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DIVERSIFICATION AND CAPITAL RAISING ON THE RISE

But at what price efficiency?

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NAREIM *dialogues*

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Zoe Hughes, CEO

Operational intensity is a phrase that seems to perfectly capture the environment we find ourselves in today.

At the asset level, where asset and active property management have become even more critical amid compressing returns.

At the fund level, where heightened competition for deals and capital commitments demand even greater time and attention.

And at the corporate level, where the pace of expense growth requires all real estate investment managers to do more with less.

Such operational intensity isn't a phase of the current commercial real estate cycle which will pass with time. Today's real estate investment management industry is increasingly complex and will undoubtedly remain so for years to come.

One look at the 2019 NAREIM–FPL Associates Global Management Survey — which provides the industry's only operational and enterprise benchmarking data — quantifies the trends that are reshaping our business. These trends include:

- **Product complexity.** Over the past decade, the median number of active investment vehicles managed by GPs has risen from seven in 2009 to 12 in 2018, while the number of managers investing across all four real estate quadrants (public equity and debt, as well as private equity and debt) more than doubled between 2015 and 2018.
- **Capital complexity.** Since 2009, the amount of capital raised from defined benefit public and corporate pensions has decreased from a combined 62% of all capital raised in 2009, to just over half in 2018. As a result, managers are looking elsewhere to raise capital, including to retail and defined contribution plans, which eight out of 10 managers said would be somewhat or very important to their business over the next three years.

Couple these challenges with increased requirements relating to regulation and compliance; the pressures of industry consolidation (both in terms of manager consolidation and the desire by LPs to consolidate their investment partnerships); and the management of asset, portfolio, fund and investor data; to name but a few, and it's clear running a real estate investment management business requires more attention and resources today.

Over the past year, NAREIM members have shared insight and intelligence on some of the biggest challenges impacting their business. From the adoption of published performance rankings for data errors, asset energy use or deadlines for critical corporate processes; to ideas on how to systematically validate and underwrite proptech solutions; to driving better industry data on diversity and inclusion, NAREIM members have discussed best practices and potential solutions to mitigate those risks and prepare for the future.

As we look to 2020 and NAREIM's 30th anniversary, NAREIM invites you to join our community of sharing and camaraderie as we help each other succeed in today's operationally intense world.

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The SHIFT to RETAIL capital

Capital raised from defined contribution pensions is on the rise and interest in tapping this retail source has increased significantly. It's a sign the industry is preparing for a move away from defined benefit plans. However, the costs — financial and organizational — are large, and as real estate investment managers continue to diversify their product offering to existing institutional clients, the question remains how to further drive enterprise efficiency. **Erin Green** *and* **Josh Anbil** *of* **FPL Associates** *talk to NAREIM about the shift to retail capital, industry diversification and the results of the NAREIM–FPL Associates 2019 Global Management Survey.*

By Zoe Hughes

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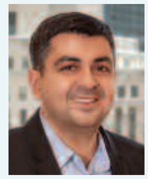
Participants:

Erin Green is a Senior Director in the management consulting group within FPL Associates.



Josh Anbil is the President – Consulting at FPL Associates.

We've seen a real increase in the importance attached to understanding, and raising capital from, more retail sources, including those of defined contribution (DC) pension plans. Why should we be paying attention to this?

Erin Green (EG): I think what you're seeing right now is an industry in preparation for the future. Today, institutional investors [largely managing defined benefit (DB) plans] still represent by far the lion's share of capital. However, there's a recognition from managers that the investor landscape is very likely going to change over the next ten, 20, 30 years and that the traditional institutional capital sources, pensions in particular, may not be the dominant sources of capital that they are today.

In response to that, firms are positioning themselves in a way that will allow them to more effectively access the retail capital channel in the future. There's this entire investor channel that, on the one hand, represents a massive quantum of largely untapped capital. But, on the other hand, it has a whole host of complexities and challenges in terms of how you access it. So if you're a manager, you'd better get moving now, because it's going to take a while to figure it out and get your system to be a well-oiled machine.

On a dollar basis, what does this mean for capital raised from more retail sources?

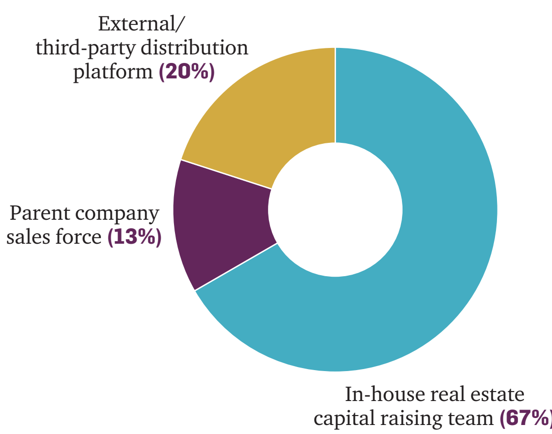
EG: In terms of aggregate capital being raised, retail and high-net-worth capital still represents a blip on the radar relative to institutional capital. In aggregate across the industry, we're still talking about less than 5% of capital coming from those types of sources. However, there's an acknowledgement and a recognition that the ability of traditional sources of capital such as public pension funds and some corporate pension funds, to invest in these types of vehicles in 20 years, will likely not be what it has been historically.

So it's less that today the pensions and the other more traditional institutional investors are putting in less money — quite the opposite in fact — than an acknowledgement that going forward they will play a lesser role. And if you can be successful in figuring out how to access retail capital, you're going to be much better positioned to be successful going forward than the firms who don't figure out how to bridge that gap.

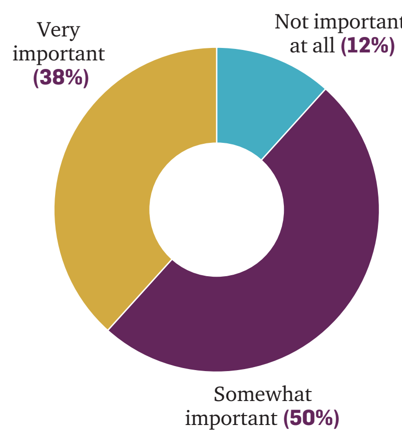
1. Retail capital — access and importance

Of the participants that raised retail/high-net-worth capital in 2018, the vast majority did so through their in-house real estate capital raising team. It is also notable that 88% of participants indicated that retail capital will be somewhat or very important to their business over the next three years.

How do you access retail capital?



How important will retail capital be to your business over the next three years?



Source: 2019 NAREIM–FPL Associates Global Management Survey.

How do you define retail capital?

EG: I'm defining retail capital as individual investors who do not fall into the high-net-worth category, where individual investors can afford to write $250,000 checks or more. These are average, everyday people investing via personal brokerage accounts, 401(k) plans or other similar structures.

This is something we track in the NAREIM–FPL Associates Global Management Survey. Talk us through the numbers for capital raising.

EG: Looking at the firms who responded to the survey this year and last year, slightly over 60% reported an increase in capital raised and, in aggregate, about 5% more was raised in terms of total volume this year relative to last year. It's a strong positive trend in terms of capital raising indicating that there is still strong demand for commercial real estate.

Specific to the retail side of the equation, we asked a question in the survey regarding the importance of retail capital to the future of participants' businesses. A total of 38% responded that retail capital was "very important" to their business versus 33% last year. Conversely, the percentage of firms that indicated that retail capital is "not at all important" decreased from 15% to 12% year over year (see Exhibit 1).

These are modest changes because they're year-over-year shifts, but what it illustrates is a clear trend in the industry toward greater recognition of the importance retail capital will likely play in the future.

Is that shift translating into new products being offered to DC plans?

EG: Yes. Last year, 5% of survey participants reported having a daily-valued vehicle specifically targeted to defined contribution plans. That's up to 13% this year (see Exhibit 2). It's a big shift in terms of firms that have one of those dedicated vehicles.

Moreover, among survey participants with a DC product, a total of $1.8 billion was raised in 2018 versus $1 billion raised in 2017, representing an 80% year-over-year increase. This is consistent with what we're hearing from clients with DC products who report a notable acceleration in terms of capital raising and acceptance among plan sponsors. This is indicative of a broader shift of real estate continuing to become a more accepted institutional asset class, in particular among 401(k) plan sponsors who seem to be getting more comfortable with the asset class as a viable investment alternative for inclusion in professionally managed funds. It is almost always included in a target date fund or similar vehicle as opposed to a standalone investment option.

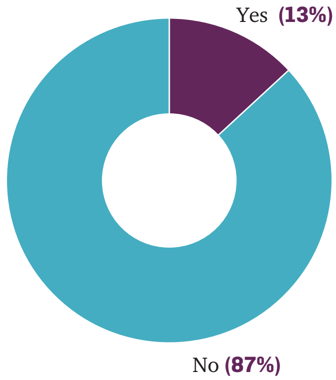
Are you seeing other new emerging sources of capital coming into private real estate?

EG: While the sources from retail capital and high-net-worth investors are very small, at 4% and 1%, respectively (see Exhibit 3), we noted that the "other" category this year is significant; it was 15% of the total capital raised. So, we asked what comprised "other."

2. Retail capital — daily-valued defined contribution product

13% of participants currently offer a daily-valued real estate product that is targeted to defined contribution investors.

Do you offer a daily-valued private real estate product targeted to defined contribution investors?



Source: 2019 NAREIM–FPL Associates Global Management Survey.

A lot of firms said interval funds, which are an indirect way of accessing retail capital.

Even though [the amount of capital raised through DC-focused and interval funds] is still not to the order of the magnitude of that raised from institutional investors, we are seeing more DC vehicles and more avenues emerge for accessing retail capital. What this means is that, as an industry, we are starting to see some success in new capital raising channels.

THE RISE OF INTERVAL FUNDS

Briefly describe how interval funds work.

EG: There are all kinds of interval funds out there investing in a variety of asset classes, but for our purposes I'll focus on those dedicated to real estate. These funds are professionally managed vehicles investing in private real estate funds, but with a liquidity sleeve typically made up of public REITs. Historically, interval funds are open-ended, perpetual life vehicles, and very core-oriented.

The really interesting part is the level of success these funds have had in terms of capital raising. When we first looked at the three largest real estate interval funds just a couple of years ago, in aggregate they had $300 million in net assets. Today these same three funds have nearly $8 billion in net assets. This matches commentary from ODCE [NCREIF Fund Index — Open End Diversified Core Equity] fund managers that suggests capital flows from interval fund managers have been increasing by orders of magnitude over the past couple of years and, to date, show no signs of slowing.

The question is, because interval funds are relatively new, what happens when the market slows down and you have retail investors who may or may not understand real estate cycles? Are you going to get a big run to the window trying to cash out and redeem? So there are some outstanding question marks around the ability to withstand the cycles.

What does it mean to the fund manager organizationally? What are the risks with interval funds?

EG: Organizationally, interval funds are incredibly low impact. The downside is, if you're the manager, you don't control it. The funding organization decides which managers are on their platform. You are therefore not controlling the capital, and you are also splitting capital with ten of your closest competitors.

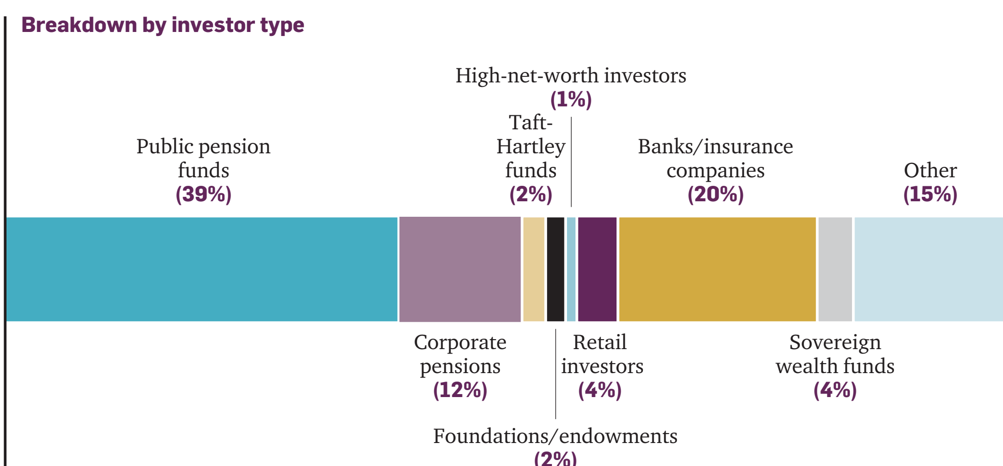
Are you therefore seeing investment managers raise capital directly from retail sources?

EG: Most investment managers are of the mindset that, ultimately, they want to control their own destiny and not rely solely on third parties for distribution. That's why you see firms also pursuing the path of being able to access retail/high-net-worth capital directly, but there are huge implications for the organization in doing so.

