Urban Land Institute
Chicago

2016 Capital Markets Mid-Year Review

This is a summary of the June 28, 2016 meeting of the ULI Chicago District Council, which gathered at LondonHouse Chicago to hear an expert panel of professionals discuss the state of the capital markets, including the tumultuous impact of Brexit, the recent referendum in which United Kingdom voters narrowly expressed their desire to leave the European Union.

The panel--featuring a pension fund advisor, a national developer, a leading private equity group, and one of the nation's largest real estate lenders--covered market sentiment, lending parameters, investor preferences, and capital availability, among other topics.

The moderator for the session was Mary Ludgin, *Director of Global Investment Research*, Heitman LLC. Panelists were Kevin Hites, *Chief Investment Officer*, The John Buck Company; Christopher Kosonen, *Managing Director*, J.P. Morgan; and Jeff Quicksilver, *Managing Director*, Walton Street Capital, L.L.C.

Given the volatility that has characterized the first half of 2016, it was only fitting that the panel discussion began on a topic that, until last week, wasn't really on the radar: Brexit, which has already had significant ripple effects in every corner of the global economy.

In response to moderator Mary Ludgin's inquiry about Brexit's initial impact, Kevin Hites said lenders and investors who were already "on the fence" are likely to be "more firmly planted on the fence or jumped off the fence and are running for the hills. So that definitely affects us."

Also, in the coming months, his firm will be "more selective" and focused increasingly on core locations. "I think the projects that are more on the fringe," said Hites, "are going to be very difficult to get built, financed, acquired."

According to another panelist, "Our spreads are widening while the index is falling. The coupons are more or less the same in our space."

And Jeff Quicksilver placed Brexit in the context of the last year that has seen much "global volatility" in the financial markets.

"This is another level of uncertainty and volatility in the markets," Quicksilver said. "For the real estate market, you've seen interest rates fall. That's probably a sign you're going to have continued accommodative monetary policy."

Also, he noted, “from a buying perspective, it’s clearly a pause for us.”

Prompted by Ludgin’s inquiry whether Brexit will intensify a slowdown that had already been under way, Quicksilver said that over the last six months, transaction volume has slowed and pricing has “corrected, at least in our space, probably 5 or 10 percent.”

“What’s mitigating that are foreign capital flows—that will be the wild card” and Brexit could accelerate that flow seeking stability and yield “as global volatility is increasing,” he added.

“From a buying perspective, our strategy hasn’t changed,” Quicksilver said. “We’re just really being careful on our underwriting.”

The depth of the market has shrunk recently. Instead of five to ten parties pursuing a deal, the number of prospective buyers is more frequently one to three, he added.

“I would agree with that, that’s what we’re seeing,” said another panelist. “Acquisitions are falling through repeatedly. And to further compound this, you have $190 billion of CMBS (commercial mortgage-backed securities) debt maturing this year and next year….it remains to be seen what’s going to happen there. Maybe some for-sales, maybe some blend-and-extends. It’s going to absolutely add some shock to the system.”

Prompted by Ludgin’s question about re-pricing, Hites said there is a “brutal” level of lack of demand for suburban office product, while on the other end of the spectrum, there is a boom occurring for newly constructed high-rise residential projects that might see somewhere between four to six funds attached to those projects.

On the topic of the depth of demand for brand new apartment space, Hites said that core long-term investors are attracted to “in-fill, high-rise product that’s difficult to replace.”

As for opportunities to seize, Quicksilver said Walton Street Capital is focused on shorter-term business plans, in the two- to three-year range, to lessen “duration risk.” Over the past 18 months, his firm has shifted its strategy toward “buying more operating assets with cash flow” in the hotel, grocery and retail markets.

“We’re trying to do more investments where we’re getting back a significant part of the investment through cash flow during the holding period,” he added.

In reply to a question from Ludgin in the context of Chicago’s financial struggles, Hites noted the importance of John Buck attracting CNA Insurance as the anchor tenant for the **under-construction 820,000-square-foot building at 151 N. Franklin St.**

CNA represents 40 percent of the rent roll, and another tenant accounts for another 8 percent, and "that made the project financeable with no recourse," Hites added.

