KBS: Don't fear the false label "late cycle investor"

Many consultants and investment prognosticators are claiming that commercial real estate (CRE) is at the "top of the cycle," and there is a pending downturn for generic CRE. Investors, however, should be wary of the hype of this prognostication because CRE is not generic. CRE assets are neither created equal nor managed equally.

IS THERE REALLY A CYCLE FOR A SPECIFIC CRE ASSET?

The term "cycle" implies that once CRE reaches the "top of the cycle," there will be a downturn trend that involves all CRE assets. However, this generic characterization ignores the reality that CRE is made up of individual assets. CRE asset characteristics and performances differ by asset class (office, multifamily, retail, industrial), market (urban, suburban, primary, secondary), investment class (Class A, B, C), tenant focus (multitenant, single tenant), and any number of other factors. Even two office buildings on the same block can have different valuations and growth prospects.

CONFUSING "CYCLE DOWNTURN" WITH LOWER RETURN EXPECTATIONS

One should be careful about confusing a strong and tight CRE market with a potential pending "downturn in the CRE cycle." These market conditions are not the same. For example, a fully leased Class A office building might experience gains in its value due to being located in an economic growth market with low supply and little to no new construction in the area. Investors in this type of asset would be attracted by the cash flow, which is supported by in-place tenant leases and an expanding job market. This scenario should not be confused with a consultant speaking at a conference about the top of the cycle. A tight market condition is not the beginning of a downturn.

Even if a specific market's conditions are tight, yielding lower returns, an individual asset might not. A specific asset/building, with long-term, in-place tenant leases, is likely to remain stable, especially if there is little to no supply of comparable buildings in the immediate market.

The return profile for a *new* investor investing in that type of asset might be lower than it was a couple of years ago, but that does not mean that the cycle is turning down. A common mistake, made by some investment pundits, bloggers and consultants, is describing a strong/tight CRE market as "late cycle" just because the return profile is lower than a previous period.

PUBLICLY TRADED REITS AND THE CONFUSION THEY CAUSE FOR PRIVATE/DIRECT CRE INVESTMENTS

All too often, publicly traded REITs create confusion for private CRE investment. During 2018, publicly traded REITs experienced significant volatility and losses in share price due to market liquidations and fear, as well as concern of retail CRE imploding.

Publicly traded REIT performance, however, had very little in common with the strong performance achieved in the Class A commercial office sector and other CRE strategies, or the stability of the pricing and asset values of private CRE investment. In the private CRE investment world, investors do not pay a market multiple for liquidity, whereas investors buying publicly traded REITs, do. In addition, publicly traded REIT pricing is based on the emotions of the market, and investments often trade at discounts to the actual NAV of the real estate assets. In some cases, the discounts to the NAV can be at significant levels, with very little chance of ever recovering to the actual NAV.

DON'T BE MISLED BY INACCURATE GENERIC CRE ANALYSIS

Don't be misled by "experts" talking about how bad things were for CRE in 2018. That just was not the case. Every deal and market is unique with specific economics and targets. There is no generic cycle that encompasses all real estate. Private real estate in many markets did very well, and these markets do not show signs of rolling over and declining in value with tenants leaving buildings. Advisers who do their due diligence and work with experienced private real estate investment fund sponsors should be able to provide attractive CRE opportunities for their clients.

FOR MORE INFORMATION

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