Wharton UNIVERSITY of PENNSYLVANIA Samuel Zell & Robert Lurie REAL ESTATE CENTER

2014 Spring Members' Meeting Summary

The Spring Members' Meeting of the Samuel Zell and Robert Lurie Real Estate Center welcomed more than 400 members, guests and students to Philadelphia's Rittenhouse Hotel. At Wednesday evening's dinner, Jonathan D. Gray, Global Head of Real Estate, Blackstone, joined Joe Gyourko, Director of the Center, in a top-rated discussion about the state of real estate around the world, in ***A Perspective on Global Real Estate***.

Roy H. March, CEO of Eastdil Secured and Chairman of the Zell/Lurie Real Estate Center, opened Thursday's meeting. The day's first panel, **Wharton on the Economy and the Prospects for the Property Markets** was moderated by Jacques N. Gordon, Director of Investment Research, LaSalle Investment Management, with panelists Joe Gyourko and Peter Linneman, Sussman Professor Emeritus of Real Estate at Wharton. Linneman said although the economy is growing about 2 percent a year, home and auto production is less than in a normal decade. Throughout history, when economic indicators seem to portray a new paradigm, it is actually mean reversion and vice versa. Both panelists agreed the economy was mean reverting, although Gyourko believed it might not mean revert fully. His concern was about the declining labor force, with the female labor force having peaked. "What worries me about longer-run growth is the massive rise in the disability rolls," said Gyourko. "Low-skilled people in this age group (25 to 54) don't appear to be employable and are going on disability. You have some people who will be unproductive roughly forever."

Gordon, referring to the Fed, asked, "Did they give us a misleading target in 6.5 percent? How should we follow this?" Linneman wondered how the Fed knows what to do. "Where did they get their divine message? The Fed is acting beyond normal right now." Gyourko was also skeptical, although he endorsed their initial actions with QE1 because "it was an awful crisis and they needed to go outside the bounds." It is a different world, agreed Gordon, calling the Fed's policy "the most accommodating we've ever known… It felt like the right thing to do at the time. Is it still the right stance, though, to be so accommodative?"

The 12 big national banks keep large reserves over and above what they need, according to Linneman, who said they keep 96 percent as excess of what they need legally, and have just recently started lending again. “No one anticipated this. They continue to pump it in, and the banks mostly hold it in. They’ve created a two-tier banking system.” And when the banks decide to lend, the amount may be unprecedented, and their beneficiaries are unknown. “I’d love to know what they’ll give it to, so I can invest,” Linneman added.

“This type of base creation doesn’t solve our depressed growth problem,” argued Gyourko. “It creates uncertainty and depresses jobs and credit creation. The Fed has a dual mandate of targeting employment, too. It’s required to do that.”

Jobs are continuing to grow, which translates to continued need for housing and ancillary materials manufacturing. In a normal recovery, jobs recovery would be at more than three million per year, so it is still depressed, Gyourko said. New construction is up a little and multi-family units are back to recent trend levels as far as demand and production.

“Netting out inflation, rents are no different from what they’ve been for the last 20 years—right around average,” Linneman said. “Go to other sectors and net out inflation, and they’re still scraping along the bottom. But after five years, we’re still back to only average.”

The United States is back in the No. 1 place in its ability to grow in absolute terms, Gordon said, but will interest rates rise? The panelists agreed that interest rates will rise modestly, although Gyourko expressed concern that there is an under-appreciation that the risk of percentage rate change will outpace percentage rate change in rents. And because this situation is unprecedented, he said, history cannot inform us.

The second panel, **Employment, Space Usage and the Office Sector**, was moderated by Asuka Nakahara, Associate Director of the Center. Panelists were Johnathan Sandler, Principal and Strategy Director, Gensler; Hastings Johnson, Vice Chairman and CIO, Hines; Marty Burger, CEO, Silverstein Properties; and Adam Neumann, co-founder and CEO, WeWork.

Changes have been evolutionary for many decades, began Nakahara. The commuting workforce, the growth of suburban office parks, trends in how people work, from private offices to the cube farms—we have seen cycles. “The tough downturn in this sector may have masked what’s been happening in the last ten years. Is it a fad or a long-term trend? What are the implications for those of us who invest in, own or lend to?” he asked.

“We’re seeing lots of pressure to change,” said Hastings. “But the biggest change in construction is the desire for floor-to-ceiling windows to bring in more light.” The U.S. market is split between the bigger markets such as San Francisco and New York City that are above trend and those like Phoenix that are below.

Sandler agreed with Burger that the place to be right now is the city. “Millennials and knowledge workers want to be there, and are willing to pay the cost,” he said. “It’s a different dynamic from 10 years ago.”

