CONFIDENTIAL – Presentation Briefing

Date: October 26, 2023

Re: Real Estate Investment Advisory Council
Second Quarter Presentation: **Equity Capital in a Turbulent Market**
Westin Buckhead Hotel

On Wednesday, October 25th, The Real Estate Investment Advisory Council gathered at the Westin Buckhead Hotel for the conclusion of its "limited series" *Show Me the Money!*

The 100+ REIAC members and guests were treated to the high-level expertise and experience of:

Terry Brown, Chairman and CEO, Asana Partners
Todd Liker, Managing Director and Co-Portfolio Manager, Oaktree Capital Management
Ambrish Baisiwala, Chairman and CEO, Portman Holdings, and
Dirk Aulabaugh, EVP and Global Head of the Advisory Services, Green Street

Consumers to the rescue

The first issue addressed was the direction of Gross Domestic Product (GDP) as the indicator of our economic future. Consumer spending accounts for two-thirds of GDP, and the speakers' opinions varied on this tough-to-pin-down measure:

- No noticeable difference in consumer spending in any way that would impact apartments. Apartments have their cash flow issues now, but because of supply coming online, not the consumer in the units.
- Yes, there is weakness in the consumer sector, as verified by a spike in past-due car loans lately, but retail space is in demand nonetheless. Especially for restaurants, which are entirely discretionary spending. Margins are stressed there, but because of rising labor costs. Overall, retail is solid.
- Consumers are starting to weaken, i.e., hospitality, having recovered, has now flattened and is trending down. The leisure consumer is tightening a bit. Will still go on vacation, but not splurge. Apartment rents are at the limit of affordability, so they will flatten too. Add increasing credit card balances and re-start of student loan payments, and how do consumers keep going?

Bottom line: **get ready for a crappy holiday season** (bah humbug!). The other shoe is starting to drop and reveal the distress.

Debt vs. Cash

Equity investors' underwriting has to react to the one main variable: debt. A lot of debt doesn't clear, and there is little debt for repositioning and retenanting.

One way to size up a deal – **do it all equity**. Especially since it can be a long timeline from inspiration to closing; one year of pre-development, two years of construction, one year of lease-up. No one can predict what debt will look like four years from now, so the backstop is an all-equity capital stack (except industrial, which is the healthiest property type because it full-cycles the fastest).

In the meantime, monitor the opportunities or emerging challenges along the way. If debt moves 500 basis points and cap rates move only 100 basis points**, somewhere the math is disconnecting**; it doesn't make sense.

During the Great Financial Crisis, debt did not have the interest rate shock like we have now. Equity needs to bring the lender to the table to get anything done**. Show the lender that he has to "pitch in"** and work on concessions in his loan terms or existing loan structures.

Lenders are slowly coming around to this approach. In some cases, to get a refinance done to roll over a loan, lenders will eat the cost of the interest rate cap that expired just to keep things afloat and moving along.

And by 2024, lenders can't deny the reality of office properties, although equity investors and owners already have accepted the big value reset there. All other property types are still in the "hopeful" bin.

Short vs. Long-term: where are rates going?

Jerome Powell is not lying; **rates will be higher for longer. Period**. Look at the forward curves, if you can trust them. If the short-term rates come down, that doesn't indicate anything about if the 10-year rates will come down (they won't). So, the cost of debt might soon equal the cost of equity, a further reason to do a deal all cash.

Making predictions even more difficult:

- An ugly, ugly presidential election coming up;
- A war or two in progress, and we don't know the outcomes;
- The consumer will be pulling back soon.

Note, though, on a scale of importance, "world uncertainty" impacts long term rates way more than politics (we're getting used to our awful politics). During wartime there is usually an international flight to quality which pushes down US treasury rates. However, the Treasury Department isn't supporting

treasury prices lately (which would be inflationary). Throw in the outlier of potential domestic civil unrest, and 2024 is shaping up to be B-A-D bad!

How to navigate the trough

Investors really need two skills: the understanding of real estate, of course, and the understanding of financial re-engineering, which most investors and developers don't have. So there are more opportunities for the financially savvy investor (with cash) to acquire the properties that haven't been re-engineered out of trouble.

Patience is also a great defensive asset. Keeping a very long-term perspective, like that of a family-run 70-year-old company, allows one to see forward another 70 years.

Public vs. Private

Are public markets a barometer for what's happening at ground-level? Do REITs and their public market performance give us insight into the future?