Cultivating the ability to directly access the highly fragmented broker-dealer and registered investment adviser

3. Breakdown of capital commitments by investor type

Unlike the previous year where banks/insurance companies eclipsed public pension funds, there is a reversion to past years where public pension funds were once again the top source of capital commitments in 2018.



'Other' includes funds of funds, charities, corporate investors, employees and other asset managers.

Note: Figures may not foot due to rounding.
Source: 2019 NAREIM–FPL Associates Global Management Survey.

networks requires a dramatically different model than calling on institutional clients. Because most investment managers are heavily oriented toward institutional capital, the requisite investor facing teams tend to be fairly small — a couple of individuals for the small to mid-sized firms and a dozen or so for the larger platforms. That is a far cry from the number of boots on the ground required to effectively cover hundreds of regional broker-dealer offices across the country. You have to have a substantial team to effectively call along those channels.

It's a huge investment and one that may very well be necessary for the future. But it's a tough decision to make for a lot of firms, and especially if you're a mid-cap private equity real estate firm. This requires a substantial re-working of your whole capital raising structure and the administration of that capital will also be very different.

Will this mean new roles — indeed a new organization chart — for real estate investment management firms?

Josh Anbil (JA): The administration required to service these different types of investors is going to lead to different positions and more people than a traditional money manager model, which would be relatively new, at least for most firms.

If you're stuck in the middle relative to size right now, on the one hand it's useful because you probably have a flagship strategy that has been your bread and butter for years and perhaps you've broadened your capabilities to play on different points, whether it's the return spectrum, or by creating separate accounts or creating an open-ended fund. But I think what's happening now is the cost of broadening your business, including covering retail investors, is substantial. And it's a longer-term investment.

A lot of these firms that have billions of dollars invested into management. They're sizable and they're often servicing the biggest investors out there in the DB space. But can they realistically shift gears into a totally different area and spend the money up front versus a company that's part of a much larger financial institution that has those relationships, has the infrastructure, or at least the playbook that allows them to do that?

DIVERSIFICATION AT PLAY: BY THE QUADRANTS

One key trend we've seen from past Global Management Surveys is an increasing desire to diversify product offerings, not just in terms of property types and risk spectrum, but real estate quadrants — private versus public, debt versus equity. Is that continuing?

EG: Yes. In the 2019 survey, firms active in just one or two quadrants comprised 76% of responses versus 83% in 2015. You're starting to see that tick down. Likewise, firms that are active in three or four quadrants is now 22% whereas that was 17% back in 2015 (see Exhibit 4).

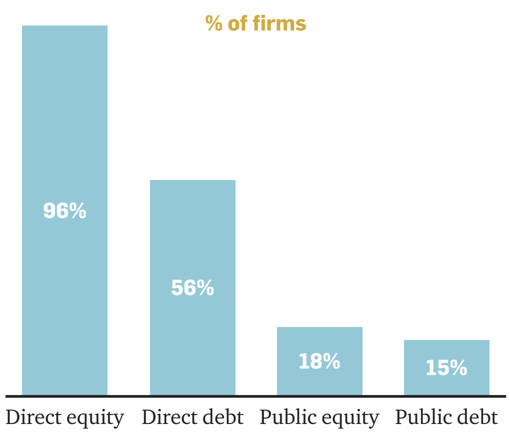
It takes time to launch a new product, but you're definitely seeing a slow industry shift, which supports what we know

4. Investment asset classes/quadrants

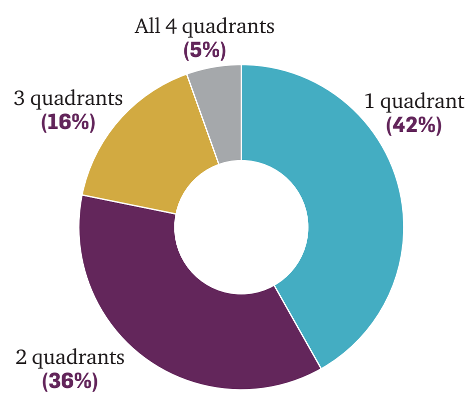
Direct equity, direct debt, public equity (REIT securities) and public debt (CMBS) are typically seen as real estate's four "quadrants" for investment purposes. Most participants invest in one or two of these quadrants, and nearly all invest in direct equity.

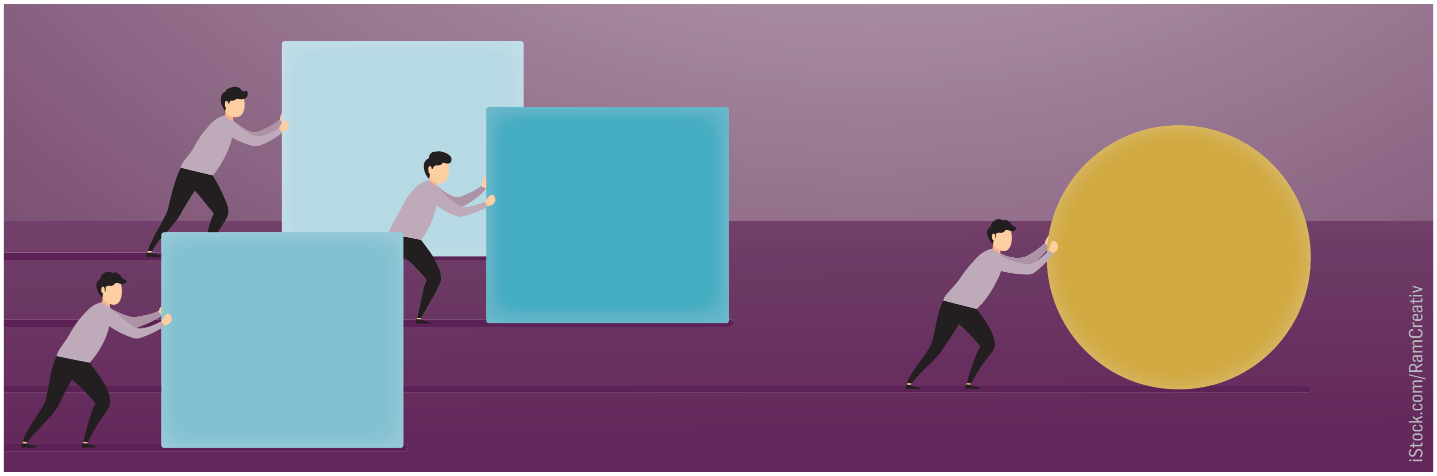
Note: Figures may not foot due to rounding.
Source: 2019 NAREIM–FPL Associates Global Management Survey.

Percentage of participants employing the following investment quadrants



Breakdown of firms by number of investment quadrants





anecdotally to be true, which is more debt offerings, more movement up and down the risk/return spectrum, and people really trying to diversify their product offerings.

That product expansion can take different forms, but what we hear consistently is firms are really trying to get away from being one thing. They want diversification, they want to better respond to investor demands, they want more stabilized fee streams to support business continuity, and in most cases they're responding to the opportunities that are in front of them. It might be a firm having a great contact in Europe and thinking that they can build out a successful business there. It might be that a firm has a couple of key investors who want them to do a core club vehicle, so they're going to start there.

It takes different forms but, again, the underlying driver is, we don't want to be just a single, sequential fund manager.

Not all managers can become a one-stop shop. What pitfalls should managers avoid as they look to become more diversified?

EG: You have to be very strategic about how you diversify. You can't go out and overnight be all things to all investors. If you are historically just a value-added sequential fund manager, with a closed-end vehicle, there's no way to go out and all of a sudden also have a debt offering and a securities offering and an open-ended vehicle and a core offering and an opportunistic fund. It's too much.

There are adjacencies when it comes to investment strategies, and then there are totally new product lines.

An adjacency could be the key investor for a sequential value-added manager asking you to create a core or core-plus separate account. That's relatively easy for a firm to take on. It gives the manager a lot of benefits in terms of more stable income streams, product diversification, increasing enterprise value and creating other ways to incentivize employees. It also keeps them active in the market, so it allows for more access to investment opportunities. Those adjacent products are relatively easy to introduce and that's how most firms start with their diversification efforts. That's a first step outside of the sequential fund manager model.

And then you see the bigger shifts from historical strategy or product offerings. That might be a traditionally equity-focused, closed-end investment manager launching an open-ended debt vehicle. It might be a historically U.S.-focused investor launching a global strategy. These types of new products can work, but the chances of success are greatly improved if the firm has some reasonable level of track record to cite as proof of concept or competency. It usually starts with doing some of those investments in the flagship vehicle, and the firm can expand once it proves itself.

But you have to do it strategically. You can't go do all things at once. You have to say, where are we best positioned if we want to do a new product line that's not just an adjacency to what we do today? Where are we best positioned to do that? Where do we see the market opportunity? Where do we see the investor appetite? Where do the economics make sense for us?

You also have to stay focused and really throw the organization into making this work. Some firms are able to do that; others spread their attention too thin and they try to do too much. And then it's really hard to do any one thing effectively because there are mixed messages in the market and your people don't know where they're supposed to prioritize.

It has to be incremental. Otherwise, it just doesn't work. ◆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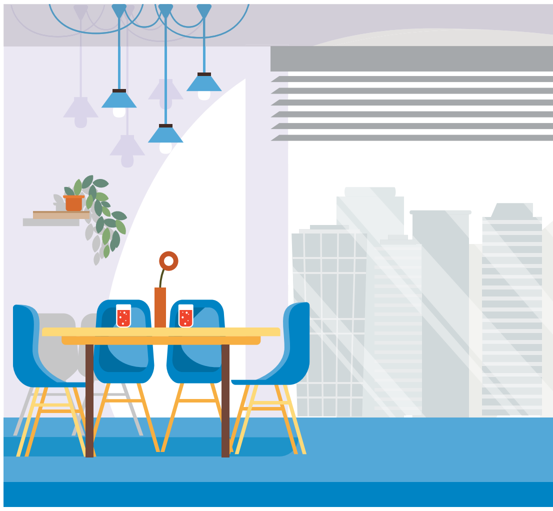
Value add in a day



For managers targeting value-add strategies in today's low cap rate environment, an intense focus on operational efficiency and operational innovation is a must. Multifamily specialist TGM Associates talks to NAREIM about its interior renovation in a day program and how that integrates with its focus on improving resident experience.

Imagine renovating an occupied apartment unit in one day, replacing the entire kitchen, the majority of bathroom components, and the lighting fixtures and door hardware throughout the apartment all while the resident is at work.

Now, imagine renovating three to four apartments in one day, even in occupied apartments — as well as an entire apartment community of 360 units in less than six months, without any increase to historic vacancy levels.

Can't be done?

For multifamily-focused TGM Associates, their interior renovation in a day program does just that. It's a core part of their investment strategy, one that focuses intensely on operational efficiencies and de-risking value-add investing. Materially reducing the project length without increasing historic vacancy levels means that TGM is able to realize rent increases more quickly, ensure product standardization and enhance the apartment's functionality, all without negatively impacting operating cash flows during the process.

Since 2007, New York-based TGM has renovated over 13,000 apartment units utilizing their interior renovation in a day program, which requires anywhere from three to six months of design, planning and supply chain coordination to execute this highly orchestrated process.

"Minutes matter," says Zachary Goldman, TGM's chief operating officer. "This just-in-time renovation process requires, time, logistics and flexibility, and only works if you are very precise. We continue to re-conceptualize every component of this process because every minute matters."

It has seen the firm travel to China to work directly with product manufacturers and suppliers to ensure that all materials meet the firm's stringent guidelines for quality and details, such as lighting fixtures are packaged more efficiently, with units pre-assembled, to ensure contractors don't have to spend additional minutes onsite assembling them prior to installation.

Pricing in the value add

The origins of TGM's interior renovation in a day program stems from the firm's

iStock.com/Tera Vector

> “Since 2007, New York-based TGM has renovated over 13,000 apartment units utilizing their interior renovation in a day program”

founding in 1991 as a vertically integrated owner and operator of multifamily communities. Since its inception, TGM has acquired over 40,000 apartment units in 28 states across the continental U.S. Today, the firm has $2.3 billion in AUM, with more than 9,500 units predominantly in markets across the Northeast and Florida, as well as locations in Ohio, Indiana and Illinois. It is focused on buying properties in markets with favorable demographic and market conditions, where it can utilize its operational innovations to improve the overall resident experience — and with it enhance portfolio performance.

John Gochberg, TGM’s chief executive officer, said gone are the days when investment managers could make money simply by buying and selling at the right time, with no attention paid to managing the asset.