Neumann agreed that people, talent and companies want to be in urban settings. He described his business, WeWork, which is a new model based on the fact that young adults, aged 18 to 40, realized after the 2008 crash that the future is not guaranteed. “The whole world was shifting, and this age group wants to change it. Thirty-five percent of today’s workforce is small business without credit,” he said. “They don’t want a car, as much space or as much stuff. They use online resources. They are willing to share everything. WeWork is a way to empower and inspire these workers.”

The freelance class, contract workers, will continue and grow, Sandler agreed. “Clients are grappling with that, and it requires flexibility and agility in terms of space design. Many shift jobs every nine months,” he said. Yet, he claimed he could not create great spaces at less than 150 to 200 square feet per worker.

Neumann disagreed, stating that he has 67 square feet per member-employee as his model.

The discussion continued with the panelists agreeing overall on various aspects of the trend toward more flexible work spaces that are environmentally friendly, allow in more light, or perhaps muted light from windows with built-in photovoltaic strips, with less density, high ceilings, open to ductwork and other infrastructure, and more communal space that is functional, such as food courts.

They have seen that people want to work near their homes, and enjoy working in ways that encourage community and collaboration, such as in a campus-type setting.

“The biggest change recently that we’ve seen is that employers are listening to and care what employees say they want,” said Hastings.

“The changes that are happening are natural and correct because people are speaking up,” agreed Neumann. “They want community, and are more productive and have more fun at work when they get it.”

“For older, stock buildings, the challenge is there—just overcome low ceilings and low light and create character and authenticity in them. Create spaces for socialization and add amenities that bring people together where they can create,” added Sandler.

Howard Marks, the day’s keynote speaker, made his presentation based on his book, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*, which was created based on the memos he publishes as chairman of Oaktree Capital Management, with lessons from his more than 45 years as an investor.

“There are many important things. At certain times, some things gain in importance and others decline, while they’re all essential,” he began. “Today, these are the most important.”

“Have a sense for where we stand,” he said. “Respond to the current realities and their implications,” instead of expecting the future to be made clear.

He advised building on the temperature of the market while recognizing the pendulum swing it follows—from euphoria to depression; between over– and underpriced; greed to fear; optimism to pessimism; and risk versus safety.

Risk tolerance is important. “Why do riskier assets have higher returns?” he asked. “Because no one would make them if they didn’t have high returns. Risk aversion is what keeps the markets honest and sane.”

Awareness of the pendulum is important; disregard for it is a good description of the years leading to the crisis: There was too much risk and too little worry. Marks believes in defensive investing, and investing consistent with your personality while practicing patient opportunism and working with what is there. “Risk control is a mindset” and happens when fear and greed are balanced.

Marks then quoted Warren Buffett: “The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct ours. And that has been Oaktree’s mantra for the past two and a half years. Move forward, but with caution.”

Although this is not a time to be defensive, remember that the outlook is not so great as to argue for aggressiveness. Put your money to work, but be cautious. Uncertainty is rampant around the world, in lots of areas. Is the world riskier today? Marks wondered. “Maybe, or maybe it’s never been as safe as we thought it was,” he said.

Although he didn’t advise the audience members to expect prosperity or a thriving economy, he did encourage them to find the nerve to spend money in order to make it, and advised they choose their approach carefully.

The third panel of the day — The Investment Market in Real Estate — was moderated by Roy H. March with panelists Dean Adler, President, Lubert-Adler Partners; John M. Angelo, CIO, Angelo, Gordon & Co.; and John Kukral, President and CEO, Northwood Investors.

March began the session by asking how interest rates affect the panelists’ views on investing, especially as it relates to their other businesses and real estate.

Angelo answered, “People have assumed rates are going up for a long time. We will buy real estate based on fundamentals, and if it makes sense to add debt, we’ll do so.”

Adler explained his business plan as getting sufficient spread on assets where possible, saying he will go outside the mainstream, staying in the best neighborhoods possible. “In terms of interest rates… know where rates and capital markets are going to go, and build your plan around that.”

Kukral doesn’t worry about hedging interest rates, saying he has a “huge chunk of debt right now. Our goal this year is to take the ones where we’ve done 80 to 90 percent of the work, sell into a strong market and take some profits. We’re about 50 percent leveraged across everything right now. It’s not our job to predict, but to anticipate.”

Adler has been an active investor in retail, including his recent $10 billion acquisition of Safeway. He spent a few moments explaining his views about the changes in the ways goods and services are being distributed in this country. “Everyone is underestimating the speed with which innovation is impacting this industry. What’s the implication? Simple. There will be fewer stores selling more and more goods. In five years, there will be no reason for many businesses. We’re in a different environment. Transform your strategy to get on the right side.”

