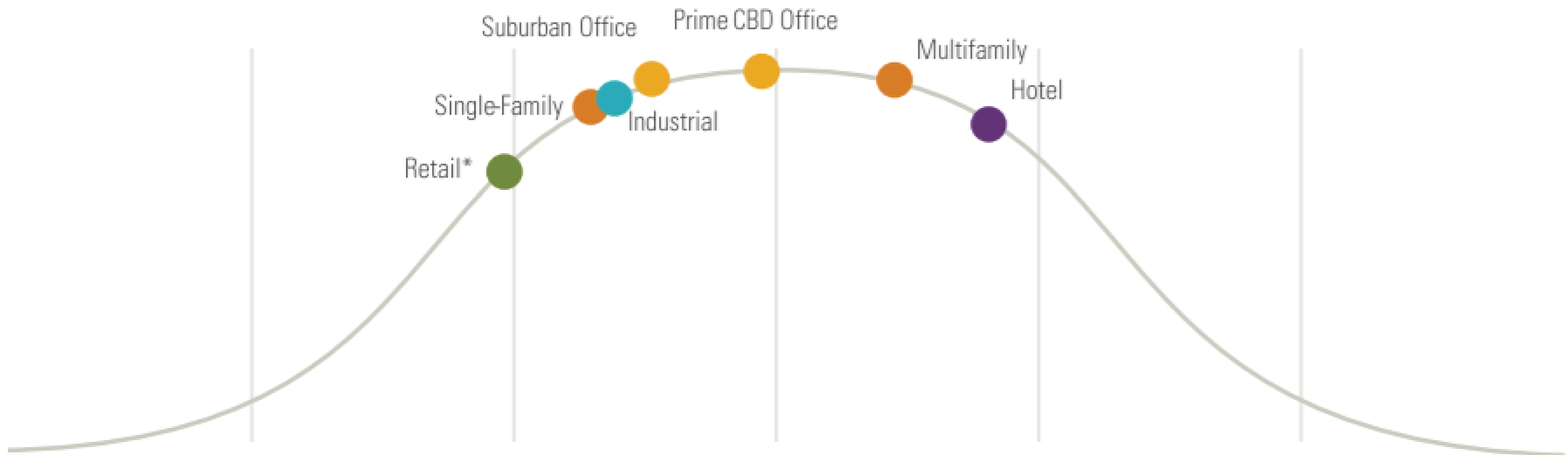
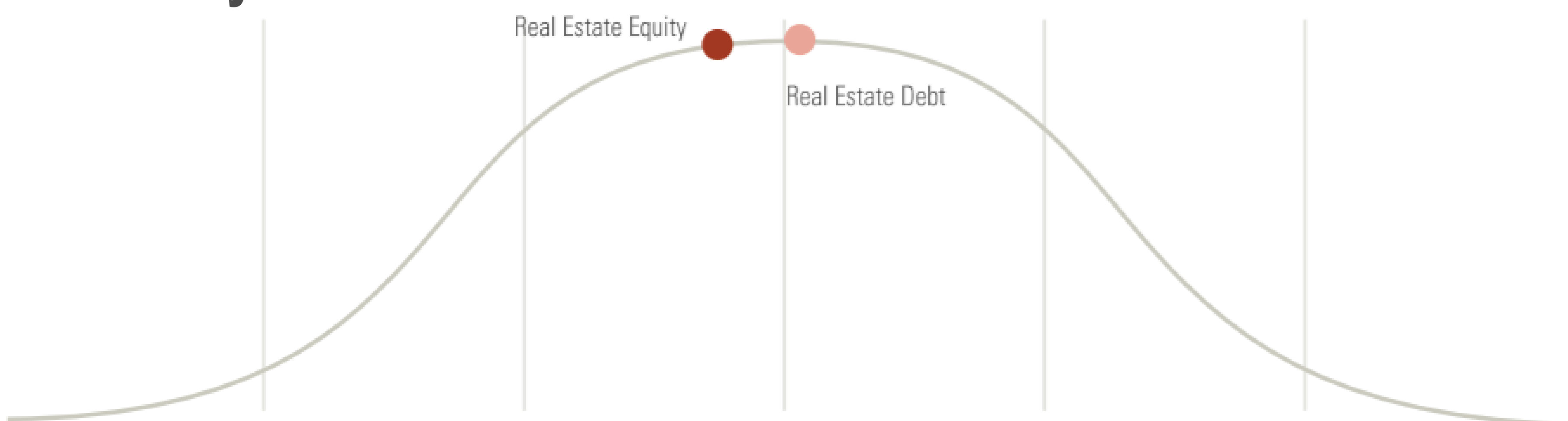
THERE IS MORE THAN ONE "CYCLE"