Today’s historically low cap rates mean that all managers underwriting a value-add strategy, “have to be perfect at executing it.” TGM believes having internal capabilities is a major competitive advantage over advisers that outsource all or part of the property operations function. And having too many apartments vacant while undertaking a value-add renovation, or the renovation taking longer than one year, can result in a significant impact on returns.

TGM’s interior renovation in a day program accomplishes four core objectives:

1. ***No additional vacancy loss occurs during the renovation period.*** This greatly reduces the time it takes to renovate the entire community as well as the risk factors associated with performing the value-add work.
2. ***Entire communities are renovated in five to six months,*** depending on the number of units being renovated and the complexity of the renovation. In the traditional value-add approach, renovations are undertaken only on vacant units and the entire renovation can take 18 to 36 months to complete.
3. ***Provide consistency and standardized quality to all units.*** By leveraging logistics and national buying power, TGM provides a consistent finish to all units within the community because they buy all materials in bulk from the manufacturer.
4. ***Reduce the amount of time subcontractors and trades are on-site.*** This reduces labor costs and disruption of the community’s staff and residents, which in turn improves the overall resident experience and maintains asset stability during the process.

The interior renovation in a day program allows rents to be increased sooner than is possible using the traditional process. And the community does not incur any of the typical lease up and vacancy costs that one would expect to see. “One of the most significant savings for us is no additional vacancy during the entire project time. For a 360-unit community, we have renovated 99% of the units within four to six months without requiring vacancy,” said Goldman.

“An additional benefit is product standardization across the community because we’ve purchased all the materials in bulk directly from the manufacturer. This allows us to negotiate longer warranties and ensures consistent quality in craftmanship.”

It’s all in the education

The effort isn’t easy, and begins with education. TGM holds town-hall-style meetings between their community staff and residents, including those about to go through the process. The meetings include community directors from other properties to discuss their experience, as well as sample units so residents can touch and experience the renovation materials that are going to be used.

“The education of residents, property staff, vendors and installers is the hardest part of this process and it’s something we are trying to improve upon all the time,” said Gochberg, who said one of the biggest lessons learned for TGM was ensuring suppliers and manufacturers were held accountable for keeping the supply chain moving in accordance with project timelines.

It's also important to build duplicity into the process. "When one of the [supply chain or contractor] groups breaks down, you have to have enough options that you can kick them off the site and have the process back up and running again within a very short amount of time. You need the depth to do that, because you cannot be dependent on any single group."

As an example, Gochberg said appliance manufacturers are penalized if they fail to provide consistent and sufficient product throughout the course of the project. They are also required by contract to go back and replace all appliances in newly renovated apartments with a new spec, at their own cost, even if half of an apartment building's units had been completed.

Renovation day

For most residents undergoing the interior renovation in a day experience, the renovation activity takes place between the time they leave for work and the time they return home. The scope of the renovation varies depending on the opportunity TGM identifies for a particular community in a specific market. The scope may include an overhaul of kitchens and bathrooms including new countertops, sinks, faucets and cabinets, as well as light fixtures, USB outlets and door hardware.

Residents do not have to move out, or move furniture or belongings other than the contents of their cabinets. "Our occupied renovations can entail almost anything as long as we don't require residents to move too many of their belongings in the process," Goldman said.

"For most residents undergoing the interior renovation in a day experience, the renovation activity takes place between the time they leave for work and the time they return home."

Residents also continue to pay the same rent post-renovation, with rent increases not taking place until lease renewal. "We do this process by building and not by lease expiration, which means we can do all the aesthetic improvements to an apartment unit and allow the resident to live in the renovated apartment at an unrenovated price, which in our experience, makes it significantly easier to pass along the value-add premium at lease renewal."

Cap rates and operational focus

For Gochberg, the interior renovation in a day program goes to the heart of one of the key challenges facing multifamily investors today: the weight of capital chasing deals, and thereby bidding up values, is so strong you have to be intensely focused on operational excellence when executing the value add of your deal, and the ongoing operations of your assets, to be successful.

"In today's world where all the meat on a deal has become significantly thinner and cap rates have compressed, you have to price in the value play very precisely and, once you've done that, you must implement it perfectly and on schedule," Gochberg said.

For TGM's chief financial officer, Michael Frazzetta, declining cap rates have helped cushion the fallout of operational inefficiency — for now.

"Falling cap rates have helped bail out the weaknesses in the industry, particularly those surrounding operational efficiency. Do I think cap rates could go a lot lower than where they are?" asked Frazzetta. "It remains to be seen, but if we get back to a place where there is an upward trend in cap rates, I think things are going to get interesting."

The rise of amenities

It's not just the potential for an expansion in cap rates that is focusing attention on multifamily operations. The rise of amenities — and resident experiences — is also fueling the need for investors to focus much more on the services they provide, and pay for, at the asset level.

"We should all remember that amenities are hubs for social interaction," said Goldman, advising all investors to concentrate on the most valuable amenity for renewing residents as well as the most usable amenities for the residents.

Once what those amenities are and what amenities best suit the residents have been determined, a sense of community can be created around them, whether facilitated directly by the landlord or led by the residents themselves.

"We can all build wonderful gyms and they do get used extensively," said Goldman. "But it's meaningless if you cannot put that amenity and all the others into action to foster a sense of community and provide an enhanced living experience for your residents, which is demanded by today's residents." ◆

“I want to drive down the street and say, ‘We own the Wrigley building.’”

Christopher Baker

President and Director of Asset Management
Zeller Realty Corporation

Interviewed by Wanching Leong

Date joined: March 2013.

Background: B.B.A. in Finance, University of Iowa. M.B.A. in Economics and Finance, University of Chicago. U.S. Air Force, Wrightwood Capital, Ares Management.

Current role: As president of Zeller Realty Corporation, I'm focused on outward capital raising. I'm reaching out to LPs and building new relationships as well as continuing to grow our existing relationships as we raise capital for deals. In addition, I'm still heading the asset management team and I continue to oversee our debt capital markets — debt financing, debt structuring, refinances, acquisition financing and closing acquisitions.

Best part of the job: I'm learning and embracing all the challenges of my new role, which I only started in May. But I think the best part is having the opportunity to meet with the LP community, meet with our potential partners and current partners, and continue to grow in the role. I love talking about the deals and our perspective, why we think we can win with a particular asset.

Worst part of the job: As I've moved up at Zeller, from an asset manager to running the asset management group, to president, the toughest part is getting comfortable getting my fingers out of the weeds of each level that I left. I've loved the challenges I was working on, but I only have so much capacity and I have to focus on the new role. Giving up some of those responsibilities and spreading them out is the toughest piece.

What are you spending your time on: My time is spent on capital raising. I'm spending a lot of time with the deal teams to get familiar with the deals and the pipeline. Although I was doing this while heading the asset management team, it was more under the sense of, these are the deals we could be executing in the near future. Now I have to understand them up front. I'm working with our acquisition team to sell these deals to our potential partners and continuing to get out into the markets and build the LP relationships.

Email or phone call: All day long, phone call. If you can't pick up the phone, it's really tough to be successful.

What could the industry be doing better: The implementation of technology to enhance the tenant experience, building management and investment management by the CRE industry could be better. So many companies are creating tech groups internally to focus on better performing operations and tenant experience. But the tech community that's trying to feed this need is so scattered and numerous. A lot of these companies need to start being consolidated, and the industry could probably be doing a better job of figuring out how to consolidate some of these tech platforms, to have a single app or a platform to go to, to solve multiple needs, versus having a one off. Having ten different tech platforms just for a single function is almost as bad as having ten different spreadsheets.

Something you've learned that has been useful in your career: I had to become comfortable with making decisions quickly and efficiently, especially in asset management. So many different functions look to me to make decisions to keep the business plan moving forward. And that is my sole role, to get the business plan executed. My decisions may not be 100% in the right direction, but I have to get things moving. It's better to get them executed, versus overanalyze and never make a decision. So, the most important thing I learned was how to be comfortable making a decision, living with it, and moving the business plan forward.

What's kept your interest about the industry: Real estate is, and is likely to be for the foreseeable future, an inefficient market. It takes time to execute business plans. The technology world around us moves so much faster, but buildings are still bricks and mortar. It's the challenge, and the opportunity, to look at a building and come up with a business plan, and decide why we, Zeller Realty Group, feel like we can win and bring greater value to the table as well as being able to go out and sell to potential partners and grow those relationships. ◆

Driving **sustainability** *through* PARTNERSHIPS

Collaboration between the various stakeholders of 500 West 2nd Street in Austin, Texas yielded ESG success, valuable lessons and happy tenants.

By Jennifer McConkey and
Joe Wanninger,
Principal Real Estate Investors

Completed in May of 2017, 500 West 2nd Street is one of Principal Real Estate Investors' most high-profile sustainable real estate investments. A premier 29-story Class A office building located in the central business district of Austin, Texas, 500 West 2nd Street maximizes efficiency and comfort through a unique array of amenities and sustainability strategies. But the success of the project did not happen in a vacuum; it required collaboration and leadership among the development's five primary stakeholders.

The story of 500 West 2nd Street examines the important role that partnerships play — between local government, the development team, investors, brokers, property managers and tenants — and how those partnerships aligned, incorporated numerous sustainability strategies throughout the project, and delivered a community asset (and real estate investment) for all involved.

The stakeholders

Local government:
City of Austin

Developer:
Trammell Crow Company

Investor:
Principal Real Estate Investors

Broker and property manager:
CBRE

Anchor tenant:
Google

The City and the parcel

500 West 2nd Street is sited in downtown Austin on the Green Water parcel, the former home of the Thomas Green Water Treatment Plant. The area covers a four-block span of land nestled along the banks of Austin's Lady Bird Lake, a popular downtown reservoir perfect for boating, running and community events. The treatment facility was decommissioned in 2010 after 58 years of operation, and became a key focus area of the municipality's urban revitalization plan as part of the Seaholm District.

The City set its sights high in terms of sustainability in its vision for redevelopment of the Green Water site, including strict sustainability expectations in their official request for development proposals. Buildings proposed for the site would be required to earn at least two stars under the Austin Energy Green Building program, purchase reclaimed water from Austin Water Utility, and contain adequate underground parking to accommodate all properties on the land parcel.

Trammell Crow won the bid with a proposal to build Austin's newest luxury apartments, a hotel, a mixed-use retail space and a Class A office building. In addition to earning the required two stars under the Austin Energy Green Building program, each development would have to be LEED certified.

The investor

Principal Real Estate Investors and Trammell Crow Company have a robust partnership history, particularly in Texas, having worked successfully together on projects such as five Energy Center properties and Hess Tower in Houston, and Legacy Tower and M-Line Tower in Dallas. Through our decade-long relationship, we have fostered a mutual understanding of sustainability strategies and how they add value to our real estate investments in a way that benefits tenants and residents, lowers operating costs, and adds competitive distinction to each development.

When presented with the opportunity to invest in 500 West 2nd Street, it met our criteria for potential investment pro forma and sustainability attributes. Principal Real Estate Investors has a long-standing commitment to corporate stewardship and an established track record in responsible property investing. Since 2013, Principal Real Estate Investors and our partners have used an overarching environmental, social and governance (ESG) framework called the Pillars of Responsible Property Investing (PRPI) initiative. This framework helps drive asset management and fiduciary governance as we strive to deliver positive financial and environmental results.

As a part of this program, we have a portfolio-wide goal to reduce energy consumption by 20% by 2020, and we integrate ESG aspects in every step of our investment process. Specifically, we make the commitment to partner with our clients and investors to implement sustainability strategies, such as energy efficient lighting and utility monitoring systems that add value to our real estate investments. At the property level, we engage with tenants, residents and guests to ensure these programs meet the needs of our communities.

Additionally, we collaborate with our joint venture partners, property managers, technicians, vendors and service providers to implement our ESG expectations. Given the planned sustainability attributes of the development, the City of Austin's requirements and our past experiences with the Trammell Crow Company team, we knew the 500 West 2nd project had great potential to demonstrate best practices in ESG and sustainability in real estate and thus decided to become the primary investor in the project.

The design

Principal and Trammell Crow Company worked with the project architect (Gensler) on a design that would appeal to a knowledge-based workforce, millennials and high-credit tenants while also meeting the needs of the downtown Austin community. The resulting design strategy took 14 months from the initial concept to finalized plans, and features both a modern and sustainable aesthetic, with operational aspects focused on health, comfort and productivity.

