Tracking special situations

Q&A with Albert Behler, David Zobel and Brent Morris

Would you share with us some Paramount background, and let us know where you are spending your time and energy in the current environment?

Behler: For more than 40 years, we have owned and operated class A office buildings in the gateway U.S. markets — our current investment portfolio is entirely located in New York City, San Francisco and Washington, D.C. Our goal was to establish a deep local presence and build a best-in-class, vertically integrated platform in our target cities. We believe this level of focus and depth uniquely positions Paramount to source and evaluate all manner of investment opportunities in our target markets. Our investment activities have targeted equity, debt and (at appropriate times) special situations/distressed opportunities. Over the decades, during multiple cycles, we have negotiated many billions worth of transactions as both borrower and lender, so we feel quite comfortable navigating any potential investment structure in the current environment.

Zobel: Given the uncertainty in the current market, there is a lot of caution from both buyers and sellers, making traditional asset sales difficult to negotiate. We have been spending a lot of our time on debt and special-situation opportunities. Our debt strategy is focused on originating sub-70 percent loan-to-value loans on high-quality office assets in our target markets. The goal is to generate strong current income with a significant equity cushion to our last dollar of risk. Our Special Situations strategy seeks to generate opportunistic returns by providing capital solutions to distressed owners of high-quality office buildings in our target markets. These structured solutions may come in the form of equity, preferred equity, and/or high-yield debt. We previously formed a Special Situations fund following the 2008 financial crisis, and we see the potential for similar investment opportunities in the current environment.

What were your views on your markets prior to COVID-19-related disruption?

Behler: As long-term investors in our target markets, we have seen multiple economic cycles. We started thinking about a Special Situations fund long before COVID-19 entered all of our lives. We were noting some classic signs of late-cycle behavior in our markets, specifically in some of the underwriting for transactions we evaluated. In many cases, there were aggressive lease-up and rental growth assumptions being utilized by buyers. We thought at the time that these assumptions likely required perfect execution and highly cooperative markets in order to justify valuations. Adding to this, the over-expansion and subsequent deterioration of the shared workspace environment put pressure on owners of properties with significant exposure to this tenant base, punctuated by the failed WeWork IPO. On the capital markets side, we were seeing certain non-U.S. capital partners, who had been very active over the prior five years, exit the U.S. market due to geopolitical pressures. These foreign investors triggered forced capital events or backed out of transactions. We believed the sum total of the above might lead to some form of correction in office markets. Obviously, we didn't anticipate that COVID-19 would produce such a strong exogenous shock to the system.

Zobel: As Albert mentioned, we started thinking about a Special Situations strategy in the second half of 2019. Over the past few years, as we noticed we were continuing to lose on competitive auctions (particularly in New York), we began building a database of transactions that stood out to our team as particularly "head-scratching." These transactions contained some combination of ambitious underwriting assumptions, aggressive exit assumptions and risky capital structures. We anticipated that the assets on this list were more likely to underperform and be subject to distress or a forced recapitalization in the future. Since COVID-19 has reared its head, we have been closely watching the assets on this list, looking for signs of distress. Over the next year or so, we expect to transact on some of them.

We all hear noise from various sources claiming that this is the end of the traditional office model and that New York City and San Francisco are "dead." What do you say to that?

Behler: When we hear things like "NYC is dead," we get excited for investment opportunities. We like to invest in an environment where "fear" is overcoming "greed." We do believe these office markets will face near-term pressures, which should create pain for some existing owners and opportunities for new investors, including our Special Situations strategy. Even before COVID-19, remote working was a viable and fairly prevalent component of many companies' workplace structures. We anticipate, especially in the short-to-medium term, that remote working will continue to be a component, in some cases a significant component, of employee work plans. However, the office will remain the primary location where idea creation, mentoring and collaboration happen. These things form the foundation of company and team culture. There is a reason why WeWork, despite its business-model flaws, appealed to tenants, including some very small tenants who truly didn't need an office. It is because those tenants wanted to go to work, collaborate and feed off the energy of other hard-working people. That cannot be translated to a computer screen.

Zobel: In the long term, we believe the gateway office markets will continue to be attractive for all the same reasons they were attractive pre-COVID-19. New York and San Francisco are two of the nation's largest and most diverse labor markets. Even with advances in technology, the vitality of these cities and the vibrancy of their office cultures provide a strong attraction for keeping or growing a business. Remote work has its limitations, and we have found that young professionals want to be out of their apartments and in the world. We have also found that people are unlikely to operate at their highest level wearing sweatpants and slippers for an entire work week. Of course, safety is the first priority, and we don't see things getting back to normal until COVID-19 is in the rear-view mirror.

Brent, what are you hearing from the investors you talk to regarding the market?