Property Market Cycle



Debt Market Cycle



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CONTRARIAN INVESTING AND THE CYCLE

Not Predicting (or Ignoring) the Cycle, But:

- First, recognize it's harder to recover from a loss in value than from missing some of the growth
- Then:
  - Have a Cycle Strategy (know what you're going to do beforehand)
  - Monitor the Cycle (internal and external indicators)
  - Act Accordingly (actually do what your strategy tells you to do)

Having a Perspective and a (Data-Driven) Plan Upfront Allows Us to be Better Contrarian Investors:

- We won't panic when times are tough
- We won't follow the herd over the cliff
- We'll have dry powder available to take advantage of opportunities when they arise

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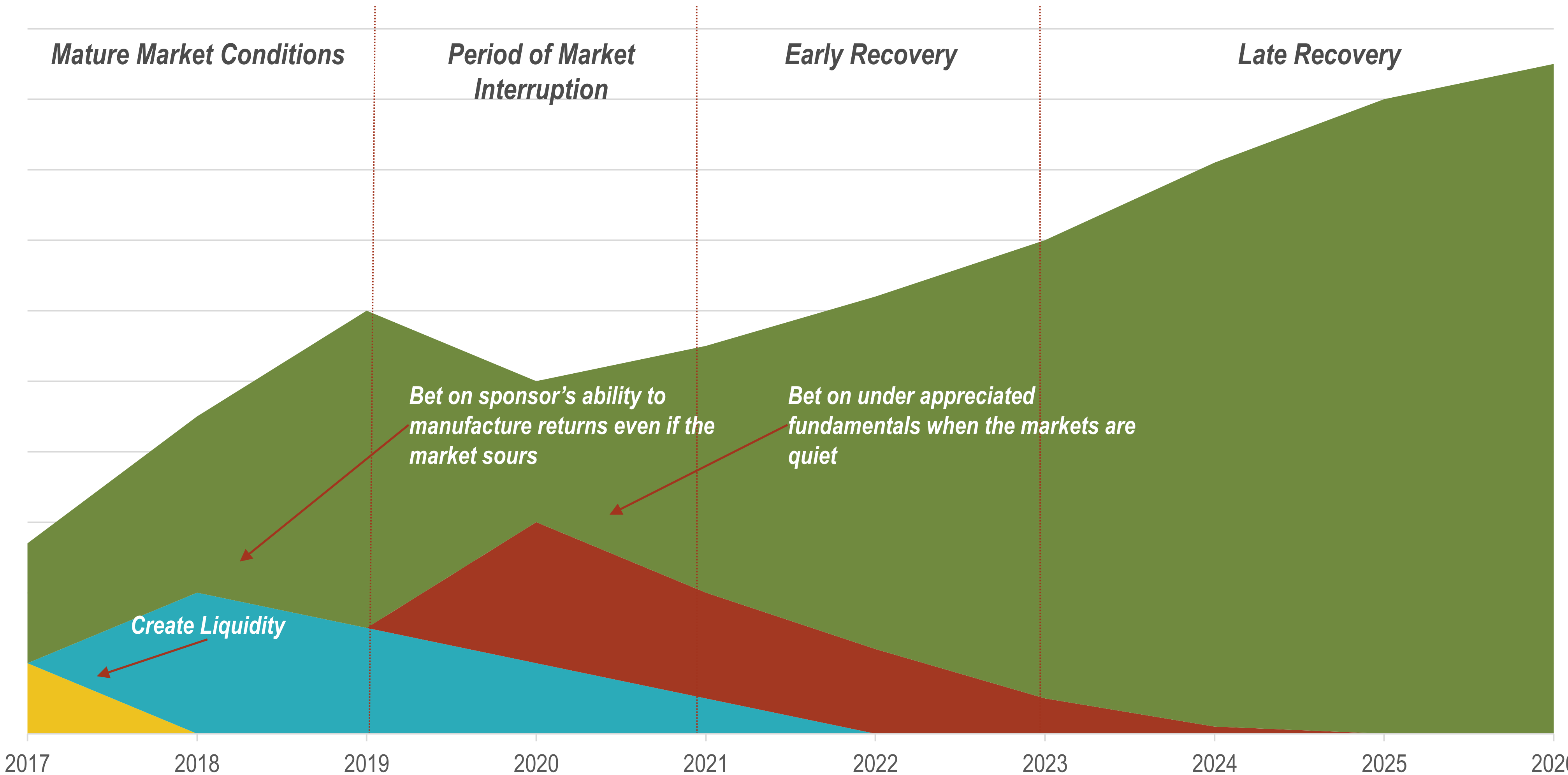
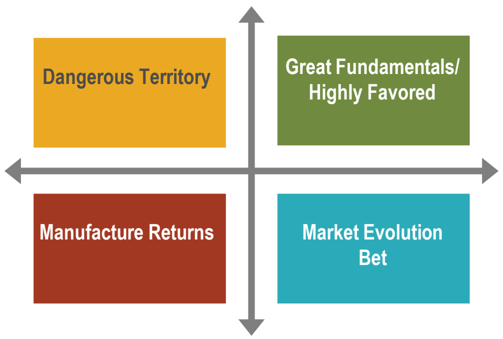
PORTFOLIO APPROACH WITH CYCLE FRAMEWORK