The building's sky-blue glass façade and sleek design meshes with the existing downtown infrastructure and natural banks of Lady Bird Lake. Floor-to-ceiling

Notable 500 West 2nd Street sustainability strategies:

- **Google's water condensate system:** A water conservation system where water is recirculated back into the office for use.
- **Destination dispatch elevators:** Elevators group passengers by their destination. This technology reduces wait and travel time by 25%. 500 West 2nd Street was the first building to offer destination dispatch elevators in Austin. Our tenants love them, and they can reduce energy consumption by 27%!
- **Electric vehicle charging stations and efficient vehicle parking:** We encourage tenants to take greener forms of transportation by offering EV charging stations in our garage as well as prime parking locations to tenants with fuel-efficient vehicles.
- **Submetering systems:** We track utility consumption at the tenant level. Our tenants are able to request this data to better understand their own consumption patterns.
- **Energy recovery wheel:** Reduces overall energy consumption associated with the HVAC system.

glass architecture also serves to flood the interior office spaces with natural light and allows for expansive views of the Colorado River and downtown Austin. To further establish the connection between building tenants and the outdoors, 500 West 2nd Street was designed with seven terraces — allowing for fresh-air working, meeting and dining opportunities.

Additional health and productivity aspects of the building include a high-end fitness center and locker room; kayak and bicycle storage to encourage tenants to take advantage of their proximity to the lake and surrounding trails; flexible meeting spaces including convertible conference rooms and cafes; and walkability to Austin's vibrant mix of parks, retail, entertainment and restaurants.

Through these efforts, combined with a variety of operational features to increase sustainability, the building achieved LEED Gold certification. This allowed us to market the sustainability features to prospective tenants and the community.

Despite the building's ultimately successful development process, the team did experience two notable challenges along the way. As part of Trammell Crow Company's agreement with the City of Austin, we investigated the use of glare prevention technique to ensure the glass exterior of the building would not negatively impact the comfort of people in adjacent properties or the lake environment. Through this process, we learned that glare prevention strategies would increase the energy consumption of the building, since more heat would theoretically enter the building instead of being reflected away — creating an additional cooling load on building systems. Although sustainability was a high priority for this project, it was also important for us to be a good neighbor and recognize the health and well-being of people *outside* the building as well as our occupants. Therefore, we opted to move ahead with the reduced glare techniques while attempting to mitigate solar radiation using high-performance curtain walls, exterior shading elements and other energy efficiency strategies.

Another challenge was the use of reclaimed water at the property. 500 West 2nd Street was the first major office development to utilize reclaimed water from the City of Austin for non-potable tasks. However, several issues soon emerged. We found that the reclaimed water clogged toilets and resulted in irregular water pressure throughout the building, partially due to differences in filtering specifications. To resolve these issues, the team collaborated with the City on potential ways to improve the operation of the reclaimed water system. The City is currently working on implementation of these strategies. In the meantime, the property is being served by potable water, but we hope to rejoin the reclaimed system once these issues are resolved.

Marketing and moving in

When marketing and leasing began in 2015, the largest businesses in downtown Austin were law firms and financial services firms. We originally thought that our tenant profile would be similar. Many of the technology firms associated with Austin were located in the suburbs or along the main highway corridors. Our selected broker and property manager, CBRE, led our marketing campaign — which highlighted the previously discussed health-based amenities, walkability and transit access of the property.

Six months into marketing, CBRE landed an audience with Google, who ended up taking space as the anchor tenant and leasing seven floors of the building for their Austin office. This signaled a demographic shift, with technology firms also wanting alternatives to suburban office parks and the ability to attract millennial employees interested in working, living and playing in the downtown urban core. We widened our target demographic and adjusted our marketing tactics accordingly. As a result, 500 West 2nd Street was 100% leased prior to opening and is now home to prominent tenants from many different sectors, including Deloitte, CBRE and Austin Fraser.

Our tenants played an important role in shaping 500 West 2nd Street's sustainability journey. The property management team at CBRE worked with Google to customize their space and meet their own corporate sustainability goals. Their discussions on the build-out and operation of the space focused on health and tenant comfort. Principal's team collaborated with Google to enhance their leased area with additional sustainable features including composting services, a dog relief area, dedicated terraces with access to outdoor space, six-inch carbon filters to improve air quality, and adding occupancy sensors to the LED lighting system to further reduce energy consumption. A unique water feature was installed in Google's space passing through several floors, utilizing condensate water from the building's cooling system. This partnership continued into the operation phase, where Google's facilities manager works with CBRE to regularly collect ESG data for Google's own tracking and reporting purposes.

Lessons learned

While the project is universally considered a success, there were challenges and lessons along the way. From a strategy perspective, we were reminded of the value of aligned interests. Through partnerships and a shared prioritization of sustainability between all development players — including the City of Austin, Trammell Crow Company, CBRE and Google — we created one of the most sustainable properties in Austin and in the Principal Real Estate Investors portfolio.

From a credibility and competition standpoint, we realized that the history of Trammell Crow Company and Principal Real Estate Investors brought a unique marketing bonus. Our demonstrated success and market reputation enabled us to gain traction with a high-profile tenant such as Google. Due to demand for this office space, a larger building may have been warranted. Within the building itself, we are finding that a larger lobby and increased locker size in the gym areas are aspects that benefit our tenants' current use of building features. We are already putting these lessons learned into practice. Our new project with Trammell Crow Company, Indeed Tower — another urban Austin property — will leverage the knowledge we gained through the development of 500 West 2nd Street.

Conclusion

As the saying goes, "success has many authors." Our experience with 500 West 2nd Street is a good example, particularly from a sustainability perspective. In today's market, sustainability is no longer an amenity — it is a requirement. High-quality tenants now expect sustainability features and services in their workspaces at a minimum. To provide the highest quality sustainable offerings, we must be transparent about our sustainability goals, ensure stakeholders have aligned interests, and work in a collaborative spirit for best results. ◆

Jennifer McConkey is a Senior Director — Operations and Sustainability, and **Joe Wanninger** is a Managing Director — Asset Management at Principal Real Estate Investors.

Q&A

Keeping it in the family

NAREIM speaks with Ron Zeff, CEO of multifamily specialist Carmel Partners on how they are keeping a laser sharp focus on improving the tenant experience by managing development and renovation in house, while looking for a margin of safety on both developments and renovations.

You run a fund that does development and renovation on multifamily properties. How do you manage the different risk profiles of these strategies?

Our requirement for a larger margin of safety for development projects is one way we account for the differing risk profiles. Development does have a lot of risks, but I believe Carmel's approach to development significantly reduces the risk because we are vertically integrated and we manage the process ourselves. Because of the elevated flows of capital into acquisitions, particularly over the past several years, we often find that Carmel can build projects more cheaply than buying and renovating existing properties.

Risk is a function of price and opportunity. Whether they're existing assets or development assets, rents for apartments move to market very quickly. The typical fear you have if you build a spec office building and deliver it into a recession is you could have no tenants. In apartments, you're building a very small percentage of the housing stock, and the normal turnover for market rate apartments is

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> “I believe we’re one of very few firms that, on a national basis, does direct development as well as renovation within the same fund. We are selecting what we think are the best risk-adjusted returns, whether they are development or renovation.”

50% a year. Apartments, whether new or existing, very quickly go to the market clearing rent. Rents for existing product will almost always be a discount to new product. We’re not taking different market risks by building versus buying. But when we can find the larger development margins, we’re going for the deal with the best margins.

In search of a margin of safety

Describe Carmel and your focus on multifamily apartments today.

I founded Carmel Partners in 1996. It is a successor firm to my father’s company that started in 1965. He was an owner-builder of multifamily apartments in the Denver area where I grew up, and ultimately became the largest apartment owner in Denver with over 8,500 units.

Our approach has not changed since I formed Carmel Partners — we consider ourselves multifamily experts. We look for markets we believe will outperform over the medium to long run. We believe that investing in real estate is a local business, so we have local offices with teams working on finding existing assets as well as development deals in each of our target markets.

We look for a true margin of safety. What we mean is, on a renovation deal, for example, if the project were finished today as we anticipate and at the renovated rent and renovated expenses, and we turned around and sold it today, would we have a meaningful margin of safety between the current yield and the sales cap rate? We’re looking for a 15% to 20% margin on renovations, and at least a 20% to 30% margin for development deals.

I believe we’re one of very few firms that, on a national basis, does direct development as well as renovation within the same fund. We are selecting what we think are the best risk-adjusted returns, whether they are development or renovation. Because our investments are done directly, we’re not paying a separate developer promote and fees like the opportunity funds. We’re doing it directly with our own underwriting and looking for an accurate margin of safety.

Does your fund have a predetermined allocation for development versus renovations?

We don’t have a predetermined allocation. We’re looking for the deals with the best margins. As we are concerned about geographic diversity, we don’t want to put all our eggs in one of our targeted markets. Looking for the best risk-adjusted deal is a function of our teams finding the opportunities that have margins combined with capital flows. We found that there was much more capital chasing development pre-recession, depending on the market, than post-recession. It was very hard to find true margins of safety on the development side pre-recession, and the opposite is true today. There’s a tremendous amount of capital pursuing value add and often bidding up these properties, so there really is almost no margin of safety. The value add is built into the price. We’re tending to do more development

> “There’s nothing better for returns than to have rising rents and declining cap rates, so people who have invested in that space have done very well. I would say that if you didn’t make money in apartments in the last ten years, you probably shouldn’t be in the business.”

today because we’re able to create our required margins.

Multifamily and cap rates have gone down to historic lows. Is the market priced to perfection?

We’ve seen pretty significant cap rate declines in the value-add acquisition space, particularly as time has gone on. As cycles get extended, we often see declining cap rates into secondary product, older product, workforce housing, affordable housing, secondary and tertiary markets and locations. There’s nothing better for returns than to have rising rents and declining cap rates, so people who have invested in that space have done very well. I would say that if you didn’t make money in apartments in the last ten years, you probably shouldn’t be in the business. That said, Carmel’s approach has always been to assume that there’s going to be a recession during our hold period for any individual asset, as well as for the fund.

We know that, historically, in every other recession, the reverse has happened, where there are declining rents and rising cap rates, particularly for secondary product. We think there’s a lot of risk in those investments in a recession. It turns out that those investments haven’t had that correction yet, and so they’ve turned out fine.

When you think about the Class A new development product, particularly in the high home price markets that Carmel focuses on, the cap rates really haven’t fallen as much since pre-recession levels. These assets tend to perform better in recessions. Nevertheless, we know that every day that goes on, we’re closer to the next recession, so we always stick to our strategy. Putting together a deal that has our required margin of safety has become increasingly difficult given construction costs and regulatory environment.

Fundamental changes

When do you get worried in terms of the real fundamentals?

We’re constantly worried. There has been a lot of supply in all of our markets, but it does appear that there is a light on the horizon relative to reduction of supply. We are seeing declines in starts in a number of our markets, but there are still certain submarkets where there’s a lot of supply coming in the short run. We look beyond the short run and decide whether we are comfortable with the supply or not.

The markets that we’re focused on are the Seattle area, San Francisco Bay Area, Southern California, Honolulu, Denver, Washington, D.C. and the New York City metro area. In all those markets, the ones that I worry about the most actually are performing incredibly well, which are the more volatile markets of Denver and Seattle. They don’t seem to slow down in delivering supply, yet all of those units keep being absorbed because of just the sheer job growth in those markets. Those markets will have a more violent reaction to a downturn, so we’re hesitant to invest too much in those markets relative to these other markets which we think are more stable.

We’re starting to see the millennials do what their parents did, which is move out to the suburbs. How are you reacting to that shift in demographic of the millennials having kids?

We’re interested in both urban and suburban markets for rental product, but if it’s suburban it’s going to have to be near job centers and/or public transportation. We’re trying to find that real margin of safety, but locations and product that will have good long-term viability.

We believe that we’re protected in the suburban markets that we invest in because of their high home prices — it’s much harder to shift to be a homeowner. Urban core locations have long-term viability; millennials there are very well-educated, have higher incomes and are postponing marriage much longer, than, let’s say in the Southeast. So that moment of truth of having children and wanting to own a home appears to be further in the future, particularly in these markets. At the same time, you also have the baby boomer generation starting to look at moving into these urban locations and getting rid of their suburban homes.

Millennials are going to ultimately shift into buying homes, particularly once they have children of school age. I think that that is going to be a much bigger movement in the markets that people are investing heavily in, in the Southeast and the Sunbelt. That risk is higher there, which is why we haven't invested in those markets.

Land development opportunities are obviously very pricey, especially in the New York and Washington, D.C. metro areas. Is it harder to deploy capital today in this market?

It's very challenging, but I'd have to say it's been challenging the whole time we've been in this business. It's very competitive, and with our level of scrutiny to find something that actually has a real margin of safety is very hard. It's a function of finding the perfect site as well as having our in-house design and construction teams create a product that is more efficient and, as a result, costs less to build. At the same time, we want to deliver amenities and finishes that can get higher rent. We've tried to figure out how to build a higher quality product for less than most of our competitors, and to achieve higher rent. That's our focus.

What is absolutely critical today in multifamily? What's coming down the line?

