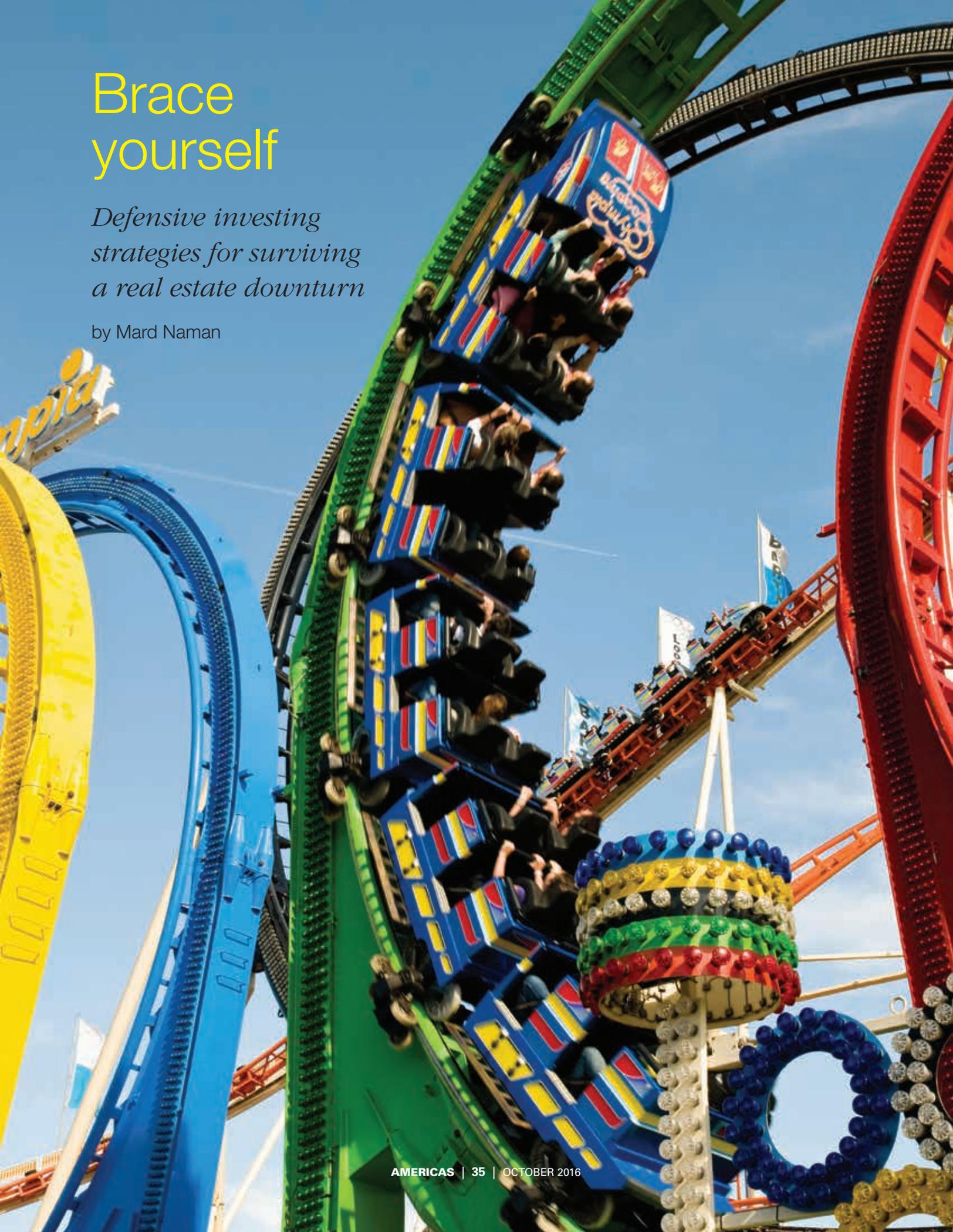


# Brace yourself

*Defensive investing strategies for surviving a real estate downturn*

by Mard Naman



**I**t's coming. Everyone knows it — but not when, what will cause it, or how bad it will be. “It” is the next downturn, of course.