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How might we think about debt or capital stack formation in pursuing investments that are harder to price?

DEBT AND CAPITAL STACK

Most Investors Still Doing This Backwards:

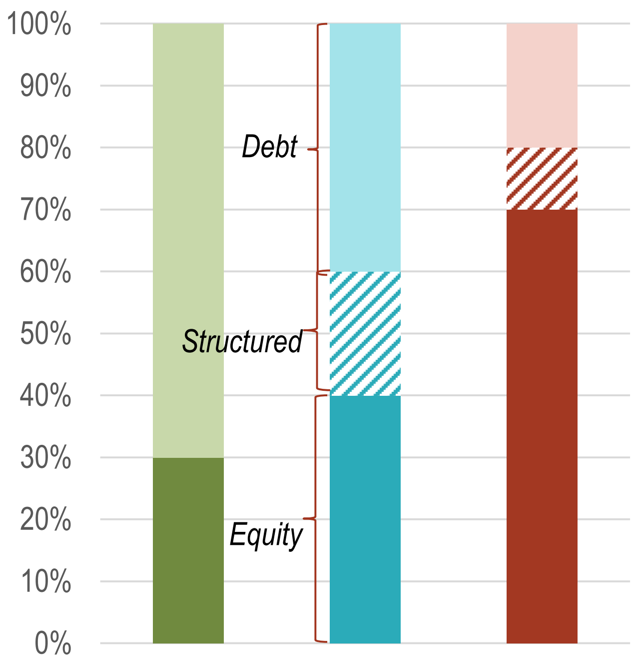
- Low levels of debt on low risk (“Core”) investments
- Conservative on fixed/floating rate to stabilize long-term cash flow
- Higher debt levels on higher risk investments, e.g. development

Contrarian Approach:

- Ability to finance contrarian investments relies upon a different capital strategy
  - Increase debt exposure on lower risk investments
  - Fund most contrarian investments with cash
  - Use preferred equity or other exotic capital stack tools as Contrarian Bets settle and market matures

