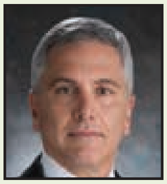
USAA Real Estate Company

Value investing in today's market cycle



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Recently, **Jonathan A. Schein,** managing director of global business development at Institutional Real Estate, Inc., spoke with **Len O'Donnell,** president and CEO of USAA Real Estate Company, **Craig Solomon,** managing principal at Square Mile Capital, and **Edmund Donaldson,** managing director – portfolio management, at USAA Real Estate Company. The following is an excerpt of that conversation.

How did USAA get to where it is today?

O'Donnell: We know what it means to be an investor. We understand how strong cash flow and asset appreciation can support a larger mission, why capital preservation is critical, and how service and integrity build lasting relationships. The firm started 35 years ago, investing solely on behalf of USAA. Over time, like-minded investors chose to align with us, and we have grown into a fully integrated asset manager with over 90 investment partners from across the world. Today, about 70 percent of the capital we manage is on behalf of third-party investors, and the portfolio we manage is valued at over $17 billion. We've assembled an incredible team of experts that allows us to invest in a broad array of real estate strategies covering the entire capital stack. But through all of this, we've never forgotten our roots. The investor-first mindset still sits at the core of who the firm is today — and it influences everything we do.

How did the GFC affect USAA?

O'Donnell: Our discipline and focus on real estate fundamentals distinguished us before, during and after the GFC. Post crisis, we were able to return every dollar of investor and USAA capital with a positive return. We had no losses, no foreclosures, and no defaults on mortgages. That made us highly liquid and poised to invest when asset pricing was favorable. Our historic track record combined with that unique example of capital preservation let us expand our client list and attract additional capital from other institutions.

What is your strategic focus?

O'Donnell: Two driving forces keep us on track. One is to provide exceptional service and performance for our investment partners, and the other is to be the capital provider of choice to the industry's best developers and operators. We target best-in-class properties with best-in-class partners, to deliver and execute on the most attractive value-oriented investment opportunities. In order to do this, we make sure we're the type of partner with whom people want to do business. We earn the trust of both our investment clients and our transaction partners by staying focused on our culture of service and integrity.

When did you add debt products to your offerings?

O'Donnell: About five years ago, we developed a strategic partnership with Square Mile Capital. That partnership was one of the final steps in our plan to become a fully diversified investment manager with expertise in every segment of real estate investing, across all major property types and the risk spectrum.

How do USAA Real Estate and Square Mile complement each other?

Solomon: The partnership with USAA has allowed both of us to become all-weather firms. We now have a panoply of strategies covering the entire capital structure, from first-mortgage loans to opportunistic equity investing. We also benefit from having a network of real estate experts across the country, enabling us to decisively understand local factors (e.g., submarket fundamentals, property details and sponsor requirements) in a timely manner. Having a full menu of strategies allows us to select the best option for any particular time in the cycle. We like to call it value investing.

What exactly is value investing?

O'Donnell: Value investing across the risk spectrum means focusing on the best relative value at a particular point in the cycle. It requires having the ability to dial up and dial down different strategies at the appropriate time. Thus, we were an aggressive buyer of existing assets from 2010 to 2012, when asset pricing was favorable. Today, we think pricing is at or near its peak in many markets, so we are less active in buying directly than we are in finding other ways to create value, whether it's through value-add transactions, development, debt structures or preferred-equity positions. We are looking to control our basis and access point to the investment, and achieve the best risk-adjusted returns.

What do you look for in value investments?

O'Donnell: They must be high-quality assets in the best locations and have broad appeal to occupiers and to eventual institutional buyers, as well. We are always an active seller — we do not fall in love with properties, and we do not hold them forever. We also look at our basis. If acquisition costs are higher than replacement costs, we will choose to develop rather than purchase. Today, for instance, some assets are trading at prices as high as 125 percent of replacement cost. It is a matter of finding the right opportunities, at the right time, and being very selective.

How is your approach distinctive?

Donaldson: There are two big-picture differences. The first is structural. We are not driven by growing assets under management. Having this mentality permits us to focus purely on real estate judgment. Second, we operate throughout the entire capital stack. Whether it is an opportunistic debt structure or a core equity transaction, we always focus on value investing. Pursuing strategies such as core-creation allows us to access properties below long-term values and to potentially create incremental value, as well.

What are core-creation strategies?

Donaldson: As mentioned, we believe high-quality assets in the top markets are priced above replacement cost. Instead of buying existing assets, we use core-creation strategies where we are able to access assets at a more attractive basis. For example, we have actively pursued build-to-suit strategies in the industrial/logistics sector because we are able to develop best-in-class assets at replacement cost, with long-term leases to credit-quality tenants in strong markets. These investment yields are probably 100 to 200 basis points better than buying existing assets, which enables us to build our long-term portfolios more efficiently.

