CONTRARIAN REAL ESTATE INVESTING

STRATEGIES FOR IDENTIFYING VALUE IN A MARKET THAT SEEMS FULLY PRICED AND FAIRLY CROWDED

ADAM DUCKER, MANAGING DIRECTOR
TAYLOR MAMMEN, MANAGING DIRECTOR
NREI WEBINAR | MAY 9, 2017
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 OPPORTUNITIES

- **Questionable Fundamentals;** but investors are still active
- **Great Fundamentals;** highly favored by investors
- **Poor Fundamentals;** investors are out of the market
- **Good to Great Fundamentals;** which investors don’t yet appreciate

High Investor Appetite

Weak Long-Term Structural Growth

Strong Long-Term Structural Growth

Low Investor Appetite
INVESTMENT OPPORTUNITIES PRESENT THEMSELVES IN EACH QUADRANT

Dangerous territory...

Stable returns rely on improving operating performance, predictable investor appetite

Returns from identifying good opportunities despite headwinds or where investors have been too quick to exit

Outsized returns result from strong operating performance and improving values as investor appetite grows
Dangerous territory…

Invest alongside structural trends

Rely on expertise to identify and underwrite underappreciated opportunities

Build the case!

IDENTIFYING VALUE OF GEOGRAPHY / PRODUCT TYPE DYNAMICS WITHIN THE FRAMEWORK
INVESTING ALONGSIDE LONG-TERM STRUCTURAL TRENDS

• Critical to identify:
  o What hasn’t yet peaked (or maybe isn’t proven) in terms of demand
  o What isn’t or isn’t likely to be oversupplied

• Opportunities:
  o Seniors housing
  o Industrial/logistics
  o Medical office
  o Housing (in general)

Great Fundamentals; highly favored by investors

Stable returns rely on improving operating performance, continued investor appetite

Invest alongside structural trends
LONG-TERM STRUCTURAL TRENDS

Aging Population Requires More (and New Types of) Seniors Housing and Other Services

*Projected Population and Growth Rate, Total Population and Age 75+; United States of America*

*Source: US Census Bureau*
LONG-TERM STRUCTURAL TRENDS
No Matter What Happens to the ACA ("Obamacare"), We’ll Need More Healthcare Facilities

Healthcare Spending by Age Group; United States of America

Source: Centers for Medicare & Medicaid Services
LONG-TERM STRUCTURAL TRENDS

eCommerce is the Only Type of Retail Experiencing Sales Growth in 2017 (Good for Industrial)

Retail Sales Growth; 1993 to February 2017

Source: Centers for Medicare & Medicaid Services
LONG-TERM STRUCTURAL TRENDS
Housing in the U.S. is Only Just Recovering

Housing Completions Relative to Household Formation

Source: US Census; RCLCO
USING EXPERTISE TO IDENTIFY & UNDERWRITE UNDERAPPRECIATED OPPORTUNITIES

• Real estate is supremely inefficient (every parcel is different, many of them still great)

• Strong operators really do create value; characteristics of organizations that do this type of investing well:
  o Ability to ask tough questions of themselves & evolve
  o Creative capitalization
  o Discipline in underwriting
  o Actual asset management
  o Fine-tuned market observers

• Examples:
  o Suburban office
  o Retail
  o (Upscale/Luxury) Hotels

Poor Fundamentals; investors are out of the market

Returns from identifying good opportunities despite headwinds or where investors have been too quick to exit

Rely on expertise to identify and underwrite underappreciated opportunities
UNDERAPPRECIATED OPPORTUNITIES
Investors Uniformly Assuming Significant Risk In Suburban Office — Certainly Mispriced in Places
UNDERAPPRECIATED OPPORTUNITIES
Retail is Under Threat and Not Favored, but Opportunities Clearly Exist

Vacancy by Retail Center Type

Source: CoStar
Supply Concerns Leading Investors Away From Hotels, But Likely Create Opportunity Around the Corner

**Cap Rates by Property Type**

- All Hotels
- Full-Service
- Limited-Service
- Botique

**Net Change in Hotel Keys**

- Net Change in Supply
- 2000-2015 Avg Change in Supply

*Source: Real Capital Analytics*

*Source: PKF Hotel Horizons Report*
OUTSIZED RETURNS RESULT FROM LEVERAGING BOTH APPROACHES

- Difficult to identify: markets may be inefficient, but they’re not stupid
  
- Difficult to underwrite: how do you know you’re right, and everyone else is wrong?
  
- Difficult to finance: where are the comps?
  