CAPITAL STACK & INVESTMENT CYCLE FRAMEWORK

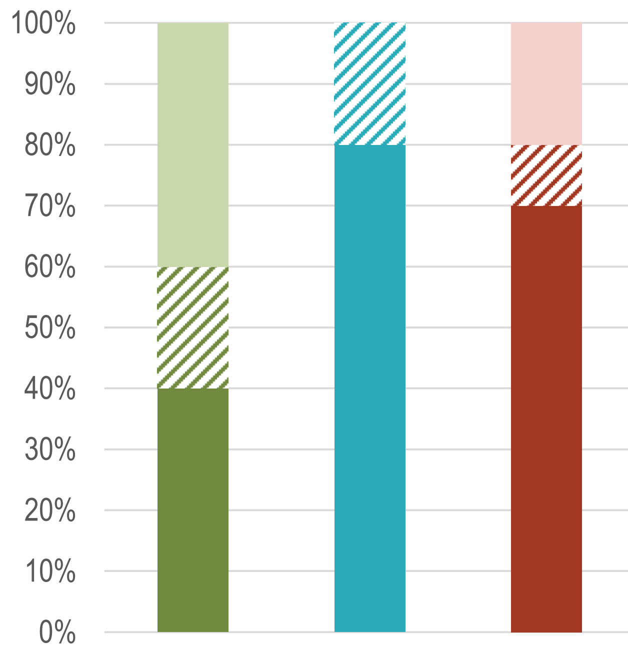
Mature Market Conditions



Balance Sheet:

- *Creating cash*
- *Establishing flexible lines*

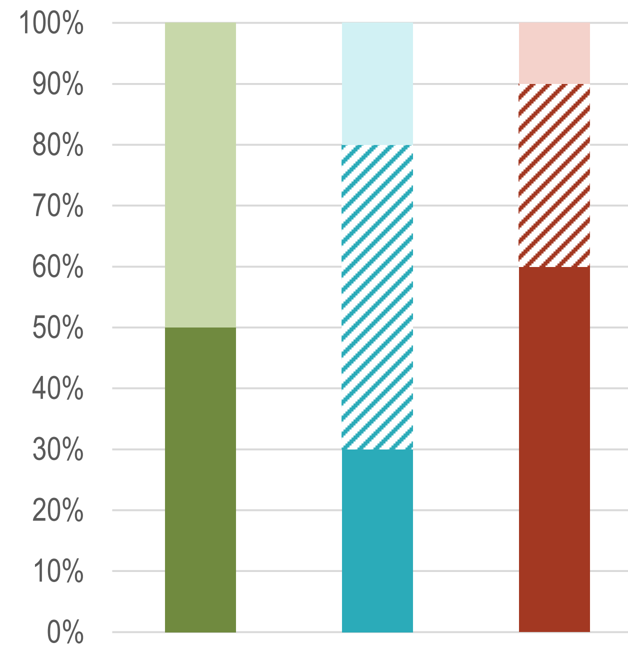
Period of Market Interruption



Balance Sheet:

- *Deploying cash*
- *Drawing down lines*

Early Recovery



Balance Sheet:

- *Converting portfolio leverage to projects*
- *Building organizational capacity*
- *Harvesting value*

Great Fundamentals/ Highly Favored	Equity	Structured	Debt
Market Evolution Bet	Equity	Structured	Debt
Manufacture Returns	Equity	Structured	Debt

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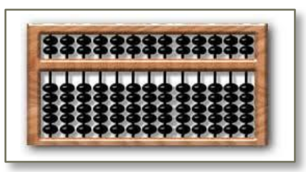

How do you underwrite a contrarian strategy?

UNDERWRITING A CONTRARIAN STRATEGY

Conceptual Framework:

- Contrarian investments should produce a higher return for a similar level of risk
- Responsive to structural lifestyle change (although population niches are okay)
- Legitimate obsolescence of existing product
- Emotional scarring in place that makes risk pricing difficult

(Additional) Underwriting Approach:

- "Green shoots" and triangulation
- Consumer research
- Advanced analytics and datamining

Pitfalls

- Timeline to realization
- Capacity for execution
- Falling in love with the asset not the strategy
- Can be too contrarian (even if right)

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UNDERWRITING CASE STUDIES

Active Adult Rental

Short Term Furnished Housing

High Street Retail

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How do you vet a manager's ability to execute an unproven investment hypothesis?