What is your sector and geographic focus right now?

Donaldson: We are focused on markets with the strongest and most diverse economic drivers. We are avoiding tactical markets and sectors, such as multi-tenant office, that we might have pursued earlier in the cycle. The multifamily and retail sectors historically have performed the best throughout the cycle, including downturns. Consequently, we have intentional overweights to multifamily, and we are heavily focused on investing in quality retail. We are also committed to growing our industrial/logistics exposure.

What makes your opportunistic investment strategy distinctive?

Solomon: We are staying within the opportunistic space, but we are targeting a more senior segment of the capital structure. This approach affords us some contingent upside if the market cycle continues to expand, while also creating a cushion against a significant market correction over the near term. We are doing this by creating flexible solutions for our development and operating partners through preferred equity structures, where we are giving up some of the perceived upside over the long term in exchange for some subordination of equity capital to soften the blow of a market correction. This approach distinguishes us from many other opportunistic investors, who either are continuing to try to find transactions that will produce that 20-plus percent return — which we think is not practical in today's market — or are moving down the risk spectrum into value-add and core-plus investments.

Open- or closed-end funds?

O'Donnell: Both have their place. Open-end funds provide an opportunity to develop strategic/long-term portfolios, where investors can participate in fully developed real estate investment strategies. Closed-end funds tend to be more tactical and focused on specific, or niche, opportunities. So there are benefits to both vehicles in the marketplace.

Solomon: Closed-end funds are more suited to strategies involving three- to five-year business plans focused on repositioning, refurbishing or retenanting assets. Open-end funds are ideal for strategies focused on more stabilized assets that one can envision holding for the long term, while enjoying the benefit of cash flow. We are, however, seeing a few open-end vehicles focused on credit. Debt strategies function best with a durable balance sheet. Having an open-end fund often results in a business where the loans are relatively short term, particularly when the capital stays in the fund and can be redeployed over time.

Where are the opportunities today?

Solomon: We see tremendous amounts of liquidity and relatively cheap debt, but it is not available to all developers equally. It is very challenging today to get more than 50 percent or 60 percent debt on nonstabilized assets, and even that amount is often insufficient to complete a capital structure. We don't see that changing any time soon. So our opportunity is to continue filling gaps in capital structures and to facilitate refinancings or business recapitalizations when traditional sources of capital are not widely available.

Donaldson: On the equity side, we expect pricing for core assets in prime markets to remain at a level that makes it hard to justify acquisitions. In the near term, we expect to continue the core-creation strategy that has dominated our activity over the past 18 to 24 months, be it industrial, multifamily or retail. There may be buying opportunities by 2018 and 2019, and we are positioning ourselves to take advantage should those conditions materialize. But in the near term, we are continuing to build the portfolio, prudently through core-creation strategies.

O'Donnell: We have a tremendous amount of dry powder, both on our balance sheet and from our clients, that will allow us to take advantage of buying opportunities that emerge over the next 24 to 36 months. I am not suggesting a repeat of the opportunity we had in 2009 or 2010, but there will be a time when our capital is more attractive to the marketplace than it has been for the last couple of years. It is just a question of where the market and the broader economy go over the next 24 to 36 months. There is clearly some market uncertainty in that regard.

Solomon: It is a complex picture to evaluate with a lot of conflicting signals, so we think it is time to be cautious but also ready to take advantage of the market as it reveals itself. Investors have to avoid the temptation to get too general and, instead, should focus on specific markets, specific asset classes and specific capital structures in order to navigate today's investment environment.

Where do you see your platform five years from now?

O'Donnell: We want to be the best real estate investment manager in the country. That does not mean being the largest. It means being the most respected firm in the industry in terms of integrity and level of service. It means being a best-in-class real estate "investor" and "investment manager." On the debt side, we want to be the capital provider of choice. To do all that, we need to maintain our investor-driven culture of service, responsiveness and quality. Our job is to continue to grow, while maintaining the discipline and character that has gotten the firm to where it is today.

CORPORATE OVERVIEW

USAA Real Estate Company, with over $17 billion in assets under management, provides co-investment, acquisition, financing, build-to-suit and development services for corporate and institutional investors, and arranges commercial mortgage loans on behalf of affiliates. The USAA portfolio includes over 75 million square feet of office, industrial, multifamily, retail and hotel properties. USAA Real Estate Company is a subsidiary of USAA, a leading financial services company, serving military families since 1922.

Square Mile Capital is a leading investment manager with an established history of successful investing in commercial real estate and a depth of experience supplying flexible debt and equity capital solutions, in diverse property sectors and across the risk spectrum. Square Mile's strategic partnership with USAA Real Estate Company enables a unified sourcing and investment philosophy capitalizing on opportunities throughout all phases of the market cycle.

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