2015 Spring Members' Meeting Summary

More than 400 members, guests and students attended the Zell/Lurie Real Estate Center's Spring 2015 Members' Meeting at The Rittenhouse Hotel in Philadelphia. Following the Wednesday evening dinner, Real Estate Department Chairman Gilles Duranton announced awards recognizing outstanding students and faculty. The featured speaker was Thomas J. Barrack, Jr., Chairman and Chief Executive Officer of Colony Capital, LLC, who spoke on "The Opportunity Today May Be in the Mortar, Not the Bricks."

Thursday morning, Roy Hilton March, CEO of Eastdil Secured and Chair of the Advisory Board of the Zell/Lurie Real Estate Center, welcomed the participants, thanked the staff and the incoming chair, Spencer B. Haber, Chief Executive Officer of H/2 Capital Partners, LLC. Joe Gyourko, Nancy A. Nasher and David Haemisegger Director, Zell/Lurie Real Estate Center updated the members on goings-on in the Center.

The day's first panel discussion was **"Wharton on the Global Economy,"** moderated by Todd Sinai, Professor of Real Estate and Business Economics and Public Policy at Wharton. In opening the conversation, he noted he was part of a similar panel in last year's spring meeting, when energy costs weren't on the radar, but "Oil has gone from $100 to $55 a barrel today. What does that mean?"

The panelists, Joe Gyourko and Peter Lineman, agreed the cut has largely meant positive things in the United States, being the equivalent of a nearly 1 percent tax cut. It's also been good for a number of other economies dependent on oil imports, but cutbacks are likely in the energy industry. "It is tough on the energy industry," Linneman said, "but it will be cleansing and they will be stronger on the other side. Those that are eliminated are the most marginal and everyone reduces their cost. When times get tough, you tighten up."

Although Houston, Dallas and Denver are adding jobs faster than they have in two years, surprisingly, the effects of oil price cuts will be felt, with investment projects and production workers feeling the pinch first, said Gyourko.

“What is important overseas — for them and for us?” asked Sinai.

The European Union is “a disaster,” said Linneman. “They confused currency unification with unification, when it’s just a fixed exchange rate system. It’s destroying their economies — a euro break would be the best thing to happen— there won’t be notable growth until that happens.”

Gyourko is bullish on China. “In the short term, the government will do what it needs to do. There’s a natural slowing down…” because the economy can’t continue to grow at 10 percent; they are realizing overcapacity problems in certain industries, including shipbuilding and steel. Real estate in China is a “huge driver of the economy.” In the medium term, the country will decline further. He predicts growth numbers down from 10 percent to about 4 percent or 5 percent, which could also impact Europe, which does a lot of trade with China.

“The problem is they went on a leverage finance binge,” continued Gyourko. “When you put out that much credit in a short time, you have bad deals that aren’t productive. A lot of their industries bet on the growth trend, but the government is pretty sane and they want to deal with it and they have the financial power to deal with it.”

Sinai asked about the big picture and began a baseball metaphor that would last throughout the remainder of the panel. “What inning is the economy in?” he asked.

“Based on historic norms, the economy would look to be in the 7th or 8th inning, but probably is in about the 5th,” said Linneman. “Baseball is a slow game and can end sooner than you think. On the capital market side, I think we’re in about the 3rd inning.”

Gyourko believes the country is in the 6th inning, but a difference will be felt if the Fed starts to raise interest rates. Rates “will inch up by the end of the year, but I can’t see it happening until well into 2016,” he clarified. “I’m worried about a slowing in China and can see less robust conditions globally, but foreign capital flow is huge here and I don’t see it stopping. We won’t see a sharp rise in the U.S.”

The second panel, **Canaries in the Mine: Are they chirping? What should you be doing now to prepare for a changing cycle?** Featured panelists Ziel Feldman, Chairman and Founder of HFZ Capital Group; James Groch, Chief Financial Officer and Global Director of Corporate Development, CBRE; Jeffrey C. Hines, President and Chief Executive Officer, Hines; and Spencer B. Haber, Chief Executive Officer of H/2

Capital Partners. They talked about red flags that mark the end of an upcycle. The discussion was moderated by Asuka Nakahara, Associate Director, Zell/Lurie Real Estate Center at Wharton.

Nakahara began by asking the panelists about the state of the recovery. The panelists generally agreed the country varies greatly by region. Worldwide, the disparities are even greater.

“It depends on where you are coming from,” said Feldman. “In Manhattan and parts of Miami, you’re in the [final stages]. Supply and demand is as healthy as it’s ever been. Manhattan is the best opportunity for foreigners in the country, and 25 to 30 percent of investors” come from outside the United States.

Nakahara asked about red flags. Feldman noted one issue is when people buy land in certain regions when construction costs are up; then they need to get a certain price per foot. “Those prices were never achievable, and when that happens, the media will proclaim a fire sale. Real estate is not different from the stock market. There’s a herd mentality and can cycle down.”

“When you see a credit curve across asset classes, from worst to best in any market or asset class,” answered Haber. “Starting to see signs of that curve steepening would be a warning sign and it can steepen quickly. There is not as much leverage in the system today; it’s about asset prices adjusting and it’s hard to see what implications are of zero percent interest rates globally. Assets will re-price and it’s hard to know what the implications are because we’ve never seen this before.”

“When rental growth goes up and cap rates are getting near historic lows, that’s a red flag, when the downside is greater than the upside,” said Groch.