If you are looking for signs it may be approaching, pick your poison. Cap rates are at record lows. Commercial real estate values are well above their 2007 levels, but net operating income has not kept pace with the growth in values, which could point to a pricing bubble. Then we have China's slowing economy and rollercoaster stock market, the shaky global economy, looming Brexit shockwaves, and the most polarizing U.S. presidential election in memory, which could lead to more economic volatility. Or simply consider it is almost 10



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years since the Great Recession started, and we are due for the next down cycle.

The uncertainty is palpable. CBRE's recent *Global ViewPoint*, “How Close Are We to the End of the Current Cycle?” notes, across all regions, the volume of capital flowing into real estate fell in first quarter 2016. “Investors interpreted the market volatility as indicating either an imminent financial crisis in China or the end of the U.S. economic cycle — or both — and decided to be cautious,” the report states.

While many in the industry do not believe a downturn is around the corner, investors are talking more about taking a defensive posture. To make like Boy Scouts and be prepared — braced for a hard or soft landing — here is what several experts advise.

### **Tilt toward income-producing investments with long, staggered leases**

Todd Henderson, managing director and head of real estate, Americas, for Deutsche Asset Management, makes it clear his firm is not calling for a downturn, but rather, going forward, for more muted real estate returns than we have experienced in the past five years. “We still believe real estate returns are going to actually be very good from a risk-adjusted perspective, as well as compared to other investment alternatives,” he says.

That said, for those investors who think a downturn is imminent, Henderson says the first thing to do is ensure their portfolios are tilted toward more income-producing real estate investments. “If you look at performance through all the downturns, income held up very well,” explains Henderson.

If you examine the returns of the NCREIF Fund Index – Open-end Diversified Core Equity during the global financial crisis, for example, yield-focused funds held up better than strategies that did not target income. Furthermore, during the economic recession of the late 1990s, total returns were positive despite negative appreciation because core real estate still produced income returns in the 6 percent to 7 percent range.

“Defensive investment strategies are generally oriented toward lower loan-to-value ratios and higher income components, so investors can protect their capital while also producing income,” says Kye Joon Lee, director – head of Asia for Clarion Partners. For value-add or opportunistic strategies, which generally involve higher loan-to-value ratios and capital growth rather than income generation, Lee recommends investors target smaller and entitled projects with shorter investment horizons to mitigate the risks of a downturn.

It is vital for investors to examine their portfolios and implement regular pruning of nonstrategic properties to bolster portfolio competitiveness, notes Lee. In addition, leasing strategies need to be designed to benefit from longer lease terms and, more important, staggered leases, which ensure occupancy does not take any sudden plunges. “Right now, landlords are in a stronger position to demand longer-term leases and offer nonstandard lease terms to stagger lease expiration,” advises Lee.

The primary risks to a portfolio in a downturn relate to too much debt, occupier weakness and potential empty buildings, along with rents, says Robert Gilchrist, CEO of Rockspring Property Investment Managers. “But the most



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**Chris Macke  
American Realty  
Advisors**

serious of them is undoubtedly being overleveraged in a falling market,” he adds. Investors need to ensure diversification of debt durations, watch for too-restrictive covenants (debt ceilings), and avoid excessive LTVs that can destroy the capital account in a falling market and, at worst, make refinancing impossible.

Meanwhile, says Gilchrist, it is too easy to say the game will be over when interest rates rise, which has been expected virtually every year since 2012. Rather, real estate investing also should relate to supply and demand for real assets by occupiers and, thereby, the prospects for rent. “Does it matter if cap rates reach record lows if rents are in the process of doubling?” asks Gilchrist. “A low cap rate does not necessarily mean too expensive.”

Investors should be structuring diversified core portfolios today to have a blend of quality stabilized assets with sustainable cash flows, combined with targeted core-plus and value-add assets that offer upside potential to maximize risk-adjusted performance, says Jim Clayton, head of investment strategy and analytics for Cornerstone Real Estate Advisers. “Creating value through re-leasing, renovation and repositioning offers the most upside in a market where declining interest rates and, hence, cap rates will no longer be the major driver of value gains,” he explains.

Clayton believes quality, stabilized assets in major markets (primarily gateway cities and Sun Belt metros) should form the main foundation of the portfolio. The remaining 10 percent to

20 percent should be allocated to select value-add investments, including “build to core.” Of importance, at this stage of the economic and real estate cycle, given lowered expectations for price appreciation in core assets, investment is less about broad national trends in a sector and more about individual submarket dynamics and specific asset characteristics, explains Clayton.