- Examples we’re seeing right now:
  
  o For-sale residential
  o Suburban apartments
  o “Missing Middle” residential products
  o Multitenant industrial
  o Hybridized product types
  
Great Fundamentals; which investors don’t yet appreciate

Outsized returns result from strong operating performance and improving values as investor appetite grows

Build the case!
UNDERAPPRECIATED TRENDS
For-Sale Residential Potentially Coming Out of the Wilderness

U.S. Housing Starts

U.S. Home Ownership Rate

Source: U.S. Census
Source: U.S. Census
UNDERAPPRECIATED TRENDS
Investors Overly Focused on (Sexy) Urban Apartment Markets Despite Similar Performance of Other Place Types

**Average Effective Rent by Place Type, United States**

Source: Axiometrics; RCLCO Place Type Characterization System
UNDERAPPRECIATED TRENDS
Market Has Turned Away Without Basis from “Economic”/Place Type Missing Middle

*Average New Multifamily by Place Type, Atlanta MSA*

Source: Axiometrics; RCLCO Place Type Characterization System
UNDERAPPRECIATED TRENDS & PRODUCT TYPES: MISSING MIDDLE

**Family Lifestage Distribution by Housing Type; United States**

- Multifamily Rental: 8% Post Grad, 17% Family, 27% Older Workers & Retirees, 21% Middle Aged, 27% Young Workers, No Kids
- Single-Family Rental: 4% Post Grad, 10% Family, 49% Older Workers & Retirees, 20% Middle Aged, 18% Young Workers, No Kids
- Single-Family Owned: 3% Post Grad, 31% Family, 17% Older Workers & Retirees, 48% Middle Aged, No Kids
- All Households: 1% Post Grad, 32% Family, 18% Older Workers & Retirees, 40% Middle Aged, No Kids

**Place Type of Current Residence; Millennials (25-34)**

- Top 50 Metros: 28.4% Suburban, 71.3% Urban
- Gateway Metros: 31.0% Suburban, 65.9% Urban
- Philadelphia: 36.1% Suburban, 60.1% Urban

Source: U.S. Census

Image: Opticos Design
UNDERAPPRECIATED TRENDS

Small-scale (Usually Multi-tenant) Industrial Exhibits Strongest Market Fundamentals

**Percentage Change in Industrial Inventory by Size Category; 2007-2017 (YTD)**

- 1,000,000+ SF: 7%
- 500,000-1,000,000 SF: 16%
- 250,000-500,000 SF: 8%
- 150,000-250,000 SF: 3%
- 25,000-150,000 SF: 1%

**Average Industrial Vacancy by Size of Building; 2007-2017 (YTD)**

Source: Costar
## UNDERAPPRECIATED TRENDS

Evolving Trends in American Life Driving New and Creative Product Hybridization

<table>
<thead>
<tr>
<th>TREND</th>
<th>SOLUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increasing Residential Transience</td>
<td>Short-Term Furnished Rental</td>
</tr>
<tr>
<td>Rise of Work From ‘Home/Sole Proprietorship’</td>
<td>Residential/Office Hybrid Conversions</td>
</tr>
<tr>
<td>Retail Box Store Obsolescence</td>
<td>Mall Anchor Medical Office</td>
</tr>
</tbody>
</table>

**Saul Urban**
Unban Suites; Washington, D.C.

**Novus Residences**
eLofts; Alexandria, Virginia

**Underappreciated Trends**

Evolving Trends in American Life Driving New and Creative Product Hybridization

- Increasing Residential Transience
- Rise of Work From ‘Home/Sole Proprietorship’
- Retail Box Store Obsolescence

- Short-Term Furnished Rental
- Residential/Office Hybrid Conversions
- Mall Anchor Medical Office

**Saul Urban**
Unban Suites; Washington, D.C.

**Novus Residences**
eLofts; Alexandria, Virginia

**Underappreciated Trends**

Evolving Trends in American Life Driving New and Creative Product Hybridization

- Increasing Residential Transience
- Rise of Work From ‘Home/Sole Proprietorship’
- Retail Box Store Obsolescence

- Short-Term Furnished Rental
- Residential/Office Hybrid Conversions
- Mall Anchor Medical Office

**Saul Urban**
Unban Suites; Washington, D.C.

**Novus Residences**
eLofts; Alexandria, Virginia
UNDERWRITING “CONTRARIAN” STRATEGIES

• Contrarian investment strategies bear a higher burden of proof:
  o “What we’re observing really is a structural change.”
  o “I know about the threats, but this asset is different.”

• Contrarian returns should earn higher returns (for the same level of risk):
  o Clearly delineate and understand the risks
  o Quantify and evaluate the risks
  o Answer whether the market pricing makes sense

• Contrarian investor characteristics:
  o Inquisitive culture
  o Research-driven approach
  o Appreciation for “the cycle”
  o Patient and flexible capital

• Investment vehicle/approach matters:
  o Fundraising, lifecycle, and approach make it difficult for commingled funds to be contrarian
CONCLUDING THOUGHTS/QUESTIONS

• So, how might you think of constructing a portfolio “staking” investments in these categories?

• How do we overlay thinking about market cycle and this approach?

• How do we use debt or creative capital stack formation with each?

• How do you underwrite a manager’s contrarian strategy?