Also as part of that deal, John Buck has **acquired the 1.1 million-square-foot building at 333 S. Wabash Ave**. from CNA Insurance, currently located in that property.

"We saw it really as an opportunity to reposition the fund," said Hite, adding that the upper portion of the 333 S. Wabash building has been underwritten as having the potential to convert to residential if office absorption is not strong.

When asked about the forces shaping the CMBS market, one panelist said the first half of this year is about half as active as the first half of 2015, which he chalked up to volatility in the market.

"For us, given the impending amount that is coming due…. the coupons are just low enough where borrowers are saying, `I should take advantage of this,'" he said.

The nearly $200 billion in maturing CMBS loans, which generally were originated at the peak of the market about 10 years ago, is composed approximately of $20 billion in hotels, $25 billion in multi-family developments, and the remainder—about $150 billion—in office and retail, he said.

A key category to watch: malls, because so many were financed via CMBS, said the panelist.

"Obviously there's a massive stress in that market and what happens in that space?" he said. Traditional mall owner-operators have been selling to private equity firms, which are now having a hard time finding buyers, he added.

"You're going to see the better malls get better, and the 'B' malls will have to go through a re-position," he said.

Panelists also discussed various ways they manage risk, with one noting that "our competitive advantage is we can do large loans and we can …use our distribution capabilities" to structure transactions.

Quicksilver, meanwhile, said his firm's creation of a **$655 million real estate debt fund** came about partly in response to the CMBS market volatility and risk retention regulations.

Most of the fund came from foreign investors, attracted by "favorable tax treatment," he said, and the average spread on the loans is LIBOR plus 950. The net effect is "an incredibly attractive risk-adjusted return in this environment," he added.

Panelists also discussed cap rates, which Hites said he did not believe would necessarily go lower if interest rates decline—and may actually have an inverse effect.

“I do think that demand for institutional quality U.S. real estate will remain pretty strong, which is obviously good for cap rates,” he said. “But on the flip side of it, I think as people start to factor in slow, or negative, rent growth for the next 12 to 36 months, that has the opposite effect.”

Quicksilver said he hopes that interest rates do not decline and that his firm is underwriting increasing cap rates. “Frankly we’ve been talking about increasing cap rates and interest rates for three years and we’ve all been dead wrong,” he said. “So I think it’ll be interesting to see what happens.”

On the topic of what to avoid, Quicksilver pointed to “yield chase, where you give up quality to move into tertiary markets.”

One panelist said it’s important for owners and investors of multi-family housing as well as in the hospitality space to have strong reserves, so cash flow from rent does not “leak out to the equity.”

“If we’re going to go higher in leverage, we’re going to want more reserves,” he added.

During a question-and-answer segment that closed the session, panelists tackled several topics, including:

*Park Tower at Transbay, a San Francisco project in which John Buck is partnering with Golub & Co. and MetLife Inc. The 43-story office tower broke ground earlier this year and is projected for completion in 2018.

Conversations with potential tenants from the technology sector have just begun, Hites said, and a key focus has been identifying an anchor tenant. Viable candidates are mature tech companies, around 10 to 20 years old, with “massive balance sheets” and might be in the Fortune 100, he said.

*Whether there will be enough capital supply to refinance the CMBS debt coming due: (yes, according to a panelist.)

*What factors determine in which categories to invest. According to Quicksilver, stability and an overall market’s health are key factors—particularly markets with “strong supply and demand fundamentals.”

“I don’t think this is the time for us to take outsized risk,” added Quicksilver.

Hites echoed that sentiment, saying that John Buck's prioritization isn't so much based on property types as "looking at different ways to make returns on the risk spectrum."

"A couple of years ago, we probably would have pursued well-located land deals in almost any urban environment," he continued. "Today we're taking a little bit of a step back and trying to find deals that might have some in-place income but in really good locations."

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