Investors should target properties with longer-term leases in place and with below-market rents that are not fully priced into the sale price, says Chris Macke, managing director of research and strategy at American Realty Advisors, with tenants that are financially stronger.

Macke believes investors seeking downside protection should focus on securing superior long-term income growth and price resilience, rather than chase marginally higher initial yields in slower-growth, less resilient markets. This means buying into metropolitan areas that historically have had superior income growth and where prices have bounced back sooner and more strongly after downturns. “These are typically markets that have higher education and income levels and greater barriers to supply,” says Macke. Investors who succumb to the attraction of marginally higher yields in slower-growth markets are taking a major risk because these markets may take much longer to recover after a downturn.

Although the income component of core equity real estate has historically met the actuarial requirements of most funds, that is not the case today, points out Ryan Krauch, a principal with Mesa West Capital. As such, Krauch is a proponent of debt investments as a safe core alternative investment in the current environment. Debt cannot provide the upside that comes with equity ownership, however, and Krauch says many investors worry about underperforming their peers or the NFI-ODCE benchmark if they overweight to debt.

“But if the priority is to be defensive, then, logically, sacrificing some upside should be worth it to outperform in the downside scenarios,” reasons Krauch. With the more conservative lending strategies having 25 percent to 45 percent of subordinated capital, this creates a significant cushion for values to fall without investors suffering any losses, he adds.

### **REITs in the mix**

When it comes to managing risk in one’s portfolio, Peter Zabierek, CEO of Montreal-based Presima, says investors can reposition their portfolios toward more defensive geographical locations and asset classes, or

simply buy cheap. “One of the best risk-management strategies is acquiring assets at a discount,” he says. While the search is more difficult today, Zabierek believes the listed market provides some good opportunities because many REITs are trading at a discount to their intrinsic private real estate values.

Zabierek says some investors have turned to the listed market to diversify their portfolios and to provide downside protection. Public real estate can be more volatile in a downturn, but it provides the liquidity private real estate tends to lose in a downturn. After the Brexit vote, he notes, many U.K. direct property funds advertised as “open-end” actually froze redemptions. Listed products, in contrast, continued to trade freely.

Several listed products are available that perform well in down markets, says Zabierek. “Most of these products are composed of conservative stocks that focus on core global markets, have simple business models and derive the lion’s share of their total return from income as opposed to capital appreciation,” he says, adding these products are globally diversified and a few include derivatives to limit downside risk and create additional income.

A mix of 80 percent direct real estate and 20 percent real estate securities appears to be an optimal balance, says Deutsche Asset Management’s Henderson, as it has demonstrated strong risk-adjusted returns throughout cycles.

### **Best property sectors in a downturn**

Retail has been one of the best performers through all the downturns, according to Henderson, noting its historical performance across the NCREIF Property Index and NFI-ODCE.

Of course, the sector is not immune to recessions. The more discretionary the spending, the less durable the rental streams can be; a tenant generating reduced sales in a recession may not be able to afford to pay as much rent. So, more specifically, Henderson likes retail tied to nondiscretionary spending. “Certain types of retail are more durable — necessity retail is more durable than highly discretionary retail,” explains Henderson, citing grocery- and pharmacy-anchored centers as examples.

Clarion Partners’ Lee likes multifamily. “It’s defensive to invest in multifamily, which has historically been the least volatile,” he says. “Even in a recession, people have to live somewhere.” Lee also says niche property sectors, such as student housing and medical office, can be good defensive choices, as they tend to generate higher income, and the demand

drivers are much less affected by an economic downturn.

Krauch says the problem investors face is how to invest when they want to be defensive, considering their traditional safe haven of core equity may not be as safe as it used to be. The answer for many has been to turn to “core alternatives,” which include nontraditional product types such as student housing and senior living, build-to-core strategies, global core markets, and debt investments. Although all have pros and cons, Krauch is a big proponent of debt investments in the current environment.

“With the banks constrained by increasing regulation, large lenders like GE Capital vacating the space, and CMBS having an uncertain production volume, the ability for institutional investors to both capitalize on the current market opportunity and create a new home for their defensive real estate allocations could not come at a better time,” says Krauch.