We are a believer in very high-quality amenity packages, and we invest in them both for renovation projects as well as for development. We have a number of renovation projects where we installed and built from the ground up major clubhouses that didn't exist previously. We believe that can help create a long-term sustainable advantage.

“We are a believer in very high-quality amenity packages, and we invest in them both for renovation projects as well as for development. We have a number of renovation projects where we installed and built from the ground up major clubhouses that didn't exist previously.”

We tend to do larger projects, so we're amortizing the cost of both building and maintaining those amenities over more units. What I've found is, it is hard to get fully paid for having a well-amenitized project when the markets are relatively strong, but when they start to get soft having a fully amenitized project will give you a better competitive advantage in staying full.

Improving the tenant experience

There's a phrase, “All real estate is hospitality now.” Given your vertical integration, how are you approaching that kind of hotelization?

It's obviously going to be market specific and neighborhood specific, but we are very customer focused. You have to be very, very careful about which of these vendors and services you're going to work with and be careful not to lock yourself into any long-term commitment. Everybody's been to a hotel room where you have nine channels because they signed a long-term agreement.

We're very focused on our residents. What we want to do is to create options for them. We don't want to force them into Amazon or Google or any particular vendor; we want to give them choices. We're not focused on trying to extract income out of those services. We're focused on trying to give the customer the best service. We'll spend a lot on trying to give them the very best internet service we can provide with 100% flexibility to switch or upgrade, and not be locked into a particular group while constantly looking for the next best idea to offer to them.

What amenities are you seeing as critical by tenants and residents today?

Units have gotten smaller over time and residents are looking to have some sense of community within the building. So our buildings have a robust set of amenities: WeWork-like spaces where residents can work and congregate, demonstration kitchens, well-equipped gyms with live classes, dog spas, happy hours and the list goes on.

At the same time, you have to be very protective of the experience residents are looking for. Most of our buildings avoid providers like Airbnb, because the residents don't like random people coming in and out of their buildings, using their amenities, and not taking care of them. As an example, there are groups that want to rent out cars in our garages. Does that compromise the safety and security of the garage? What guides us is thinking about what's best for the resident and creating optionality for them. ◆

Opportunity zones and affordable housing: Perfect together?

Opportunity zones have the potential to alleviate the shortage in affordable housing, but results could take years to be seen.

By Paul Fiorilla,
Yardi Matrix

Two of the most topical subjects in commercial real estate are the dire need for affordable housing and the prospects for investing in opportunity zones. Can the solution for the two issues be intertwined, like the old candy commercial where chocolate meets peanut butter?

The picture on affordable housing is dire, one that grows worse by the year. As apartment rents increase faster than income, the number of households that pay a substantial portion of income on housing is rising. Meanwhile, supply of affordable units is constrained by rising land and construction costs, as well as stringent restrictions on building in many metros.

Opportunity zones were created by the 2017 tax law to encourage development in areas with low household incomes. Investors may defer taxes on capital gains and avoid paying taxes on profits for investments in qualified zones that are held for the long term. A law designed for development of real estate in low-income areas should help solve the demand for affordable housing. Although the start was slow while capital was being raised and regulations are being clarified,

1 Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2019.*
2 Cushman & Wakefield, *In the Opportunity Zone: Location. Timing. Capital.*
3 Economic Innovation Group, *The State of Socioeconomic Need and Community Change in Opportunity Zones.*

the number of opportunity zone funds and projects started has begun to gain momentum. There's little doubt that opportunity funds will contribute to the effort on housing affordability.

However, because of the complicated nature of affordable housing, the nuances of the opportunity zone program, and the demands of investing in real estate risky submarkets, it will take several years to get a full picture of the impact on the affordable housing puzzle.

Affordable housing in short supply

The need for affordable housing in the U.S. is well-documented. Some 47.4% of U.S. renter households are cost-burdened, meaning they pay 30% to 50% of income on housing, while 10.8 million renter households are considered severely burdened because they pay more than 50% of income on housing, according to a 2019 report by the Joint Center for Housing Studies at Harvard University.[1] Most households with an annual income of less than $35,000 are cost-burdened, and the percentage of burdened renters is higher in metros with high rents.

The affordability issue is exacerbated by the lack of new affordable housing. The Harvard study estimates that the country should be building 1.5 million housing units per year based on household formation and other factors, but in 2018 the number delivered was short by 260,000. Furthermore, new housing construction is concentrated on the luxury segment, while demand is highest for units affordable to mid- and lower-income households.

Opportunity zones should incentivize at least some housing development. As of mid-year 2019, more than 300 funds are raising upwards of $50 billion of capital to invest. The Treasury Department estimates that $100 billion will be invested in opportunity zones within the next few years. A study by Cushman & Wakefield[2] found that housing is being targeted by 82% of opportunity zone funds, more than any other asset type.

Most development within opportunity zones is likely to target low- and middle-income households, since the zones have weaker economic profiles than the nation as a whole. A study by the Economic Innovation Group[3] found that opportunity zones had almost twice as many households living in poverty (28.7% versus 15.1% for the U.S.), median income was lower ($42,400 versus $67,900 for the U.S.) and had higher housing vacancy (12% versus 8.2% for the U.S.). All told, there are more than 8,700 opportunity zones in the U.S., encompassing roughly 10% of the U.S. population and 12% of the land.

Exhibit 1: National overview of properties in opportunity zones

	In-place and unconstructed	Planned and prospective	Total
Multifamily opportunity zone units	1.9m	455,000	2.3m
% of total multifamily units	13.1%	19.3%	14.0%

Source: Yardi Matrix.

Potential multifamily development

The potential to build multifamily units in opportunity zones is enormous. As of year-end 2018 there were 1.9 million apartment units in properties with 50 or more units in opportunity zones, and another 455,000 multifamily units in pre-development stages, which could add 24.2% to stock, according to Yardi Matrix's database (see Exhibit 1).

Potential for development varies by metro. Because states make decisions about which zones to choose for the program, there is only a loose correlation between metro size and the amount of potential opportunity zone housing supply. Some states decided to focus on more developed areas in which there are shovel-ready projects, while others are trying to encourage development in more rural areas or far-flung suburbs.

For example, about 60% of the opportunity zones in New York are in the boroughs of New York City, while roughly one-quarter of Arizona's opportunity zones are in the Phoenix area. Texas concentrated 96 opportunity zone tracts in Houston, about 13% of the zones in the entire state, while designating only 23 zones in San Antonio, 19 in Austin, and fewer than ten in Dallas. Only 11 of California's 879 zones are situated in San Francisco, where NIMBY (not in my back yard)-ism and red tape prevent the construction of badly needed new housing stock. Miami, Los Angeles and Washington, D.C. have the most planned units in opportunity zones, while Chicago and Dallas have among the least (see Exhibits 2 to 5).

Rents are also weakly correlated. In markets such as Chicago, San Francisco and southern Florida, multifamily rents in opportunity zones trail the metro average, but in some metros that include urban Philadelphia, Brooklyn and eastern Los Angeles, average

Exhibit 2: Most in-place and unconstructed multifamily units

Market	Units	% of market total
Washington DC	55,453	17.5%
Phoenix	54,467	17.2%
Brooklyn	49,080	32.5%
Manhattan	47,329	14.6%
Richmond — Tidewater	45,250	20.5%
Detroit	43,045	20.1%
West Houston	42,655	9.4%
Metro Los Angeles	40,299	20.8%
East Houston	39,017	20.1%
Portland	36,408	22.9%
Boston	35,816	14.9%
Cleveland — Akron	34,952	21.7%
San Fernando Valley	31,373	20.7%
Urban Atlanta	31,099	12.7%
Baltimore	30,726	13.7%
Inland Empire	30,034	19.4%
Northern New Jersey	29,791	12.9%
Northern Virginia	28,634	12.6%
Bridgeport — New Haven	27,853	20.7%
Indianapolis	27,765	15.9%

Source: Yardi Matrix.

Exhibit 4: Most planned and prospective multifamily units

Market	Units	% of market total
Miami	27,341	29.8%
Metro Los Angeles	25,426	35.4%
Washington DC	24,492	24.8%
Northern New Jersey	20,520	26.1%
Bay Area — East Bay	14,256	33.3%
Phoenix	12,023	30.2%
Brooklyn	11,925	40.7%
Boston	10,586	20.6%
Seattle	9,339	14.7%
Eastern Los Angeles	9,195	40.3%
Bridgeport — New Haven	8,553	32.6%
Tampa — St Petersburg	8,356	24.0%
Detroit	7,898	56.9%
Baltimore	7,835	26.7%
Cleveland — Akron	7,265	69.9%
Urban Atlanta	7,212	21.1%
Denver	7,100	12.5%
Nashville	6,949	23.8%
Richmond — Tidewater	6,843	30.6%
Portland	6,663	31.1%

Source: Yardi Matrix.

Exhibit 3: Least in-place and unconstructed multifamily units

Market	Units	% of market total
Fort Worth	1,996	1.0%
San Francisco — Peninsula	5,005	4.0%
West Palm Beach	6,137	9.1%
Suburban Twin Cities	6,236	7.4%
Tacoma	6,876	10.1%
Bay Area — South Bay	7,133	5.3%
Jacksonville	8,898	8.6%
Suburban Atlanta	9,860	4.8%
Orange County	9,921	4.8%
North Dallas	10,117	2.8%

Source: Yardi Matrix.

Exhibit 5: Least planned and prospective multifamily units

Market	Units	% of market total
Suburban Chicago	50	0.3%
Pittsburgh	406	4.6%
Fort Worth	602	3.3%
North Dallas	723	1.3%
Suburban Philadelphia	743	3.9%
Suburban Twin Cities	1,025	7.2%
West Palm Beach	1,151	4.5%
Inland Empire	1,298	8.5%
Tacoma	1,694	20.5%
East Houston	1,734	15.8%

Source: Yardi Matrix.

multifamily rents of properties in opportunity zones are higher than the metro average. Again, the discrepancy has to do with the way the states drew the lines for the zones and the nature of urban neighborhoods in which neighborhoods with expensive real estate can be adjacent to less wealthy areas (see Exhibits 6 and 7).

Exhibit 6: Highest rent spread between inside and outside opportunity zones

	Rent spread		Rents ($)		Rent growth (%)	
Market	$	%	Inside	Outside	Inside	Outside
Urban Chicago	$869	86.9%	$1,000	$1,869	8.5%	4.2%
San Francisco — Peninsula	$792	34.2%	$2,315	$3,107	1.5%	5.3%
West Palm Beach	$522	44.6%	$1,171	$1,693	4.2%	3.5%
Ft Lauderdale	$387	30.4%	$1,274	$1,661	4.0%	3.6%
Urban Atlanta	$362	36.1%	$1,003	$1,365	8.0%	5.3%
Northern New Jersey	$360	22.7%	$1,587	$1,947	2.2%	2.4%
Metro Los Angeles	$358	16.2%	$2,205	$2,563	4.9%	5.3%
Manhattan	$354	9.2%	$3,868	$4,222	3.9%	3.9%
Orange County	$351	20.2%	$1,735	$2,086	4.5%	2.7%
Suburban Chicago	$349	39.6%	$881	$1,230	2.2%	2.7%
Northern Virginia	$294	18.9%	$1,553	$1,847	3.9%	2.4%
Seattle	$294	19.0%	$1,550	$1,844	2.2%	4.4%
Pittsburgh	$283	33.5%	$846	$1,129	1.3%	5.8%
San Fernando Valley	$269	15.6%	$1,724	$1,993	5.1%	5.0%
Orlando	$268	25.0%	$1,071	$1,339	5.8%	5.0%
San Diego	$265	15.7%	$1,687	$1,952	7.1%	5.3%
Las Vegas	$251	29.9%	$839	$1,090	8.1%	7.7%
Miami	$247	17.1%	$1,446	$1,693	6.6%	3.0%
Charlotte	$230	25.3%	$909	$1,139	3.2%	3.7%
Inland Empire	$221	16.8%	$1,317	$1,538	7.7%	5.3%

Source: Yardi Matrix.

Exhibit 7: Lowest rent spread between inside and outside opportunity zones

	Rent spread		Rents ($)		Rent growth (%)	
Market	$	%	Inside	Outside	Inside	Outside
Urban Philadelphia	$(410)	-22.5%	$1,820	$1,410	4.7%	3.3%
Brooklyn	$(344)	-11.3%	$3,032	$2,688	-0.6%	4.0%
Bridgeport — New Haven	$(340)	-19.4%	$1,749	$1,409	1.9%	1.7%
Eastern Los Angeles	$(257)	-12.4%	$2,069	$1,812	2.8%	5.1%
Indianapolis	$(221)	-20.4%	$1,084	$863	1.7%	3.7%
Cleveland — Akron	$(150)	-14.4%	$1,040	$890	5.5%	2.9%
Central New Jersey	$(79)	-4.9%	$1,624	$1,545	1.1%	1.6%
Bay Area — South Bay	$(77)	-2.6%	$2,934	$2,857	3.4%	5.5%
Bay Area — East Bay	$(69)	-3.0%	$2,315	$2,246	3.1%	2.7%
Portland	$(60)	-4.2%	$1,438	$1,378	3.0%	3.7%

Source: Yardi Matrix.

