HEITMAN
A REAL ESTATE INVESTMENT MANAGEMENT FIRM

Today's value proposition, diversification through alternatives

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Mike Trench,** executive vice president in Heitman's North American private equity group and an equity owner of the firm. Following is an excerpt of that conversation.

How extensive is Heitman's experience investing in North America value-added real estate?

Heitman has been investing in North America value-added real estate since the early 1990s. During this period, we have made investments through separately managed accounts and commingled-fund vehicles. In aggregate, we've invested more than $19 billion of capital in the value-added arena, across both traditional and alternative property sectors. These investments have spanned a variety of strategies, including ground-up development, renovation and refurbishment, as well as portfolio aggregation.

What are you observing in today's market? What opportunities do you see in value-added investments?

The landscape during the past 24 months has been dominated by the Fed moving interest rates up in an effort to chase inflation down. Consequently, private market real estate values are down approximately 20 percent to 25 percent. The devaluation in property markets creates an attractive vintage-year opportunity from an entry-point perspective. In an environment where transaction volume is muted, owners who, for whatever reason, find themselves under pressure to create liquidity, may turn into very motivated sellers. That creates leverage for the investor to exploit, often tipping the risk-reward balance in our favor. Heitman is currently in position to have capital to deploy to take advantage of this capital-starved environment.

We believe there's a wide array of opportunities in the value-added space, given current market dynamics. Capitalizing on that opportunity set relies on our understanding of how each individual property sector behaves at different points of the cycle and, as a result, is valued very differently. The current relationship between cap rates and today's cost of debt certainly isn't what it has been historically and may not be again for quite some time. Understanding what that relationship was, and then projecting forward what we expect it to be given our view of the macro environment and how real estate should be priced in a broader capital markets context, is one of the key considerations for investing in real estate today. Marrying that higher-level perspective with the granular operating fundamentals of each individual property sector is the lens through which we view opportunity in the space today. We believe the beauty of a diversified portfolio is the ability to maximize positives and minimize negatives – managing risk, in part, through diversification. Each individual property sector can add something a bit different to the whole, and when you have the right mix of ingredients, it makes for a more attractive risk-adjusted result.

How does Heitman differentiate itself in its investment approach?

Heitman differentiates its value-added investment approach in two distinct ways. The first is our focus on alternative property sectors. We were early adopters of alternative property sectors, having invested for more than 20 years in self-storage, medical office and student housing, to name a few. We recognize – and appreciate – how differentiated the demand drivers are for several of these alternative sectors. They've proven over time to be less cyclical in nature, and we continue to use that resilience as a diversification tool and a meaningful way of creating value.

Another is the way we execute in the value-added space, largely through joint ventures with operating and development partners, both public and private. The reason we believe executing the strategy this way produces better results is threefold. First, having operating and development partners co-investing equity alongside our own creates alignment between both firms. Second, leveraging the operating expertise of these operating platforms is very critical to success. Many of these business plans are very granular in nature; therefore, it is beneficial to be able to tap into the sector and geographic expertise of these operators. And third, these partners provide access to deal flow. We have our own sourcing team, which is very robust across all geographies and all property sectors in North America, but tapping into the pipeline of sector specialists in defined geographic regions augments our own team's efforts and is an important part of our value execution.

On what sectors and/or strategies are you focusing right now?

Given the dynamics of today's market, we are stressing alternative property sectors. We have found in prior downturns – similar to the portion of the cycle we're in today – those cash flows, those demand drivers, have been more resilient. No surprise, sectors such as medical office and student housing are rising to the top of the list today. Medical office is a very good example of the demand drivers. Individuals make healthcare decisions and visit their physicians in both good and bad economic times. Similarly, the resilience we see in student housing is attributed to steady enrollment growth at top-tier universities, which does not necessarily fluctuate with general economic conditions.