“How are you playing that game, Dean?” asked March.

Adler answered that he is focusing on creating a scenario where he has the dominant supermarket business or combining private equity and real estate.

Kukral spoke up to agree with Adler and expand on his theory. “What Dean explains is happening to all kinds of real estate across the board. The difference is technology—no matter the sector. It’s happening in retail and across the board, even in hotels.”

He asked, “Will this thing be relevant and survive and how much will it cost over the next 10 to 20 years? What will we need? How does and will technology affect this?”

The men discussed the changing landscape thanks to changes in technology—how products are marketed and delivered; how business people reach their customers and keep their costs competitive. They also compared what has happened in Europe with what is continuing to happen in the United States. Prices have gone up, but financing is available. The cycle is somewhat behind that of the United States, but good buys are possible and will continue, according to Kukral.

They also agreed that the changing marketplace has required some innovative thinking, such as the plan outlined by Adler to build on the 70,000-square-foot roof of the building across the street from 30th Street Station in Philadelphia. “That’s almost two acres in the heart of the city. We’ll build 300 apartments right on the roof, with no land cost.” The apartment units will be above the first eight floors of the building, the best place to live, he added. “Create value. Focus on fewer things and create the best that can be.”

Angelo added that his philosophy is “You can make money by being opportunistic… with smaller opportunities and being opportunistic.”

The day’s final panel was A Conversation with Sam Zell and Barry Sternlicht. Zell is Chairman of Equity Group Investments, and Sternlicht is Chairman and CEO of Starwood Capital Group. Peter Linneman guided the conversation.

“In hindsight, what do you wish you had done in the last four years?” Linneman began.

“Buy everything in sight,” answered Zell, to laughter. “But there’s never been a time that, when you look back, you don’t do a coulda-woulda-shoulda. We’re equipped to always look forward. Never look at a deal thinking what someone else is going to make… you can always see the good and the bad when you look back. Don't get hung up on anything you missed or you will be a bad investor."

Sternlicht talked about market cycles and luck. "The cycles humble you, and I know a lot of what we do is luck, so set yourself up to be lucky. Luck is when preparation meets opportunity—one of my favorite sayings."

He said that no one could have expected the Fed to do what they did; due diligence was just a waste of money and time.

The men talked about the flow of capital and the fact that it is increasing in Europe. Zell has made significant investments abroad, especially in Brazil. Since equity capital has nearly disappeared in Brazil, he is interested in the markets in Peru, Colombia and Mexico.

"Brazil went from growth to redistribution policy," said Linneman. "We're doing it here and Europe is doing it. Are you worried about it slowing growth?"

"Growth and income redistribution don't belong in same sentence," replied Zell. "It's one or the other. Redistribution impedes growth and impacts all of society."

Sternlicht added that he is not a fan of redistribution, and referred to education in his explanation. "Brazil grew beyond its educational workforce; they ran out of skilled labor. You see it in India too."

He added that in the United States, the average guy doesn't have assets; his income isn't going up; his real disposable income is lower than it was seven years ago. "You see it play out everywhere, and it impacts everyone, and all goes back to education. We need to fix the education backbone of this country to create jobs and a growing economy that feels better."

Linneman wondered what countries or situations excite Zell at this point.

"Peru is a wow country and has significant growth. They're building like crazy, interest rates are modest, and the safety issue has changed," he said.

Colombia has benefited dramatically from the Free Trade Agreement, he said, adding that their infrastructure is "miles ahead of everyone else." And Mexico has benefited from the nuclear accident last year in Japan, which "disrupted the supply chain.

North of Mexico City, on the Pacific, manufacturing has taken hold and is growing fast."

"You see the power of the leader in Mexico," Sternlicht said, in agreeing with Zell's assessments. "He gives people confidence." He also believes Brazil will be fine, long-term and said "places with good tax rates, win." He added that Europe is "interesting" to him, in addition to emerging markets such as Colombia and Brazil.

Sternlicht then asked Zell, "What's your view of high-end residential in New York City?"

Zell's response was quick: "It's scary. It's la-la land. If you catch it right, you'll make a fortune, but I wouldn't make it a business."

In spite of arguments against buying or leasing in the center of the city, both men agreed that people want to live and work there; Zell said places sell based on their "walking score. The biggest demographic shift in the coming 25 years is going to be the de-suburbanization of America," he added.

Zell's last word for the day was "complacency." He cautioned about getting comfortable and ignoring factors such as unemployment rates among the young and social unrest around the world. "We could see something macro happen in the world that would shock things," he said.

Roy H. March adjourned the meeting. The Fall Members' Meeting will be held on Wednesday, October 29, 2014 at The Inn at Penn.

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