And the poorest-performing sectors in a downturn? Henderson says office and hotel are two procyclical sectors that underperform in a downturn. “In the face of a downturn, you do not want to be significantly overweight in procyclical sectors,” he says.

But for those who think a recession is likely in the near term, Henderson is not saying you should dump your office and suddenly go all in to retail and multifamily. “You should stay reasonably balanced with a diversified portfolio and tilt on the margins to capture excess returns or to protect the portfolio’s returns,” he says.

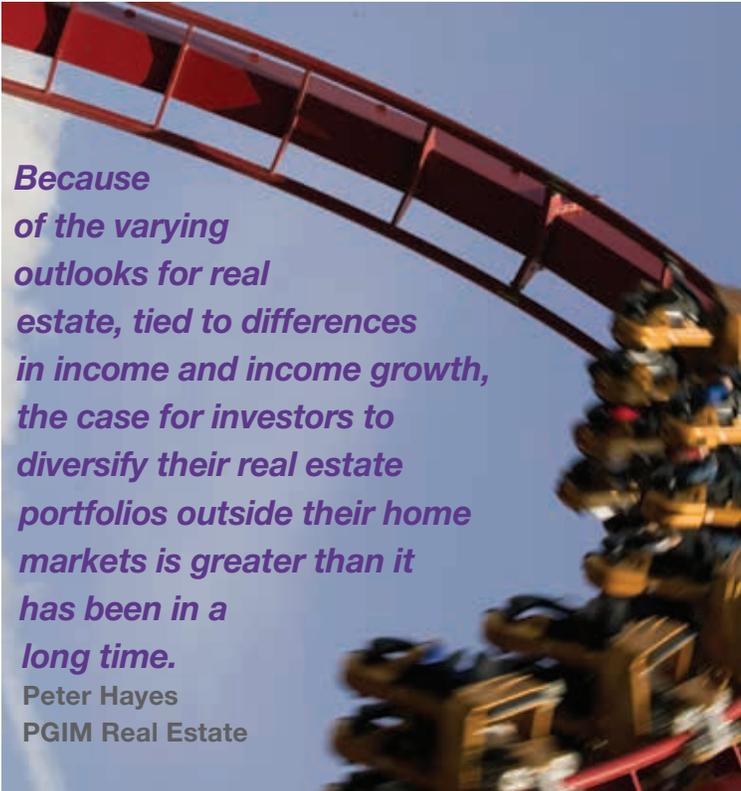
### **The power of diversification is growing**

Diversification is among the keys to protecting against potential downside and achieving longer-term investment success, according to Lee. Portfolio diversification depends on the correlations among different assets: Lower or negative correlations provide better diversification benefits and higher overall risk-adjusted portfolio returns.

“It is critical to determine the demand drivers for a region, a country or a particular market,” says Tim Wang, director, head of investment research for Clarion Partners. Canada and Australia, for example, largely are commodity driven. San Francisco is primarily technology driven, while New York City is mostly supported by financial services. “Careful selection of mixed regions and markets with different drivers and return behaviors should help construct a more diversified, mixed-asset portfolio,” says Wang.

Investors have become used to reading about the ever-increasing globalization of markets and increasing correlations between market cycles. Obviously, highly correlated markets make it more difficult to obtain the benefits of diversification in a downturn.

But things are changing. “When it comes to real estate returns, markets are becoming less, not more, correlated,” says Peter Hayes, global head of investment research for PGIM Real Estate. On a five-year rolling basis, regional markets are the least correlated they have been for 15 years, he notes.



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**Peter Hayes  
PGIM Real Estate**

The United States has embarked (albeit slowly) on a rising interest-rate cycle, while Europe still struggles with the legacy of the sovereign debt crisis, Brexit and heightened political uncertainty. Asia and other commodity-driven economies are dealing with the China slowdown.

“Each region is facing a different set of risks and, as a result, differing return projections,” says Hayes. “Indeed, regional linkages are weaker off the back of a slowdown in global trade growth, leading to domestic demand acting as a key driver of global growth, and the strength of domestic demand varies around the world.”