ASSESSING A CONTRARIAN MANAGER

Conceptual Framework:

- Burden of proof is necessarily much higher
- More about capacity and culture than track record

What we are scoring:

- Underwriting success
- Sophistication of human capital plan
- How research driven is the sponsor, really
- Long-term investor-manager alignment

Pitfalls

- New managers are not necessarily bad, but. . .
- Great people and ideas, lack of reporting capability
- Can be too contrarian (even if right)
- Compelling trend, but not enduring

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UNDERWRITING MANAGERS CASE STUDIES

For-Sale Housing Land Development

Medical Office

Last Mile Distribution

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What monitoring and asset management complications does this investment style create?

MONITORING & ASSET MANAGEMENT

Conceptual Framework:

- How to assess when you don't know what to expect
- Benchmarking complexities
- The concept versus timeline dilemma

Positive Benchmarks:

- Ability to predict/manage costs (if not revenues)
- Discipline and structure around concept evolution
- Team formulation and wise resource management
- Long-term investor-manager alignment

Negative Benchmarks:

- Excessive dead deal costs
- Side ventures and explorations
- Timeline management failure
- Communications and reporting breakdown

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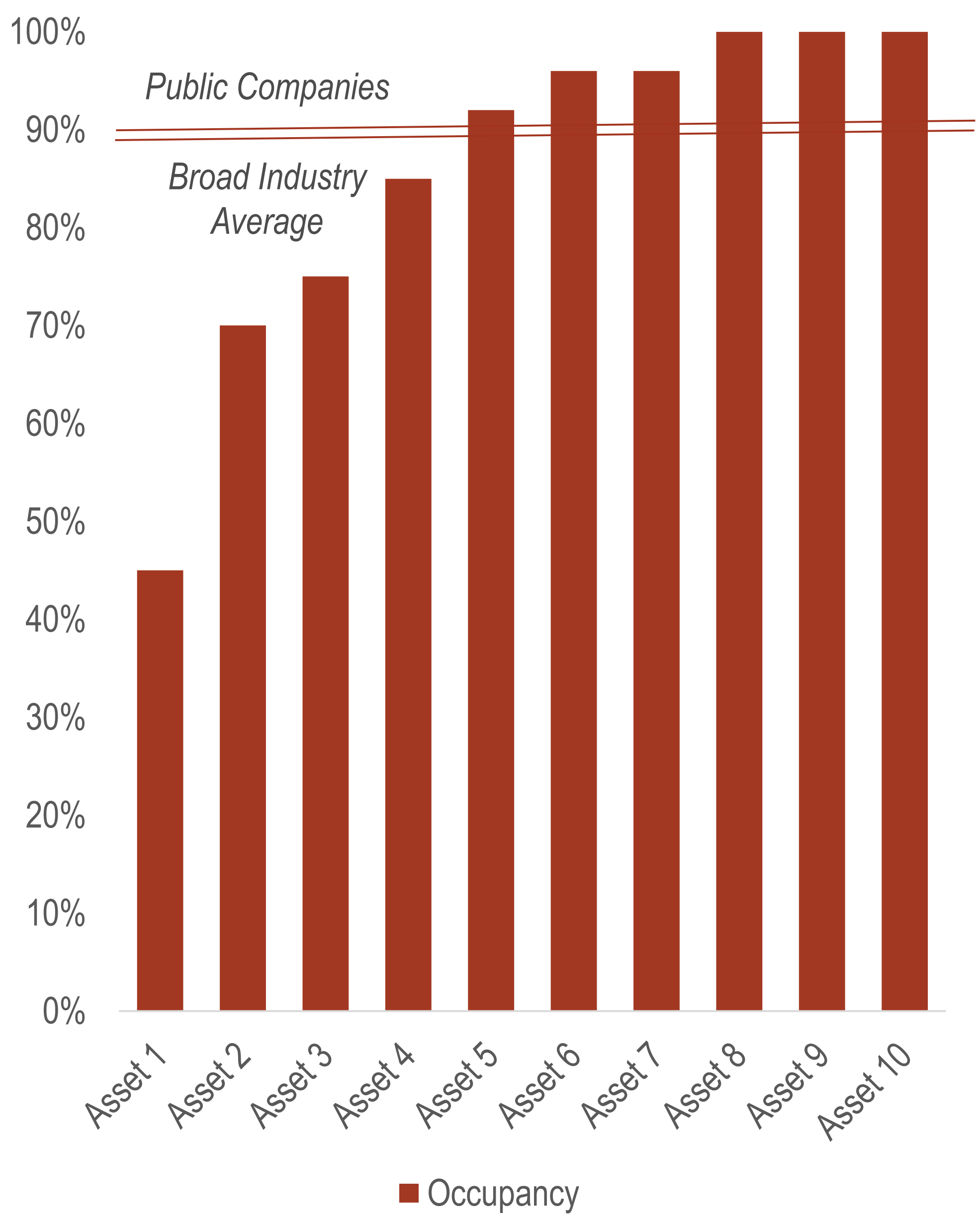
CASE STUDY: AN ASSET MANAGER'S DILEMMA