Poor match for subsidized housing

The solutions devised by municipalities to combat the affordability crisis range from fully subsidized housing, to relaxing zoning standards or granting developers increased density in exchange for making a portion of units available as affordable for low- to medium-affordable residents. Opportunity zone developments can help to create more housing, but they are unlikely to produce much fully subsidized housing.

For one, subsidized housing already has tax advantages for developers and investors, which reduces the allure of the opportunity zone tax subsidies. Another reason is the way the law was drawn. To qualify for the opportunity zone tax break for an existing property, a buyer must double the basis in the property. For example, if an apartment building is purchased for $5 million (broken down as $4 million for the building and $1 million for the land), an opportunity zone fund must spend at least $4 million of improvements into the property. That rules out most existing subsidized housing, because few need that kind of immediate capital improvement.

Yet another complication is time. Subsidized housing complexes typically involve extended negotiations between developers and state, local and federal officials, while the opportunity zone program has relatively strict time limits. Investors must put capital into qualified funds within six months of the capital gain, and the fund must have investments targeted within another six months. Then the fund has 30 months to spend the capital. Such strict time limits don't mesh well with new construction timetables, even more for projects that are negotiated with multiple government entities.

Sparking rehabilitation projects

Opportunity zones are more likely to produce market rate or partially affordable housing, particularly as part of a larger development. This is because the opportunity zones were selected by state governments to coincide with areas where rehabilitation is needed and, because many are in areas that wouldn't attract capital absent tax incentives, many projects could have a public-private element.

Many governments envision the program as a way to inject capital in blighted areas and to create modern live-work-play developments with a wide range of asset types, including office, retail, entertainment, lodging and housing. Municipal officials want to emulate the success of holistic developments in metro areas that attract businesses and cater to the lifestyle of the younger generations. For cities, that means redeveloping infill locations in areas that have abandoned industrial or office buildings. Smaller markets envision resurrecting downtowns that have eroded as factories and other businesses have shuttered on main streets.

The public-private nature of opportunity zone projects in areas being rehabilitated means that developers may have to layer on incentives to get the full benefit. One such example is the redevelopment of the former Brooks Air Force Base in San Antonio. To attract capital, city and state officials have designated the 1,300-acre site as a Tax Increment Reinvestment Zone (TIRZ), a Smart San Antonio Innovation Zone, and a San Antonio Tomorrow Regional Center.

Public sector participation is likely to be a key in many projects, such as the redevelopment of Port Covington, an abandoned and contaminated industrial area in South Baltimore. The site is targeted for an ambitious redevelopment led by Under Armour CEO Kevin Plank's Sagamore Development Group and Goldman Sachs Urban Investment Group. The $5.5 billion project is slated to encompass a wide range of uses that include office, retail, a food court, hotel and residential. The first phase, recently started, includes 1.4 million square feet of office, 337,000 square feet of retail and nearly 1 million square feet of apartments.

The project has attracted controversy because the port did not originally qualify to be in an opportunity zone until the state revamped its list. Objections aside, state and city officials dream the project will attract capital and create another trendy section of Baltimore that rivals the Inner Harbor. The goal is to create jobs and a desperately needed economic jolt for the area. The developers in 2016 entered into an agreement with the state that would redirect $100 million of profits into the local community.

In Philadelphia, opportunity zones are spurring a number of redevelopment projects that will produce housing, including: the conversion of an abandoned brewery into 128 multifamily units and a separate 108-unit apartment property in the Brewerytown section; the conversion of a former medical supply factory in Germantown into a mixed-use property with 39 multifamily units and commercial space; the conversion of a defunct 1920s-vintage power plant in Fishtown into a mixed-use complex that will include hundreds of apartments, coworking offices and an event venue; and the rehabilitation of a former nurses dormitory in Francisville into a 22-unit apartment building.

Can opportunity zones unlock potential?

The need for affordable housing is too big to be fixed by one tax incentive. The shortage of housing affordable to low- and middle-income households is in the hundreds of thousands nationally, and even under optimistic scenarios opportunity zones won't produce nearly that many units.

However, the fact that housing is being built in low-income areas (and blighted properties are being redeveloped) are steps in the right direction. The sharp drop-off in new housing supply after the last recession in 2008 was a major contributor to the affordability problem. Rents skyrocketed in part because household formation exceeded new supply for several years after the 2008 recession. Increasing total supply and lowering occupancy rates is arguably the best way to stem the rate of rent increases.

That said, potential remains the key word for opportunity zones. There is great potential to raise money, to make deals, to get projects financed and completed, and to attract tenants. However, there is a possibility that everything won't work, either because of an external cause (such as an economic downturn) or because the projects are not able to draw the demand needed to produce the hoped-for returns.

Given the amount of capital looking for an investment, the success that many developers have had in mixed-use projects that are breathing life into formerly low-performance areas, and the demand for housing in proximity to jobs and amenities, it's a good bet that opportunity zone developments will proliferate for the next few years and will become a critical tool to alleviate the affordability problem. ◆

Paul Fiorilla is Director of Research at Yardi Matrix.

Maria Oliva

Chief Operating Officer
Pathway to Living (majority owned by Waterton Property Management)

Interviewed by Zoe Hughes

“The investment community is seeing that senior housing is, and will be, and should be, different.”

Date joined: April 2005.

Background: B.S. in Management, National Louis University. Horizon Bay Senior Communities, Senior Lifestyle Corporation.

Current role: As COO I ask questions of, why do we exist? What is the mission of this organization? How do we build a culture, create a culture or a competitive advantage? It's my purpose to make sure that our senior living communities run smoothly. The real estate piece is mathematical. We do development and we look at what we're building. But when this building gets delivered, what happens? How will the resident actually navigate through the experience of living in our communities?

Best part of the job: The best part of my job is to innovate. I love to explore possibilities of what can be done. What can we do differently? Can we do it better? There is such a great opportunity today in our space because the consumer is going to be very different from the consumer we've been serving in the last 20–30 years. To me, that's an exciting challenge, to do focus groups to see what the baby boomers want, and also to be able to say, who is the boomer? I happen to be one. We may have ideas of what we want, but could we be an organization that could help define what you should want? It gets me up in the morning to be able to say, how do we do that? How do we lead that? Can we lead that?

Worst part of the job: Balancing recruiting and retention, especially retaining talent that we bring in from outside the space. I think we have some really great programs that we could teach people. We sometimes prefer to recruit people from outside of senior housing and then teach them. There are so many new entrants in the senior housing space that the acquisition of talent is a challenge for everybody.

What are you spending your time on: In addition to managing talent, I spend a lot of my time today looking at analytics. We are a people business and my background is in HR, but we have to look at the metrics and what they are telling us. How do we measure success? We are spending more time than ever on analytics.

Email or phone call: Email. Even if you're in a meeting, you can see you have an email. I think I'm much more accessible and I find people are much more accessible over email.

What could the industry be doing better: Several things. There could be consolidation among some of the organizations that represent senior housing. Affordability is a huge issue. How do we address that? What do we have to do? How do we get everybody on board? How do we get people interested in working in senior housing? As an industry, we have to find a balance between being a pure compassion service and measuring profit. We also need more consistent indicators for senior housing; as an industry we haven't caught up to multifamily housing, hospitality or certainly retail.

Something you've learned that has been useful in your career: What I've learned is to always ask people to think bigger. Perceptions are often limited. How do you go where no one else has gone? To detractors I say, what do you think the obstacles are and what if we remove those? What's left and how can we mediate that? You don't innovate if you don't look beyond the what's real and what's possible. It's about finding that balance.

What's kept your interest about the industry: We asked, why wouldn't somebody buy this product? It's because senior living is viewed as a loss. I can no longer live in my house or I don't want to leave my house, but I don't have all these resources and I still want to be in my house. We started thinking about it and eventually we created our mission to change the way society thinks about senior living. Senior living is about creating the best environment for people at an important stage of their lives. To me, it's the marriage of real estate and purpose. If we can create what happens inside and make a difference, it doesn't get any better than that. ◆

Future-proofing our portfolios

Effectively managing climate risk requires data-driven insights, standardized methodology and robust stakeholder engagement throughout the ecosystem of a portfolio.

By Anna Murray, BentallGreenOak

At BentallGreenOak, we manage climate risk to enhance the resilience of our clients' and investors' long-term investments. As a fiduciary, we see it as essential for us to take into consideration climate change impacts, from both a risk mitigation and a value creation perspective, in order to enhance the long-term financial and operational resiliency of the real estate portfolios that we manage for our clients and investors.

With buildings accounting for approximately one-third of global greenhouse gas emissions and consuming 40% of global energy, there is an incredible opportunity for the real estate industry to reduce its overall environmental footprint. Building owners and operators are in a unique position to proactively address the environmental, social and governance (ESG) risks that businesses face today. By doing so, we are not only mitigating risk, but also safeguarding and increasing the value of our assets.

More investors are beginning to understand the correlation between sustainability and financial performance. According to the Global Real Estate ESG Investment Study[1] published in early 2019, 83% of real estate fund asset managers have experienced increased investor demand for sustainability disclosure. The study, led by BentallGreenOak, REALPAC and the United Nations Environment Programme Finance Initiative (UNEP FI), found that investors are becoming more attentive to a rising global awareness of the financial merits of sustainable investing as a means of risk mitigation and long-term value creation.

As climate change rises to the forefront of global consciousness, tenants are demanding more resilient buildings from the real estate sector. Sea level rises and extreme weather events impact building costs and performance. With sustainability factors playing a key role in driving tenant demand and climate resilience, fiduciaries are weighing ESG factors as a critical element in their investment decision-making.

At BentallGreenOak, our approach to climate resilience stems from a continued focus on future-proofing our portfolios to drive long-term returns for our clients and investors. We

[1] United Nations Environment Programme — Finance Initiative, *Global ESG Real Estate Investment Survey Results.*

proactively address climate risks at the property and portfolio levels through strategic planning that assesses critical vulnerabilities to the built environment.

Four pillars to managing risk

Actively managing climate risk means the buildings invested in today can thrive tomorrow. When we view the buildings that shape our communities as part of a living, breathing ecosystem, we are better equipped to address the challenges that climate change brings to our increasingly fragile environment.

We focus on four key pillars to effectively manage risk and enhance long-term value: data analytics, portfolio planning, asset management and stakeholder engagement.

1 Data analytics: Understanding the numbers

Our approach to operational efficiency combines data management and stakeholder engagement to identify opportunities to lower energy and water consumption, waste and greenhouse gas (GHG) emissions. These efforts directly reduce costs and add value for our tenants and investors across our managed property portfolios.

We use our annual sustainability benchmarking survey to track property-level sustainability data, measure performance against global best practices, identify opportunities for improvement, drive business decisions, and enhance client reporting and disclosures. The survey informs budget decisions to improve sustainability outcomes in the following areas: energy, water, waste, green building certifications, tenant engagement, and health and well-being. A full 100% of properties enrolled in our sustainability data management system completed the benchmarking survey.


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Our approach to resilience includes our sustainability data management system, Eco Tracker. This proprietary tool benchmarks energy, water, waste and GHG emissions performance and provides the analytics necessary to identify savings opportunities. The objective is to enhance the resiliency of an asset, reduce costs and add value for our tenants and investors across our managed property portfolios.

Moreover, our target setting program is a formalized approach to reducing energy consumption, GHG emissions and energy costs across our office, residential and enclosed retail portfolios. Since 2012, properties participating in this program have saved CAD$36 million in utility costs.

2 Portfolio planning: Climate risk as an investment consideration

We have quantified the exposure of a significant amount of our managed portfolios to climate risk, by determining the total dollar value-at-risk (VaR) at the client portfolio level and the individual asset level. The outcomes from this project are used to inform climate risk

[2] RELi, LEED Resiliency Pilot credit, the City of Toronto's Resiliency Checklist, GRESB Resilience Reference Guide and the City of Los Angeles 2018 Local Hazard Mitigation Plan, among many others.

Task Force on Climate-Related Financial Disclosures

BentallGreenOak is one of the original participants in the UNEP FI Task Force on Climate-Related Financial Disclosures (TCFD) Real Estate pilot group. The TCFD was established in 2015 by the Financial Stability Board (FSB) to develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers and other stakeholders. Increasing the amount of reliable information on financial institutions' exposure to climate-related risks and opportunities will strengthen the stability of the financial system and facilitate financing the transition toward a more stable and sustainable economy.