Discussing if interest rates really tied to mortgage flows and the up-cycle, Hines and Groch agreed the end will come with something no one can even expect or if the economy starts growing faster. “We don’t see inflation happening to a big degree,” added Hines. Haber believes the change will come from something as yet unnamed. “Put aside the China credit bubble and global tipping points, and we come down on [it coming from] a Fed mistake,” he said. “The Fed has a bad history of getting it right.”

Looking ahead, Haber believes there will be more volatility, but also believes things can get better with higher interest rates; Hines said next year’s discussion will be similar, but “edgier;” Groch said there will be volatility in the capital market side because uncertainty around what the Fed will do creates volatility; and Feldman guessed that job growth will continue slowly, up about 2 percent to 3 percent, maximum, with interest rates climbing half a basis point, causing liquidity to continue to be a problem.

The day's **keynote speaker was David M. Rubenstein**, Co-Founder and Co-Chief Executive Officer of The Carlyle Group, speaking on "Thoughts on the Private Equity Industry." He asked: Are we in a bubble? Are there good opportunities for investing now? Will the economy go down from here? Are taxes going up? Will employers help with higher taxes?

"Real estate and private equity have a lot in common," he said. "They use the same structures, get the same tax treatment and have the same investor base." He listed some of the concerns of the private equity industry:

- The industry has grown so large because the rates of return are better than anything else over a period of time. If they go down to such a point—the industry could be in trouble.
- The government wants to change rules and regulations.
- The industry's image can use improvement and needs to do a better job of explaining how they do what they do.
- Economics: Good people have come into the industry, but if you reduce their earnings too much, you may reduce the industry's talent pool.

As for opportunities? Rubenstein suggested retail investors' involvement; expansion outside of the United States; and changes in global perception, so that investors perceive private equity as being mainstream, not exotic.

Roy Hilton March moderated the third panel, "**The Investment Market in Real Estate**," with panelists Brian Kingston, President and Chief Investment Officer of Brookfield Property Group, and Kenneth Caplan, Blackstone's Global Chief Investment Officer, Real Estate.

March asked about the global situation of capital markets and central banks, and their impact on the commercial real estate business.

Caplan confirmed that around the world, central banks have had an impact on asset values; in the United States, fundamentals (occupancies, rents) are strong. Europe is about two to three years behind and Asia has a lot of volatility, which has provided his firm with opportunity.

Kingston echoed Caplan's sentiments, and feels strongly about London, saying it's a "good jumping off point for Europe." Although he hasn't historically been a developer, since 2008 he has built up a "significant development pipeline. Assets are trading through replacement costs today and it makes sense to develop. Business is cyclical and always will be."

Caplan said his business is much different from 10 years ago. "Markets in the U.S. have recovered and lenders are more comfortable going into Europe. We build our portfolio here and now, there, too. A few years ago, there was more hesitation when it wasn't clear where Europe was going, and there's a lot more comfort in investing there now. We focus on larger, more liquid markets and doing less pure fixed income investments globally."

March asked what the panelists' biggest surprise was over the past 12 months. What do they anticipate surprising them in the coming year? Kingston said the state of the capital markets in Europe was a surprise and it was "not something we'd been underwriting even 12 or 18 months ago. Coming up we worry about a lot of things—geopolitical things… Europe's fragile recovery… and Asia is another big unknown." Caplan agreed with him about Europe. "Generally, oil prices coming down has a ripple effect and Brazil will present interesting opportunities," he said. "Also, the political questions in Europe; upcoming elections; and the wide spread between cap rates and stronger capital flows. In the U.S., we may see some wage inflation."

"A Conversation with Titans" capped the day, with Peter Linneman talking with Eyal Ofer, Chairman of Ofer Global; Thomas Pritzker, Chairman and Chief Executive Officer of The Pritzker Organization; and Samuel Zell, Chairman of Equity Group Investments.

"Not only are these men involved in the real estate business, but in many other businesses around the globe, and they will give us a big perspective," said Linneman. "The theme of this meeting is that things are quite good, occupancy and rents are improving, debt is good and cap rates are good. Is it any different from 2007?"

Zell said, "In most markets we're close to 2007. In the U.S., the commercial real estate market came through the recession better than everyone had anticipated. When all is said and done, this is a global economy and anyone who thinks the real estate market in the United States is unaffected by the global economy has a rude surprise coming. I can't figure out where demand is going to come from outside the U.S. The euro is down, Brazil is down, the yen is down and the ruble is down. How are we going to prosper and create demand to make the real estate we own better? I don't know."

Pritzker believes it's impossible to make an overall statement. "It's segment by segment and market by market. We're in a cyclical business and the cycle was extended because of the recession and little new supply. The cycle will resume. In other countries, there's a disconnect between what's happening in the United States and what's happening in the rest of the world. That disconnect isn't sustainable."

In Ofer's view, the United States is the only market that provides relative security. "The real estate market is a generic market. It's a local market that is then divided into areas. In New York City and London, there's a disconnect from the rest of the country in which they're located. With the dollar regaining strength, that has created imbalances. There are good points and bad points in every market."

The men went on to discuss the state of development in New York City, construction costs, and to debate the value of investments — where and when. They also talked about leadership in Europe, about how 27 different political systems can mesh. Zell reminded the audience of his belief that Europe is "a great place for castles, cheese and wine… and hotels. …But everything comes down to demand."

"The exception was the United Kingdom," added Ofer. "It took an independent view, and managed to get its act together and prosper in relative terms. The upcoming election could prove that the populace is leaning toward socialist mode."

Spencer Haber closed the meeting by inviting everyone to get involved in the Zell/Lurie Center's activities however possible: "Mentor students, help develop the program, teach a class, recruit. Everyone is welcome."

Save the date for the Fall 2015 Members' Meeting: Friday, October 30.

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