Niche Housing Portfolio Performance

- Unique strategy
- Data weak sub-asset class
- Underwriting-performance misalignment

The Proposed Evaluation Metrics

- Thoughtfulness of portfolio-wide sell/hold/invest
- Year-over-year increase in sophistication of data and performance analysis
- Nimbleness in team formation
- Openness to relationship restructuring to ensure alignment

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CASE STUDY: THE MANAGER'S PLAYBOOK

INDICATOR	Stage 1 Early Downturn	Stage 2 Full Downturn	Stage 3 Bottom	Stage 4 Early Recovery	Stage 5 Early Stable	Stage 6 Late Stable
Local/Micro Market Indicators						
Purchase of unentitled land	No one	No one	No one	Few	Many	New Players
Level of Mezz financing	None	None	None	Limited	Significant	Most Deals
Availability of capital	None	Opportunity	Land Bank	Institutional	Everyone	Too Much
Secondary players/developers and/or sites	None	None	None	Few	Some	Many
Land Leases	None	None	None	Few	Some	Many
Qualitative assessment of competitive landscape	Limited	None	Limited	Moderate	Significant	Too Much
Market Indicators/Stats:	Declining rapidly below trends	Far below trends	Below trend	Growing, but below trend	At or slightly above trend	Far above trend
# starts/permits	"	"	"	"	"	"
Job-permit/job absorption ratio	"	"	"	"	"	"
Job growth	"	"	"	"	"	"
Homeownership rate trends	"	"	"	"	"	"
Rental rate & occupancy trends	"	"	"	"	"	"
Demand/supply equilibrium	"	"	"	"	"	"
Cap rates	"	"	"	"	"	"
Land pricing	"	"	"	"	"	"
Concessions	Increasing	Increasing rapidly	Firming	Declining rapidly	Declining	Gone
NOI trends	Declining	Declining rapidly	Firming	Growing rapidly	Growing	Flat
Price to Replacement Cost	P declining rapidly	P < RC	P >=RC	P > RC	P > RC	P > RC
Residential/Condo activity	None	None	None	Limited	Moderate	Significant
Pro Forma Indicators						
Development Pro Forma IRRs	n/a	25%+	25%+	20-25%	15-20%	<15%
Going In/Out Cap Rate Spread (bps)	240+	200+	200+	150+	100-150+	<100
Loan to Cost Construction	n/a	<50%	50%	0.6	65-75%	80-100%

Office Value Add Strategy

- Highly cyclical
- Heavy trading strategy
- Returns highly sensitive to values/cap rate volatility