The pilot has developed scenarios, models, metrics and a risk assessment tool that will enable investors to assess climate risk across their portfolios. UNEP FI, together with 20 of the world's leading investors, is developing guidelines towards a first set of climate-related investor disclosures. Investors worldwide will be able to adopt and build upon the TCFD's recommended scenarios, models and metrics, contributing to a harmonized industry-wide approach.

mitigation strategies that influence future transactions, asset management and operational activities.

3 Asset management: Adaptation planning as risk mitigation

When it comes to climate resiliency, we work with our asset management teams to develop bespoke strategies to safeguard against climate risk. These climate adaptation action plans provide actionable best practices for both the asset and the properties to consider implementing to enhance their resilience to our changing climate. The result is increased building-level operational efficiency and enhanced tenant satisfaction.

In partnership with the consulting engineering firm RWDI, we provide property and asset management teams with asset-level climate adaptation action plans which include a customized climate risk assessment. The assessment identifies the priority climate-related threats that may pose a risk to each asset, as well as evaluates the current level of operational preparedness. Based on information gathered through this assessment, a second customized tool considers industry-leading climate resiliency best practices to begin future-proofing the building against identified risks.

The primary goal of climate adaptation action plans is to connect vulnerabilities to actions that could enhance the resiliency of the building. We have consulted with best practice guides[2] aimed to enhance the resiliency of a building in order to develop a climate change resiliency database that summarizes the best practices suggested in over a dozen guides in one central database. Each of the hundreds of best practices has been tagged with both the climate change threat and building system vulnerability they aim to address.

To create property-specific climate adaptation action plans for each building in the scope of the assignment, we query our database with the building-specific climate threats identified by the operators in their survey responses, as well as the vulnerabilities reported through vulnerability checklists.

4 Engagement: Collaboration within the organization and investment community

Our efforts on climate risk and resilience are done in a collaborative effort across the investment ecosystem, where we partner with cross-functional teams, occupants and the broader industry.

Through our Sustainability Innovation Lab, established with Sun Life Financial in late 2017, we look to our employees for cutting-edge project ideas that can enhance sustainability performance and the resiliency of our assets. The Lab draws on employees' ideas designed to enhance the performance of our buildings, reduce risk of obsolescence, strengthen tenant satisfaction and protect the environment.

Our approach to innovation draws on market-leading ideas that position our buildings competitively in the marketplace. The first pilot project from the Sustainability Innovation Lab was the Zero Carbon Building (ZCB) Performance certification for 100 Murray Street in Ottawa, which earned the title of the first existing building in Canada to achieve this certification. The project team quantified the embodied carbon impact of the LEED EB: O&M Gold certified building and created a zero carbon transition plan. Enhanced operational efficiencies through forward-looking solutions mean better risk management and greater value for our clients.

Engaging with the investment community

Last year, BentallGreenOak was elected as co-chair of the UNEP FI Property Working Group (PWG) to address the most imminent challenges in the field of sustainable real estate investment.

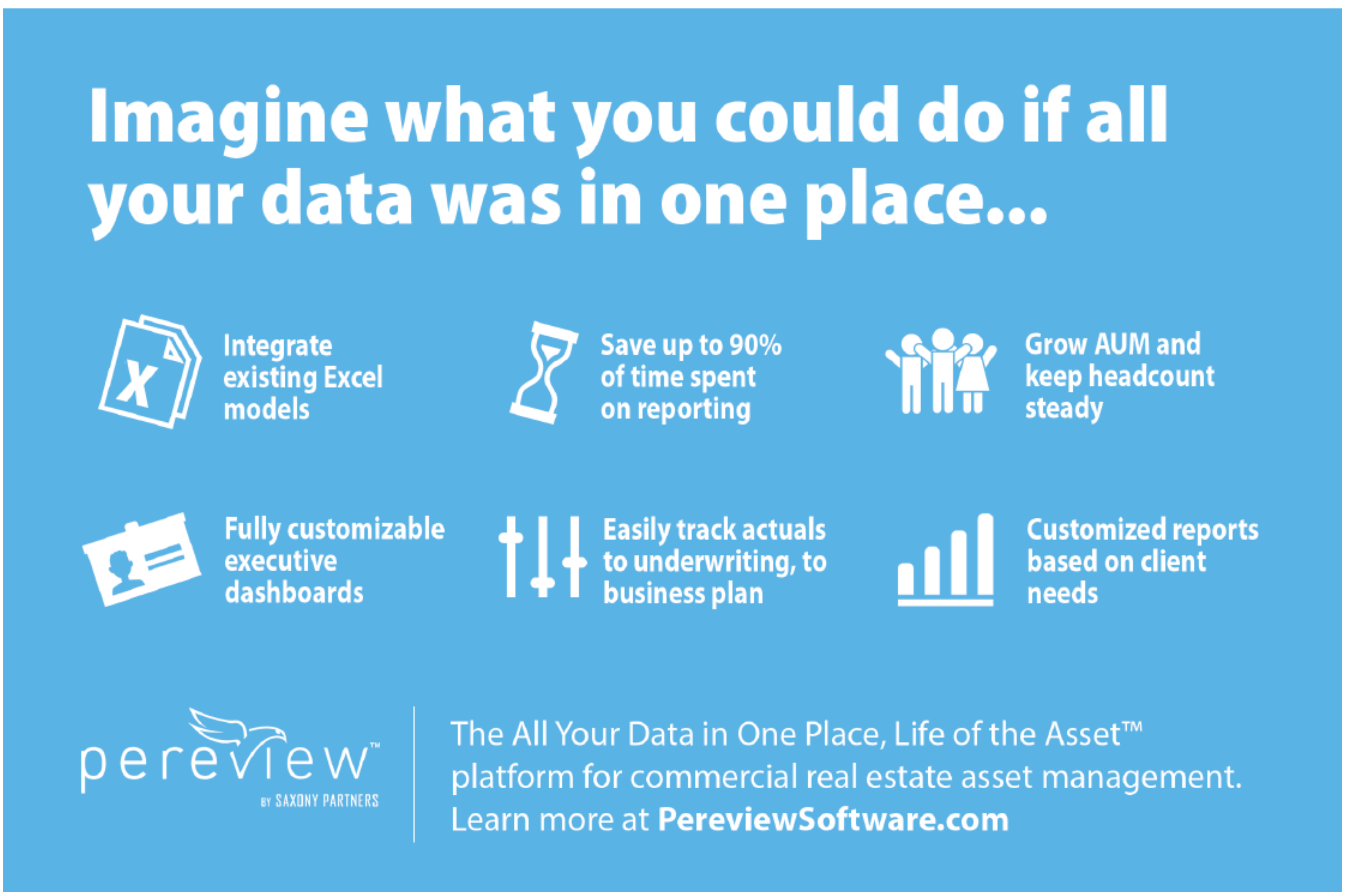
As part of our co-chair role, BentallGreenOak is also a member of the UNEP FI Investment Committee. In this capacity, we lead the global mandate to drive adoption of sustainability in real estate investment and property management. Specifically, we share the responsibility for developing and monitoring the UNEP FI sustainability strategy for the investment industry, and engaging with leading global investors to address pressing sustainability issues.

This includes helping to drive innovation in Responsible Property Investment (RPI) by facilitating access to relevant information and best practices. We're collaboratively developing the necessary tools to enable property investors and professionals to systematically apply and integrate ESG criteria into investment and lending decisions. Alongside policymakers and others in the real estate investment community, we're also developing and establishing the appropriate policy and regulatory frameworks for sustainable practices to grow.

Conclusion

Our approach to future-proofing our clients' and investors' real estate portfolios is directly informed by understanding our clients' and investors' needs, addressing our tenants' demands and collaborating with global industry. Long-term sustainable investing at BentallGreenOak is firmly planted in robust data analytics, portfolio planning, asset management and stakeholder engagement. Our sustainable investing strategies, and associated partnerships with building owners, tenants and local communities, are critically important drivers in the creation of long-term value for our investors and clients. ◆

Anna Murray is Vice President, Sustainable Investing, at BentallGreenOak.



DATA *is the* NEW leverage

Real estate needs to undergo a digital transformation to meet increasing investor demands for information — and for its own survival

By Alex Robinson,
Juniper Square

Imagine that a new Constitutional amendment was proposed that would require all 50 U.S. states to agree on a common tax code — a common set of definitions for how to levy sales and income tax, what's taxable and what's not — and the states would have to form a big convention to get everyone in the same room and agree on what's best for every state regardless of size, influence or economy.

Most of us would hear that and think it would never work. The amendment would never pass, so why would we even bother trying? And yet, an individual taxpayer looking to file his or her income tax can use a standard program like TurboTax, as though the states had all agreed on the tax code. It's abstracted for the user — the taxpayer does not care about the underlying complexity of the differences, but only its ease and practicality of use. The software knows and accounts for them, resulting in a coherent experience that feels like there are standards when, in fact, there are none. The state governments get their money and the taxpayer has, if not a joyous experience, a reassuring one that reduces error, time and anxiety.

Technology has this same potential to transform investment management in the real estate industry, which is far behind other industries in the global digital revolution. The industry now exists on a scale that is as diverse and difficult to standardize as the 50 state tax codes.

Why now

Since the global financial crisis, many limited partners (LPs) have been under tremendous pressure from their investment committees to get more detailed pictures of their real estate portfolios. As the markets were melting down, LPs were unable to answer basic questions such as, "What real estate do we actually own?" Or, "Do we have exposure to Lehman Brothers as a tenant in our portfolio?" Many LPs were unable to answer these questions because the reporting that came from their investment managers was in the form of PDFs. For an LP that invests with 50 managers, it receives 50 PDF reports each quarter. But the reports yield no insight into portfolio data because it is difficult to aggregate and analyze data that comes in such a static, unstandardized format.

The good news for LPs is that, as real estate has become more attractive as a sector for institutional asset diversification, investors have more allocation options than ever before and can be far more selective in the general partners (GPs) they invest with. What LPs demand from GPs is more transparency around investment performance, asset characteristics and risk; this data currently lives in spreadsheets and static reports that lack consistency, visibility and the timeliness required to ensure good decision-making.

In the public markets, anyone can create an account online and buy a share of an index fund for a few dollars, drill down to the asset level on a free digital interface, and then sell that stock the next day, based on accurate, accessible data. For a pension fund with a $10 billion allocation to real estate, it is not unreasonable to expect the same type of digital tools that an individual investor with $100 to invest on Charles Schwab or E*TRADE has today, and has had for decades.

The biggest data challenges for GPs

Notwithstanding increasing demands from LPs, GPs have the challenge of aggregating data from many disparate sources. Some of this data lives in property management systems, which are often managed by third parties that have their own unique accounting structures. And even if a GP is able to standardize that data across the various property managers they work with, they will still only have a subset of the data that LPs need to truly understand the assets that they own. Usually, the GP will have neither the full debt schedule modeled in the property management system, nor the capital budgeting, forecasting and valuation models. They may not have the leasing details that they need.

Collecting and organizing all of this supplementary data requires an extensive layer of work that falls on the GP, but the software tools that exist to solve this problem have either been so flexible that a GP can spend several years building the technology and, by the time it is built, it is obsolete, or so restricted that it cannot work for many investors' specific needs. Real estate varies so significantly that there is an enormous tension between the need to have a standardized data model and the need for flexibility that legacy systems cannot solve.

The end result is that all of this valuable investment data has been extracted from the GP's source software systems, manipulated in spreadsheets, and then packaged up in the PDF reports distributed to investors. LPs receiving these reports immediately begin transcribing the data back into their own internal software systems, or paying a consultant or service provider to do so on their behalf. This inefficient cycle — GPs taking data out of a structured format, sending it to LPs, and LPs struggling to get it back into a structured format — has left LPs with data that is inaccurate, inconsistent and out of date.

At some point, the pendulum swung the other way. Institutional investors need a detailed asset-level understanding of their portfolios, and many have decided the only way to get it is to design their own custom reporting templates that they impose on the GPs in order to get access to their capital. For a GP that has 50 different LPs to report to every quarter, that creates a nearly impossible workload vulnerable to error and inconsistency. All of the same manual work — data transcription, mapping a GP's data definitions to an LP's, etc. — still needs to be done, but the responsibility has shifted from LP to GP. No value has been created for the partnership as a whole.

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The challenges with standardization

Back to our tax analogy: While there is no question that the industry could benefit from standards, getting committees of interested participants across real estate to agree on common data and reporting standards would be almost as impossible as getting 50 states to agree on a common tax code. Even if the largest pension funds on the LP side and the GPs with the most clout agreed, they would only represent a tiny fraction of the whole market. Therefore, it would be very hard to get any kind of consensus in terms of a standard for the industry.