The other opportunity in the market today – not just from a sector perspective, but from a structural consideration – is trying to fix "broken" capital stacks. There is a lot of pressure being put on capital stacks today, given the rise of interest rates and the devaluation of the underlying real estate. To the extent we can solve a problem for a current owner or operator by stepping in and giving them some breathing room in the capital stack –

and extracting some return, as a result — that's something we're looking to do in a big way in today's market. We're happy to be a capital solution for high-quality operators in high-quality real estate opportunities because we believe the market will eventually reach a point of normalization, the capital markets will come back our way and value will be created.

In today's market, how specifically does the team approach portfolio construction?

Ultimately, we're looking to manage risk through diversification. Heitman is a big believer in this, not just in the value space, but up and down the risk curve. As it relates to value-added investing, we look at diversification through several different lenses. The first is sector diversification. I spoke earlier about each of these individual property sectors behaving a little bit differently at different portions of the cycle. Being able to hit the gas on some while hitting the brakes on others is an important component of what we do as investment managers. Second, we overlay investment thematics into the equation. Our investment themes are broken into three categories. The first is the delinked or less cyclical property types, most of which we consider the alternative asset classes. The second is growth. Rental housing — both single-family residential and traditional multifamily — is a good example of the growth investment theme, where performance is more closely correlated to growth in GDP. The third investment theme is contrarian. Here we look for out-of-favor markets or opportunities to create alpha.

We also look at diversification through joint venture partners, as well as geography. But the big differentiator in terms of how we think about portfolio construction is that everything is baked in research. Market research is at the backbone of everything we do. We have a 15-plus team in market research in North America, and we utilize them from both a top-down and a bottom-up perspective. Not only are they giving us guidance in terms of the macroeconomic environment and the property markets, more specifically, but they're also embedded in our investment teams with acquisitions and asset management, and they're opining on site selection, partner selection, market selection and rent growth on individual assets. That's a very powerful tool for us to have as we seek diversification. We're taking our cues from the macroeconomic environment and doing so with the help of a robust market research team.

How do you see the value-investing landscape evolving?

For some time now, we've been living with elevated interest rates, relative to recent historic standards, with the market generally taking a defensive posture, which has certainly been the case here at Heitman. I think you've seen that posture manifest itself through a much more deliberate and measured pace of deployment, and that's reflected in the muted transaction data by volume. For Heitman, we are focusing on sectors in which we have the most conviction and where we have historically seen success in realizing value. That's put a lot of focus on the alternative property sectors because of those delinked characteristics. More broadly, the alternative sectors are garnering more attention from investors as they look to rotate their portfolios away from large allocations to sectors such as commercial office. Our lengthy track record in the alternative sectors positions us well to capitalize on those tailwinds.

We believe market conditions will shift, however, and we view the interest rate environment as the catalyst for that market change. When we do see some sustained relief in the interest rate environment, that's likely to have a significant impact on both the macroeconomic environment and property markets. A more normalized interest rate environment is likely to bring an end to the devaluation portion of the real estate cycle, and increased conviction around imminent growth or appreciation will cause us to shift our focus in a couple different ways. First, pace of deployment will likely be more aggressive, as we look to capitalize on that aforementioned market appreciation. Second, we will concentrate more heavily on the growth investment theme, focusing on property sectors that are more cyclical in nature, as we look to capture as much growth as we can at the beginning of the recovery portion of the cycle. Rental housing of all kinds, as well as logistics, fit squarely in that bucket.

CONTRIBUTOR

Mike Trench
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Mike Trench's responsibilities include oversight of fund strategy, business plan execution, strategic acquisition and disposition activity, as well as investor and joint venture partner relations. Previously, he was part of Heitman's North American acquisitions and asset management groups, where he was responsible for the identification, origination and ultimate business plan execution of various value-added investment programs across North America. Trench has been involved in real estate transactions across the country with respect to a wide variety of property types and investment structures.

COMPANY OVERVIEW

Heitman is a global real estate investment management firm with more than $50 billion in assets under management, as of March 31, 2024. Founded in 1966, we have 10 offices worldwide and are an active participant in three key segments of the global real estate property and capital markets. Our collaborative investment process uses input from some of whom we believe to be the most experienced investment and research professionals in the industry.

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