



Why Commercial Real Estate Investors Should Think Timing, Timing, Timing

By James Corl
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The cyclical nature of real estate creates opportunities for those who know how to find them.

EXECUTIVE SUMMARY

We recently spoke to Jim Corl, who manages Siguler Guff's distressed commercial real estate strategy, about the historic opportunities he sees in the market and how he pursues them. According to Jim, many commercial real estate investors fundamentally misunderstand both the opportunities and the risks in today's market. The commercial real estate veteran believes many investors presume that the most attractive opportunities to generate returns lie in the difference between the price of one asset and the price of another, while overlooking the way the highly cyclical nature of real estate markets creates opportunities for those who know how to find them. As flows of investment capital shift toward or away from specific types of commercial real estate assets over time, he says, opportunistic investors are able to take advantage of the arbitrage opportunity between the valuation of a property at the bottom of the market cycle and the value of that property at the top of that same cycle. While most investors seek increasingly expensive "core" assets in a handful of locations, they often overlook the opportunities offered by under-priced properties in recovering markets elsewhere.

QUESTION: What is the competitive advantage Siguler Guff brings to identifying and capturing distressed real estate opportunities?

JIM CORL: We are investors, not money managers, so the starting point for us is finding mispriced silos of opportunity and managers with expertise in a certain silo, the perspective on valuation discipline and the ability to identify a sell opportunity. This is "high-conviction investing" and we focus on sell discipline. We believe you can time the market and can tell if you're closer to the bottom or the top. The bottom of the cycle is when you should buy, but you should also be willing to sell at the top of the cycle. We also have greater flexibility than other managers when structuring investments.



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Our distinctive attribute is looking across a broad universe of opportunities for attractive valuations and working with managers who are experts in their area of the market. Many of these kinds of distressed opportunities are not being actively marketed, so deep knowledge of local markets is invaluable.

QUESTION: What distinguishes your approach?

JIM CORL: We focus on getting the vintage right and selecting managers who have sell discipline. When we consider managers, we look at what they were doing at the peak of the last market cycle. Given my experience in the industry, I know the industry's successful investors and operators, and I understand their behavior over cycles and whether they have the discipline to sell when others are continuing to buy.

Traditional commercial real estate opportunity funds seek to be a mile wide and an inch deep. We want to be a mile wide and a mile deep. We want to look at everything and understand all of the different silos of real estate in order to find where real estate is trading the most cheaply. We recognize we cannot build a team of the best buyers of everything so we harness the alpha-generating skills of the best operators in each of these silos of opportunity.

QUESTION: You've been covering commercial real estate your entire career. How would you describe the market now compared with similar points in time during previous cycles?

JIM CORL: In the 1990s, the barriers to entry were raising capital. Once you raised your capital, all the deals were all in one place. The federal government had the Resolution Trust Company which was a clearing house. If you had money you went there, loaded up your shopping cart and walked out. These days, the money is out there, though it's still hard to raise. The challenge today is that the places where there is distress are hidden and finding them requires a bottom-up approach. To find those opportunities, you need a local sharpshooter operator who can identify the opportunities and the distress and who knows the markets, the owners and the lenders.

QUESTION: What factors are creating those opportunities?

JIM CORL: The opportunities are created by the cyclical nature of the marketplace and what I call "axes of inefficiency." Everyone knows the old saying of "location, location, location," but for my approach it is better to think in terms of "timing, timing, timing." Finding opportunities requires knowing where we are in the cycle and anticipating where flows of investment capital will go in the future. Simply buying the "best" or most sought-after, most expensive location, is like the "buy and hold" theory in the stock market. It really doesn't work anymore due to reasons of structural change and intellectual evolution. A strategy based on buying prime locations worked fine when markets were less efficient. Twenty-five years ago before REITS and the CMBS market, you could buy a building in downtown Indianapolis at a 9 percent cap rate, or yield, and one in New York at an 8 percent yield. Those valuations didn't make sense because they didn't reflect that historically rents have grown 3 percent more per year in New York than in Indianapolis. Today, the Indianapolis building trades at a 9 percent yield while the New York building trades at roughly 4 percent. That shows that the market has overlearned the focus on location. As a result, buying the "best" locations at the wrong time raises your risk of paying too much and losing lots of money very quickly when the market turns.

QUESTION: So what drives the market cycle in your view?

JIM CORL: Real estate markets are now plugged into the debt and equity markets and real estate asset values are driven less by rents and supply and demand and more by capital flows. That kind of information that used to be hard to come by has become a commodity. It's all free on the Internet. Because everybody has that same information, those who make investment decisions based on it all end up chasing the same types of assets in the same handful of locations. The flows of these investors' capital toward one section of the market is what pushes prices up there and the lack of capital flowing toward other market sectors helps push prices down in those areas. Right now, three-quarters of the money is chasing one-quarter of the assets which traditional money managers view as core properties. We want to be in areas of the market where one-quarter of the money is chasing three-quarters of the assets.

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QUESTION: So how do you find those inefficiencies that you mention?

JIM CORL: Smaller assets are more likely to be priced inefficiently than bigger, more expensive ones, so size is one thing we consider. Big investors devote lots of capital and intellectual firepower to efficiently valuing \$75 million transactions, for example. Inefficiency relates to size. Smaller assets are mispriced because the big top-down investors are not oriented toward seeking these types of opportunities. You need to look away from the large deals to find the places where real estate is trading most cheaply.

Finding cheap assets is only part of our strategy, though. In this cycle, arbitrage opportunities involve buying things that those who are buying core assets will want to buy a couple of years down the road. Doing that successfully means you need to understand where capital is going to be flowing in the future. Today, core investors are more influenced by fear than greed. They are still huddled in places like New York, Washington, D.C., and Boston but they are realizing they need to look elsewhere as prices rise and inventory shrinks in those markets. In a year or two they'll start to consider places such as Atlanta where we've bought properties that are being leased up. Another axis of inefficiency is warehouses in the southeast right now. We've moved into opportunities in southern warehouses with a manager who has both sell discipline and experience.

QUESTION: So you're anticipating that the range of assets that core investors will want is set to expand in the future. Doesn't investing in these assets while they are seen as non-core pose a lot of risk?

JIM CORL: We think differently about risk than many investors, but that doesn't mean we overlook risk. Many investors fundamentally misperceive the risks that are out there right now. They're avoiding the risks that hurt last time such as liquidity risks and leasing risk, but they're not always paying attention to valuation risk. We view valuation risk as very real and leasing risk as not as severe, by comparison. Most people investing now were scarred by their investments from 2005 to 2007 and are therefore very risk averse. Today's fear is driving people to seek core properties because they fear illiquidity. That is why they're investing in only a handful of top markets where everyone feels safe because they're comfortable knowing other buyers are interested. That view of risk makes sense if you look backward at the 2009 pricing shock but it doesn't protect you from the risk of paying too much.

At some point the core buyers' fear of missing out will overtake the fear that's in the market now.

QUESTION: What do you expect will cause the cycle to advance and capital flows to start moving toward some of the areas of the market where you are operating now?

JIM CORL: At some point the core buyers' fear of missing out will overtake the fear that's in the market now. Remember that the non-core assets I'm talking about are still historically good-performing assets. We want good quality buildings that core buyers will pay 17 to 20 times EBITDA for when cash flows stabilize in the future. The process of recovery is already underway in places like Houston where growth is further along thanks to recovery in the energy sector and the city is beginning to attract core capital. Larger central business districts with the right stabilized cash flow and growth profile, like Buckhead and midtown in Atlanta, are beginning to attract core buyers.

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