How technology can be the solution

In a world where valuation in the public markets is updated every minute, real estate cannot survive with a process where assets are valued annually. In a few short years, LPs have come to appreciate the value of having organized and transparent data. The time is coming when receiving data in spreadsheets or PDFs will no longer be acceptable.

But GPs need to focus on the buying, selling and financing of real estate — their core competency. How the reporting is exchanged with an LP is not something that every GP should be trying to invent or needs to solve on their own. Instead, GPs and LPs need to unite around a common tool, because in most cases the data that an LP requests is simply a subset of the data the GPs need for their own internal purposes.

If we can leverage modern technology to build a single system of record that GPs use to organize their investment data and streamline their portfolio management operations, that would be an immensely valuable tool on its own.

“If we can leverage modern technology to build a single system of record that GPs use to organize their investment data and streamline their portfolio management operations, that would be an immensely valuable tool on its own.”

But if GPs can *also* grant LPs direct access to a subset of the data that they warehouse in that system, and if the system is flexible enough to allow LPs to analyze and extract that data in the formats they prefer, then this decades-old reporting nightmare becomes a solved problem for the industry.

The GPs who succeed will be those who embrace and invest in these solutions.

Who will succeed

The industry will get to a point where it becomes table stakes that GPs need to be much more operationally sophisticated in order to be able to access pools of institutional capital.

LPs need to trust they can believe in the data, and to access it from the portfolio level down to the asset level securely and accurately. GPs who can provide this ability will have more access to pools of institutional capital, and the cost of that capital will come down over time as the industry gains that sophistication.

As large owners of real estate, GPs have begun differentiating themselves based on the tenant experience. Their job is to provide great experiences to attract and retain high-value tenants, as well as to increase their assets' value and returns, instead of just having a building that people go in and out of every day. That same mindset shift will start to happen very soon on the investor side, where managers will recognize the value of delivering a service, not just their ability to deliver returns. This is a significant shift from being a provider of bricks and mortar. How GPs run their companies will change, how they align incentives will change, and the types of people that they attract to their organization will also change.

The result is that GPs will have to become more facile with the evolving technology that will support that fundamental shift. The idea that someone can focus on a shoe-leather approach to properties and gut decisions is not going to be a sustainable strategy in the next five, ten or 20 years. The firms that win will be those that learn how to embrace technology in order to make better decisions to move faster, take less risk, and attract and retain better talent. And it is not just about going out and picking a vendor — if only that were the answer to revolutionizing the business. GPs have to do the hard work of looking at how to sustain their business and how they need to change as an organization to adapt to and leverage the technology that is available, because that tool set will keep changing. It is this digital and organizational transformation that will be the source of their competitive advantage in the future of real estate. ◆

Alex Robinson is Co-founder and CEO of Juniper Square.

“We should continue to incorporate sustainable building practices that support resource efficiency and conservation.”

Anne Peck

Vice President
AEW Capital Management

Interviewed by Wanching Leong

Date joined: July 2012.

Background: B.S. in Mechanical Engineering, Boston University. M.S. in Construction Management, Civil Engineering, Northeastern University. Nidec America Corp., Cosentini Associates, Bovis Lend Lease, Jones Lang LaSalle, Cambridge Housing Authority.

Current role: I have a leadership and supervisory role in our firm’s Architecture & Engineering department, where I oversee the entire physical and environmental due diligence on acquisitions, dispositions and existing assets. Our team is responsible for monitoring and overseeing the construction of all of AEW’s development deals. In addition, I play a lead role in our firm’s sustainability efforts and I have helped our firm’s core fund increase their GRESB score every year for the last five years. I am also a member of GRESB’s North America Benchmark Committee.

Best part of the job: I learn something new from every deal I work on. There are always idiosyncrasies, varying ordinances or unique approaches contractors and consultants use that offer new experiences. Last year, along with my consultant’s help, I achieved the third WELL Gold Certification for an existing office in Boston, for AEW’s Boston headquarters.

Worst part of the job: Challenges of my work-life balance. It is hard to balance my busy travel schedule with two very active children and a husband who also travels for his job.

What are you spending your time on: These days, I am balancing the demands of overseeing more than 20 new construction projects with training junior staff, monitoring some large renovation projects, managing due diligence for a few acquisitions, and supporting the firm’s sustainability initiatives. I manage the relationship with many of AEW’s sustainability consultants, continually seek opportunities for renewable energy, and help push forward corporate initiatives to improve our ESG efforts.

Email or phone call: I prefer communicating over the phone because you cannot always understand someone’s tone in an email. That being said, I am rarely available to speak on the phone. I tell people if they really need to get in touch with me, send me an email and we can set up a time to talk.

What could the industry be doing better: Properties should be built with a 40-year vision accounting for projected climate change. We try to incorporate more resilient design into our development projects in potentially high-risk locations. For example, we have one multifamily development close to the ocean, where we designed the main mechanical and electrical rooms to be above the ground floor, and the garage on the ground floor to create a pathway for water to flow if a flood were ever to occur.

Something you’ve learned that has been useful in your career: I had a boss who was able to evaluate situations from all different aspects. He taught me to try and view every problem from different perspectives before making a final decision. Engage others who may be able to bring a different perspective to the problem and try to understand their point of view.

What’s kept your interest about the industry: There are so many changes and new technologies in how buildings are constructed, managed and monitored. There are always new nuances and ways of either evaluating or constructing them, or new analytic models to evaluate the use of the buildings so we can improve how buildings are run. Better run buildings will lead to better returns. Certifications interest me. I tested the BREEAM In-Use Certification for existing buildings, and received the first BREEAM building certification in the U.S. That was very educational for the property management team and myself, which in turn helped us make the building more efficient for the long term. ◆

OPPORTUNITY ZONES: *The* way forward

Investor education, initial experiences and active public support will determine the future growth of opportunity zones.

By Ramakrishna Kaza, NAREIM Fellow

Ever since the passing of the Tax Cuts and Jobs Act of 2017 set the ball rolling on opportunity zones, markets have been busy trying to size up this new opportunity. The Economic Innovation Group, a public policy organization that played a key role in conceptualizing the opportunity zones program, estimates that U.S. households and corporations are sitting on over $6 trillion[1] of unrealized capital gains; even if a small fraction of this eligible capital finds its way into opportunity zones, the program could potentially become one of the largest public-private endeavors in the history of community development. Investment managers and real estate developers across the country have been very enthusiastic about the potential scale of this opportunity. Data analytics firm, CoStar, has identified more than 160 qualified opportunity funds (QOFs)[2] targeting commercial real estate that are active and looking to raise funds.

While there is a lot of enthusiasm around opportunity zones, capital formation in the space has lagged far behind. It may be assumed that many potential investors in QOFs have so far been holding back due to unclear regulations. However, the second round of proposed regulations recently released by the IRS[3] helps address the confusion around many critical issues like QOF asset sales, debt-financed distributions, secondary market investments in QOFs, recycling of QOF capital and safe harbor provisions. With clarity emerging, investors are beginning to move forward. Conversations that have so far been about regulations are now increasingly revolving around managers and their strategies.

Three key factors could shape opportunity zone growth and impact going forward: investor education, the initial experience and active public support.

1 Economic Innovation Group (EIG), *Opportunity Zones: Tapping into a $6 Trillion Market.*
2 Costar, *Opportunity Zone Program Falls Short of Fundraising Goal Amid Investor Skepticism.*
3 Internal Revenue Service, *Investing in Qualified Opportunity Funds.*
4 Investors rolling up their capital gains into QOFs by the end of 2019 are eligible for a 15% reduction in their deferred gain as long as they hold the QOF investment for seven years (until 2026).
5 Investors rolling up their capital gains into QOFs by the end of 2021 are eligible for a 10% reduction in their deferred gain as long as they hold the QOF investment for five years (until 2026).

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Investor education

A key aspect of QOFs that sets them apart in the alternative investments space is their source of capital. While most private equity and venture capital funds have a limited partner base that predominantly consists of tax-advantaged institutional investors, QOFs raise their capital from tax-paying individual investors, usually qualified purchasers who are high-net-worth individuals or family offices.

The channels of fundraising are also very different. Whereas institutional investors are represented by sophisticated consultants who specialize in alternative investments, individual investors in QOFs are often advised by private wealth managers, registered investment advisers and broker-dealers who are typically generalists.

The complexity of opportunity zone regulations and products means that investors and their investment advisers must scale a steep learning curve before they can evaluate and compare different QOFs. As it stands, there is sometimes a chicken-and-egg situation where private wealth managers are waiting for a critical mass of interest among their clients before they invest time researching opportunity zones, while their clients, overwhelmed by the hype and confusion surrounding the space, are choosing to wait. The onus is now on the managers of QOFs to invest time and resources into investor education. The sooner they are able to bridge this gap, the better it will be for capital formation in the space.

The initial experience

With the first deadline coming up at the end of 2019,[4] managers are pushing the pedal to raise as much capital as possible this year. This does not mean that the opportunity zone party is going to end soon; if anything, it is just beginning. The most significant benefits to taxpayers investing in QOFs are related to tax deferral and tax exclusion (the ten-year benefit). Investors will be able to enjoy these benefits even if they invest in QOFs over the next three to four years. Moreover, as long as investments are made before the second deadline in 2021,[5] investors would be eligible for some reduction in their deferred gain. The decision to liquidate existing investments and re-invest the corresponding capital gains into QOFs might not be driven solely by the deadlines of the opportunity zones program, but also by the growth potential of existing investments at any point in time. Therefore, the real consolidation of capital flows into QOFs will most likely occur when asset valuations in the current market cycle have peaked, and investors are actively churning their portfolios toward defensive strategies.

What we are currently witnessing is the early trickle of capital into opportunity zones. The experience of this initial group of investors will play a

> “Although generally overlooked, active public support, or the lack of it, is an important factor that can impact the evolution of opportunity zones.”

big role in determining the future of the program. The market will be watching the QOF managers that raise capital this year to evaluate how they operate within the opportunity zone regulatory framework; whether they are able to actually follow through with their stated strategies; if there is a scalable pipeline of investment opportunities that match the risk-return appetite; and if there are any other risks that are currently not fully understood. Once the market is satisfied with the initial experiences and is convinced about the depth of the opportunity, QOFs will likely receive incremental allocations over the next few years from investors who are actively rebalancing their portfolios.

Active public support

Although generally overlooked, active public support, or the lack of it, is an important factor that can impact the evolution of opportunity zones. To understand the effect of public support, we must look at what it means at different levels: federal, state and community.

At the federal government level, it is crucial that all the involved agencies like the IRS, Department of the Treasury and the Department of Housing and Urban Development (HUD) remain actively involved with industry and be proactive in providing clear regulatory guidance for investors/QOFs investing in opportunity zones. While the second round of regulations has cleared up most issues, there are still areas that need further clarity. The most important issue that remains unaddressed is the reporting framework for monitoring impact. The government has the tough task of keeping the framework operationally simple for QOFs, at the same time ensuring that there is no dilution in the data required to effectively monitor impact. Done well, the framework could become an effective tool for providing feedback to communities on how different projects are impacting them.

The extent to which states conform to the federal provisions of the opportunity zones program affects the program’s growth and impact. While most states have either fully or partially conformed to the provisions, some states with a large capital base, such as California and Massachusetts, are yet to do so. Delays in conformity or very limited conformity can dampen investor interest in the program, especially in states with high taxes like California. While broad conformity is important, it is only the first level of support that states can provide. Opportunity zone investing will gain much more momentum if state governments get active in exploring potential synergies of bundling other state or regional incentives with the those of the opportunity zones program.

Lastly, let us not forget that the program exists to primarily drive economic growth in underserved communities. As principal stakeholders of the opportunity zones program, these communities must encourage participation at the grassroots level in building a collective vision for themselves. Administrations at the city and county levels should consider playing an active role in setting up community working groups that can help not only in creating this vision, but also in developing specific strategies to continually monitor and realize it.

Conclusion

A reckoning of the opportunity zone program will come in 2027, the year when QOF investors become liable to pay their capital gain taxes. It may begin with a recognition of the success or failure of the program from a purely investment perspective. In all probability, it will evolve into a bigger judgement of whether the program delivered on the socioeconomic benefits that it originally set out to accomplish.

To be successful, the opportunity zones program needs to grow to a scale where its impact is palpable, not just in the “low-hanging” designated tracts of New York, San Francisco and other gateway markets, but across a majority of the 8,766 opportunity zones. While driving this growth, QOFs would have to maintain a fine balance between meeting investor expectations and delivering on community goals. Managers of QOFs have a challenging task cut out for them, but as long as they are cognizant of both sides of the mandate, we are on the right path. ◆

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