Most speakers doubt that REIT analyst reports and 10-Ks are meaningful, but they are at least informational. REITs have a very different cost load than individual properties, and pricing measurements don't provide an apples-to-apples comparison.

A derived cap rate of a publicly traded stock is about 130 bps higher than a cap rate per an individual property sale transaction. For example, Cousins REIT is yielding 9.2% while well-occupied class A+ office properties trade at a 7.5% cap rate.

Blaming the Appraiser…?

This misalignment in value is found elsewhere. The appraisal industry is notorious lagging in property cap rate measurements. Inherently backward-looking, appraisals use data points from three or six months in the rearview mirror to value an asset. Most of the "V" in LTV comes from the pricing of the debt, and in times of rapidly escalating interest rates, this means that lenders do not really have a handle on the value of their collateral, and therefore are paralyzed in decision-making on what to do about their loans. Thus, problem-solving decisions are slow in coming out from your lender on how to handle your pending loan maturity.

Appraisers will explain **that there are not enough immediate data points available (transaction volume is down 75% nationally) to get a more precise real-time valuation**. And, frankly, the appraisal industry does not want to whiplash the real estate economy by dropping values as far and fast as rates went up. The Federal Reserve is quietly onboard with that strategy, as marking every loan to market all at once would sink the banks (the fallout from Silicon Valley Bank was the shot across the bow to not do that again).

…or the Banker?

Industry insiders point out that this leads to a lot of interesting conversations between lenders and appraisers. The lender reviews the appraisal, but then asks the appraiser directly "don't write this down, but I need to know what it is really worth." And the appraiser responds with "don't write this down, but it's probably worth less…"

In the end**, bankers don't know where the equity lies in their collateral** – does the owner still have value, or is the bank now the real equity in the property? So, bankers don't know whether to kick the can down the road with a re-structuring or seize the property and sell the asset at a discount to get it off the books.

Other insider observations: larger institutional investment management firms typically have a private equity team (individual asset investments) and a public equity team (REIT stock investments). If the two groups operate separately, neither will be aware of the arbitrage between public and private valuations.

Meaning, investing in the same asset class through REITS and asset-level acquisitions will produce two different profit margins. Those institutions that combine the two sides under one management team get the benefit of sourcing the more profitable investment strategy.

Be mindful of that pendulum

REIT valuations do have some static in the otherwise transparent results. A REIT that is geographically dispersed might have some assets in cities like Portland, Seattle, Chicago and San Francisco. Which are all bad locations for maximizing asset valuations due to the (sensitive topic of) politics where the pendulum has swung too far left.

Short term investors in these markets are getting hammered, but these markets are now ideal for long term investors like the family office who has a 30-year horizon and knows that these pendulums will swing back in a decade. Thus the oxymoronically labeled "things are so bad there, they might be good" investment strategy.

Speaking of law and order, **Georgia (and Atlanta) rank fairly high on the scale of investment desirability**, due to pro-business governmental environment, which fosters:

- Job growth
- Corporate relocations
- Positive demographics
- Lower cost of living.

And better weather.

Key takeaways and advice

- It is a tough time. Clean house, preserve cash, get ahead of problems that you know will emerge, and be careful out there.
- Teach your younger employees who don't know what "RTC" stands for, that recessions are not the end of the world. "Coaching them up" is a discipline.
- Have patience during the reset. You can't stop it, it's just math. Time will fix it so that these interest rates will become the norm, and real estate will continue forward at that new reset level.

The audience then indulged in an extensive open bar and generous hors d'oeuvres spread to take the sting out of REIAC's limited series on "Show Me the Money."

About REIAC

The Real Estate Investment Advisory Council (REIAC) was established as a nonprofit trade association to provide a forum for the exchange of ideas, concerns and experiences among senior executives who conduct commercial real estate transactions. The Southeast chapter of REIAC was founded in 1994.

REIAC is an exclusive, **principals-only** national fellowship of top real estate executives that offers superior educational events, networking opportunities and community service. REIAC's institutional quality programs are presented in a social environment where members can share experiences and knowledge with their peers. REIAC events encourage members to broaden horizons and develop personal relationships that further their success within the industry.

For further information, please contact:

Jerry Monash, President, Southeast Chapter of The Real Estate Investment Advisory Council
(404) 847-9781
jerry@lancetrealtyadvisors.com