Morris: The investors we speak with are typically very seasoned and are looking for ways to go on offense in a post-COVID-19

environment. Many recall the highly profitable opportunities that appeared in the aftermath of the financial crisis of 2008. They remember that the window of opportunity was fairly condensed, and they want to have capital mobilized this time around. As opposed to the post-2008 period, most investors today are not dealing with bonfires across their entire portfolios. Notably, they are not dealing with depressed stock portfolios that would limit their ability to deploy capital into real estate — the dreaded denominator effect. They have general concerns about gateway office in the short-to-medium term, but most of the investors we speak with seem to agree with our conviction that, over the long term, well-located offices in gateway cities will always thrive.

In a market with limited transaction flow, how have you adjusted your underwriting metrics?

Zobel: We underwrite assets in each of our markets based on real-time data derived from our on-the-ground leasing, operations and development teams. Given the relative lack of live transactions in the leasing market, underwriting today is more challenging than usual. As a result, we are utilizing multiple scenarios to evaluate pessimistic, base and optimistic cases. In our base-case underwritings we might forecast rent declines of 10 percent to 15 percent, while pessimistic cases might forecast 20 percent to 25 percent rent declines. As a conservative measure, we are assuming that rents do not begin to recover for at least two years. In addition to rent changes, we are increasing forecasted concessions and reducing leasing velocity, projecting a longer lease-up timeframe.

From a capital-markets standpoint, we have increased our exit caps and discount rates by 50 basis points to 100 basis points, effectively putting a higher risk premium on the investments. When combined with the base case or pessimistic case leasing assumptions, the result is a very conservative overall underwriting. If an investment thesis still works using the pessimistic case assumptions, we feel like we have sufficiently stressed-tested the investment in question.

What factors will trigger transaction flow over the next quarters?

Behler: As with past economic crises, this could be a world of "haves" and "have nots." If you own a building with solid credit tenancy, long-term leases and long-term debt in place, you should be well-positioned to weather the downturn. However, if you are the owner of a highly leveraged office building facing significant lease maturities and/or existing vacancy, you will face pressure in the current environment, particularly if you are facing loan maturity.

Zobel: At the onset of COVID-19, lenders were generally accommodating, and floating-rate borrowers benefited from a precipitous drop in debt service due to LIBOR's plummet. As more time passes and leases expire, we believe cashflow shortages will cause lenders to put increased pressure on borrowers. In addition, certain JV partners with liquidity rights, driven by considerations beyond whether it may be the right time to transact, may contribute to forced recapitalizations. We believe these factors will all trigger transaction flow, and some of the most interesting transactions will feature high-quality assets facing circumstantial difficulties.

What's an example of a "special situation" you are tracking now?

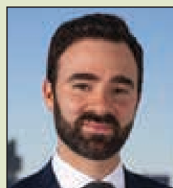
Zobel: In one of our target markets, we are tracking a class A office asset in an irreplaceable location that was acquired by an owner-occupier in the past few years. Due to external circumstances, the owner will be vacating the asset and is now compelled to sell the (nearly vacant) asset in the midst of the market disruption. The owner's equity position in the asset is highly impaired, and there is likely to be a workout between the existing lender and the owner. We are exploring ways to partner with the existing lender in executing this workout and providing the local operating expertise to restabilize the property. This is a good example of the kind of "distress" we are targeting, because the situation features a high-quality asset in a great location with a distressed capital structure and distressed ownership.

There are a lot of high-quality managers out there that invest in your target markets. How is Paramount different from its peers?

Morris: First and foremost, we are a sector specialist, which we think is more important today than ever. We are experts at owning and operating office assets in highly competitive and dynamic markets, and in this climate we believe it is easier for us to find idiosyncratic opportunities and understand fundamental office valuations than for a generalist. We have recently been seeing institutional investors gravitate toward sector-specific opportunities with individual managers. Rather than selecting a broadly diversified fund that attempts to cover an array of asset classes and markets, we see many investors selecting managers with a specific focus to build out, on their own, best-in-class diversification. They are looking for fly fishermen rather than those casting a wide net. Much of the recent sector-specific activity has been focused in the industrial and multifamily spaces, which is not surprising. However, we believe the office sector is being overlooked. For investors looking to capitalize on gateway-city office opportunities in the current environment, we believe we give them a fantastic "pure play" option to get exposure.

CONTRIBUTORS

Albert Behler
Chairman, CEO & President
Paramount Group



David Zobel
Executive Vice President
Head of Acquisitions
Paramount Group

Brent Morris
Senior Vice President
Paramount Group

CORPORATE OVERVIEW

Headquartered in New York City, Paramount Group, Inc. is a fully integrated real estate investment trust that owns, operates, manages, acquires and redevelops high-quality, class A office properties located in select central business district submarkets of New York City and San Francisco. Paramount is focused on maximizing the value of its portfolio by leveraging the sought-after locations of its assets and its proven property management capabilities to attract and retain high-quality tenants.

This article presents the authors' present opinions reflecting current market conditions. It has been prepared for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product. Past performance is no guarantee of future results.