CROSSWATER REALTY ADVISORS

RAMBLINGS   January 2018 Edition

It's been quite a while since I wrote one of my "Ramblings". I'm not really sure why but it's probably because the markets and the investment management business have been cruising smoothly at 40,000 feet. As Crosswater's workout and restructuring business is not particularly busy given the current hot market I've had time over the holidays to think about lots of miscellaneous "stuff". That is always a dangerous situation, as I probably will get myself in trouble with some reader. But what the hell.

THE MARKETS

I got a call from a client several days ago who views me (probably correctly) as Doctor Doom because of my workout history. He wanted to know what I thought of the markets and when they might turn for the worse. As I am not an active player in deals I tried to avoid the question by pleading ignorance (it won't be the first or last time). What I did tell him was that we are, like it or not, in a highly cyclical business and that nobody is going to take the cycles out of it. Stuff is going to happen – sooner or later. The workout cycles (that is, real estate values slump) I've experienced since I got into the business in 1975 have usually been triggered by either a period of serious overleveraging or serious overbuilding. When we get both at the same time the slump morphs into disasters with Billions of dollars lost and firms collapsing. I told my client I didn't see either of those two factors raising their ugly heads - yet.

Yes, we are building away in the multifamily sector, but primarily in places like California and Seattle where we there is also a serious shortage of housing, especially in the affordable range. Despite such a shortage, Downtown L.A. looks it might be the first sub-market to experience significant difficulties. The problem I see is on both the supply and the affordability front. Every so often I will hop in my car and "shop" a new apartment development and am simply astonished at the rents these new projects are asking for and, so far, getting. It blows my mind. I guess there are a lot of young people out there who can afford these rents, but I wonder how long that can be true and just how deep that market can be. We shall see.

I am also told regulated lenders are tightening up their underwriting standards which should help cool things down a bit. But there is a growing pool of unregulated lenders out there who are playing in the LTV space above 55-60% to maybe 75-80% -- or greater. These are often provided by investment managers using institutional capital. As that money is not as easily tracked as regulated funds I wonder whether we are wandering into troublesome territory and might be rudely surprised one day soon, if interest rates suddenly pop up. Time will tell.

One mitigant of these risks is that a lot of the money out there is being managed by sophisticated or quasi-sophisticated investors and investment managers. That brings me to my next subject.

IS HUGE ALWAYS BETTER?

I've written before about the cosmic change in our industry where a bunch of MEGA FIRMS now dominate the capital raising and thus investing and are part of what I call the "private equitization of real estate investment management". I was looking at a recent article that lists the Top 100 Firms and noticed that the #10 firm had an AUM of over $60 billion. That's "real money". As I operate under the assumption that these firms grew large because they were careful, intelligent investors, maybe their clout in the marketplace means that when a slump hits they can act as a buffer and help prevent it from sliding into a disaster. I must note, however, that many of the Wall

St/Wall St related firms that did so well in the 1990s and early Aughts, had pretty miserable track records starting in the late Aughts. Maybe they were not so smart after all. One note of caution I see is that these firms have been so successful in raising capital to actually invest these funds they have to make pretty enormous bets and/or go international. If the markets turn sharply against them these factors might well eliminate some of the perceived mitigants.

Despite these positive indicators, I don't doubt for a minute that the hot markets we are now experiencing are going to shift downward. Where and when I do not know, but it will happen eventually. And we are in the 7^{th}-8^{th}-or 9^{th} year of a strong recovery, which is a very long period for our industry to go without some sort of correction. The question is how severe the correction will be and for how long.

NOTE: Over the holidays I read a couple of articles on Big Data. Understanding what Big Data is and how it might impact the real estate industry is way above my paygrade. But I do think I know enough to understand that Big Data implies Big Costs. If I am right about that the Big Firms will be the ones who can best afford to use Big Data and will thus get another competitive advantage. Big Data is impacting virtually every industry in the world and it would be naïve to think real estate will somehow be exempted.

As the old adage goes: "if it seems too good to be true, it probably is." Or as the late economist Hyman Minsky argued: long bull markets inevitably end in large collapses. That's called "The Minsky Moment".

I always look for "tells" to get an unscientific hint of the markets turning. One of the tells I look out for is the increase in M & A activity in the real estate investment management business. If I see small-middle size real estate investment managers being sold by their entrepreneurial founders – and most particularly, to a large institutional players – it's usually because those founders sense that the real estate markets are reaching their peak and the value (the multiple) of their firm is also reaching a peak and it's time to take their personal money off the table. I sense that is going on today. Or maybe the recent poor showing of the IPO of Newmark Group is a small, but unnoticed, "canary in the coal mine"? Or maybe the recent report in the Wall Street Journal that, what they call "private equity real estate" fundraising has hit the wall.

I must admit that my "cycles" assumptions are being tested by the experience in China. Despite the many predictions by my colleague Jack Rodman, a/k/a/ The Panda Bear, – that the Chinese real estate markets will collapse any day now, they have stayed steady for going on 20 years. The reason probably is that China is not a market economy subject to traditional market cycles and the government can and does interfere quite frequently and aggressively.

PS: Despite the above The Panda Bear still believes the "end is near".

MARKETING/PRESENTATIONS

Last year we helped a client who was thinking about going international in a substantial way. We did a "desktop" search for the firms we thought were major and reasonably successful international players. We then asked 5-6 of them to come in to present to the client and Crosswater. We had sent them a fairly thorough (if not, intrusive) questionnaire beforehand so we knew quite a bit about their structure, personnel and track records.