What does this mean for investors? Because of the varying outlooks for real estate, tied to

differences in income and income growth, the case for investors to diversify their real estate portfolios outside their home markets is greater than it has been in a long time, according to Hayes. “The growing benefit of portfolio diversification combined with a slower growth and low interest-rate environment helps explain the significant increase in cross-border investing in core real estate,” concludes Hayes.

American Realty Advisors’ Macke points out greater market diversification also helps investors from being disproportionately exposed to the specific nature of the next downturn because downturns often have an industry-specific nature. As an example, he compares rents and occupancy rates during the subprime housing crisis in 2007 and the dotcom bubble bursting in 2000. Peak-to-trough, tech markets were hit harder than housing after the tech bubble burst, and housing markets were hit harder than tech markets during the subprime mortgage crisis cycle.

### **Stay dry and sell high**

Paul Dougherty, president of PRP LLC, says one of the common and obvious decisions investors make if they think a downturn is coming is keeping their powder dry, so they are prepared to take advantage of any resetting of values that occurs as a result of a downturn. That has its place but is not necessarily an entire strategy. “Sitting on the sidelines, while an easy go-to and perceived to be smart, is not always the best course of action,” says Dougherty.

Dougherty is a firm believer in opportunities during all stages of the cycle. “While investors pursue strategies that rely on rent growth during an expansion of the economy, one’s focus should be more defensive, relying on opportunities for temporary dislocations as a result of tightening of the credit markets or end-of-fund-life situations where sellers have to exit assets at any cost,” he says.

What else can investors do if they think a downturn is imminent? “First and foremost, investors are repatriating capital by selling anything they can sell in anticipation of a downturn,” says Dougherty.

American Realty Advisors sees a strategic opportunity at this point in the cycle because, while acquisitions get most of the attention, dispositions can be an equally important tool for securing more stable returns going forward. “De-risking by disposing of assets with limited going-forward upside in favor of better-positioned and -priced assets can be a key strategy,” says Macke.

### Debt can be a killer

Dougherty says a primary lesson learned from the global financial crisis is debt is a killer. “When used properly, it can help enhance returns if the timing is right, but it can turn deadly if used improperly or excessively,” he cautions. Dougherty says investors must make sure their debt strategies are appropriate for the specific business plan of each investment and the duration of their fund. “During the GFC, many investors were killed



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because of overleverage or duration that was not matched to the expected holding period for investments,” he explains.

Having said that, Dougherty believes investors are in better shape this time around, not so much because they have learned their lesson but because the market has evolved to put governors in place to check overexuberance and overleverage.

“The market is much more disciplined, with lower loan-to-value ratios overall, than it was before the global financial crisis,” says Lee.

Lenders are more conservative in underwriting due to regulatory pressure — Basel III and the Dodd-Frank Wall Street Reform and Consumer Protection Act — that limits the amount of debt banks can provide. And market data has become more transparent and up-to-date, so investors are making more-informed investment decisions.

After a recession, gateway markets recover faster, recover more robustly and typically exceed their prior peaks, according to Henderson. To experience those new peaks, as opposed to losing assets in a recession, financial leverage needs to be managed appropriately. That will help bridge across any downturns and get to the other side when these assets begin to recover and outperform the non-gateway markets.

That means having laddered maturities in a portfolio. It means managing the percentage of fixed-rate versus floating-rate debt. “When your cash flows are being impacted because of tougher economic conditions, you want your debt costs to be reflective of the tougher economic conditions. If all your debt is fixed-rate, you won’t have that,” cautions Henderson.

If investors could predict the future, Henderson says they would de-lever their portfolios on the eve of a recession. But because no one has a functioning crystal ball, “you’ve got to manage your leverage levels across your portfolio at all times and not try to seesaw your leverage up and down depending upon where you think we actually are in an economic cycle,” he advises.

### The bottom line

Are you ready? Whether you think the next downturn is near or far, mild or major, it is a good idea to ensure your house is in order and your portfolio is positioned to minimize damage from a downturn — and maybe even benefit from the impact on those who are less prepared.

That means having good, durable income streams in a diversified portfolio, long and staggered leases, and appropriate leverage levels and debt maturities that are spread across multiple years. It may mean having a place for public real estate securities or debt investments in your portfolio, or becoming a seller of nonstrategic properties in the current market. Because although no one can predict the future, greater success generally follows those who prepare for the worst, even while they hope for the best. ❖

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