The Proposed Risk Management Tool

- Detailed market monitoring system
- Aligned with "tripwire" playbook corresponding to market changes
- Track record of disciplined action
- Flexible financing and deal structure to allow flexibility around the exit

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CONCLUDING THOUGHTS/QUESTIONS

- The Contrarian Framework suggests there are compelling investment opportunities, even though markets seem fully priced
- Every real estate investment involves a contrarian element -- betting that the asset is underpriced, rent growth upside, etc.--- because all markets are inefficient
- Better underwriting results from clearly identifying the risks, understanding that some new and different form of analytics is required to measure them, and deciding which ones you're comfortable taking
- Contrarian Investing is almost intrinsically tied to market cycles -- you don't have to be a market timer, but you do have layer the cycle into your risk management
- Asset management is much more difficult in light of the above dynamics, and requires creativity in assessing manager and asset performance

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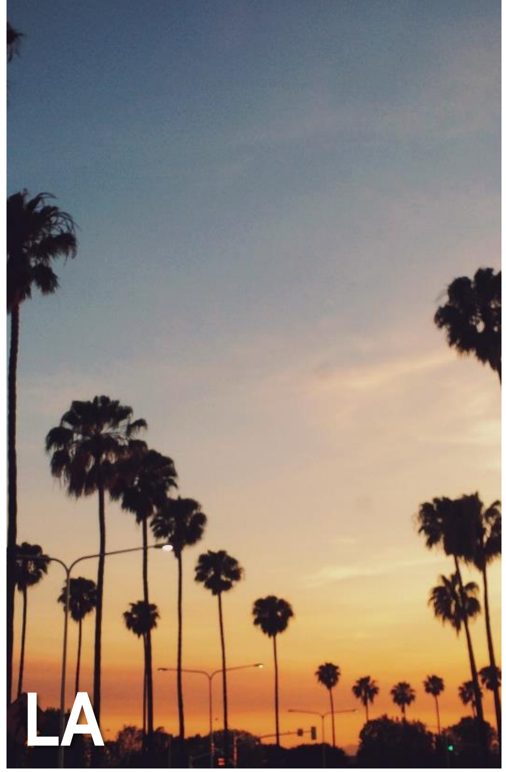

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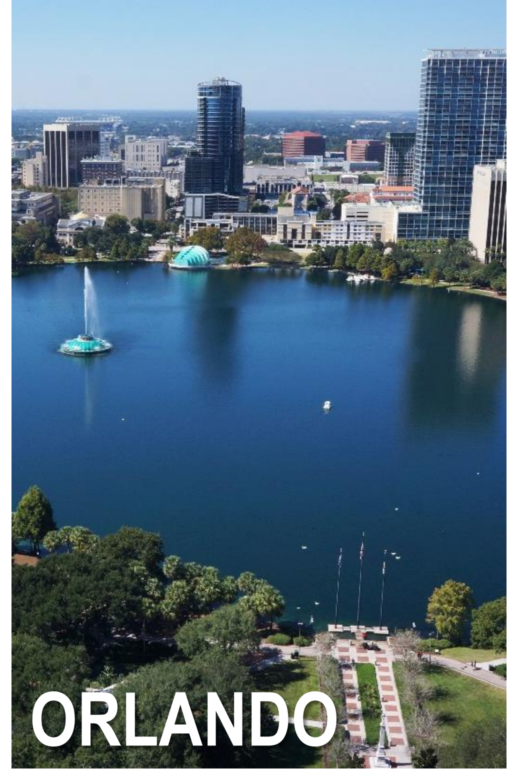

964 Lake Baldwin Ln
Suite 100
Orlando, FL 32814

7200 Wisconsin Ave
Suite 1110
Bethesda, MD 20814

RCLCO
REAL ESTATE ADVISORS

Adam Ducker
Managing Director
P: (240) 644-0980
E: ADUCKER@RCLCO.COM

Taylor Mammen
Managing Director
P: (310) 282-0437
E: TMAMMEN@RCLCO.COM