We asked them to be ready to discuss the *concept o*f international real estate investing. Why should a major pension go international? What are the pros and cons? If they believe the client should go overseas, how would they suggest structuring such a program? What property types should be the focus? Where? What and where to avoid? They were told – *in very clear terms* - that this was to be an informational session for our client and not a pitch meeting. We explained: No Pitch Books! No Marketing Staff! Only the top 4-5 decision makers from each firm would be invited to attend! And absolutely No Selling! They were told that, if they drifted into "selling", Crosswater would "gong them". It was to be an unstructured conversation on the merits of international investing.

It worked out surprisingly well (although the marketing people were really miffed for being excluded!)

Each 90 minute session was free-wheeling with both Crosswater and client staff asking a lot of questions and the firms asking good questions about what the needs of and constraints on the client were. By getting away from the usual highly scripted presentations we were able to get into (what I call) the *soul* of each organization. The managers had to think on their feet as the questions were coming fast and furious from all directions.

All of the managers did very well (albeit some doing quite a bit better that others). One manager even made a compelling case that our client should not yet pursue an international strategy - "it was the wrong time in the cycle". They got points for their honesty. I think on the whole all the participants enjoyed the session and the format. One CEO (an old friend) said to me later that "it was the hardest meeting he ever had to prepare for, but the most enjoyable to participate in". It was easily the most interesting and productive meeting I've ever been involved with -- in either my investment manager days or my more recent consulting days.

I tell this story because of my belief that the most difficult task investor staffs have is to pick the right manager to execute their investment goals. Over the last 25 or so years the highly structured pitch meeting has not always led to intelligent decisions and, in fact, has probably led to many poor decisions. The managers have simply gotten too good at their presentations and thus have the ability to disguise what could be potential problem areas the client should be aware of. I've come to believe that some sort of wide-open, free-flowing session such as the one described above can give an institutional investor much better and deeper insight into both the skills and "soul" of a prospective manager.

NOTE: Crosswater has recently been involved in reviewing several "troublesome international investments". Our corporate takeaway from the discussions described about was that international investing did not produce the diversification goals touted by the managers and consultants. Most importantly such investing did not generate the appropriate risk-adjusted returns, if political, legal, compliance governance and currency risks are realistically taken into account.

CONSULTANTS

We at Crosswater don't view ourselves as pension fund consultants - at least in the usual definition. We are really a bunch of crusty old workout and restructuring guys and gals who got together during the GFC to help clients who had never really experienced a horrific drop in real estate values and very poor manager performance. Although I don't view ourselves as "consultants" Crosswater is nonetheless lumped in with them by most people and it has caused me to observe the changes that may be taking place in the business.

Real estate consulting to institutional investors really began in the late 1980s as institutional investors began to invest in real estate. The traditional equity/fixed income consultants looked down their noses at the real estate business and the players in it. I remember one traditional consultant telling me real estate managers "were like used car salesmen, but with much nicer suits". They didn't foresee the value in and/or growth of real estate as an asset class, so they didn't staff up for it. Entrepreneurial firms such as Townsend brilliantly charged into the breach. However, since then – and because of several downturns – investor staffs have learned a great deal about the benefits and vagaries of real estate investing. A lot of institutional investors – primarily public funds – continue to see a need for consultants, but my hunch is that the "job description" of that need is shrinking. If I am correct, that means less work and less revenue for the consultants. Despite their already modest fees, consultants are now subject to the same "fee pressures" as the managers. Given these changing economics will they be able to attract the talent needed to provide truly valuable advice to their clients? The more strategic real estate consultants have tried (some successfully) to expand into the investment management business, yet retaining their consulting business. How clients allow that is puzzling to me given the obvious serious conflicts. I don't blame the consultants for finding ways to grow their business – all power to them. But I am amazed that clients allow this to continue.

Another factor I think may be changing is that at the same time as investor staff gets more sophisticated about real estate, the original entrepreneurial consulting firms are, for a variety of reasons, being drawn into the much larger equity/fixed income consulting firms. (See comments above under "Tells" on manager M & A). This inevitably will mean that the entrepreneurial spirit of the early consultants will be diminished. It's just the way it happens no matter what the asset class or business. The result may translate into less and less desire for investor staff to use real estate consultants as they won't see a clear "value add". These changes will certainly go on well past my career, but it will be interesting to see if I am correct.

MILLENNIALS

I periodically teach a class or two at business schools or graduate real estate programs. My most recent ones have been at Cambridge, Chicago and USC-Lusk. My standard topic is *"Why you need to know about workouts in a hot market?*

I don't think I need to explain this concept to most of my readers, but to Millennials it's an important message. Most of the students I meet think this hot market is going to go on forever. (When the markets last crashed they were in junior high school!) I always try to end the class by handing out my list of *Ted's Top Ten Life and Business Lessons,* which you can see below. I often wonder if any of these young men and women actually read it. By the way, feel free to tell me there are others I should mention. After all, they are not The Ten Commandments!

TED'S TOP TEN BUSINESS AND LIFE LESSONS

Work for the VERY BEST firm that will hire you, **and**

Don't worry about titles or compensation.

Learn to write well. It's never too late.

Network seriously. Not just beer parties.

Get a Mentor. Someone who has successfully navigated BOTH hot and cold markets.

Great real estate wealth is lost, but also created, at the bottom of a cycle.

LEVERAGE KILLS! Debt never makes a deal an intrinsically better deal…just a riskier deal.

Never make an important decision based on an appraisal.

ALWAYS be client/investor focused: Sun-up to

Sun-down.

Keep on learning after you graduate. Don't just read about real estate. Read The Economist. The FT. NY Times.

All the best, Ted

PS: Comments , criticisms, and especially praise are always welcome.