A Client Memorandum from Rockstreet Partners

Where's the Lighthouse?

March 10, 2016

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Some thoughts on navigating bull market signals.

The start of 2016 finds the world grappling with a number of issues: the future leadership of the US, the pending retrenchment of China, volatile stock and commodity markets and the impact of deteriorating emerging market economies. If that weren't enough the bull market just had its seventh birthday. Only two bull markets since 1928 have lasted longer than this one: the nearly decade-long period from late 1990 to early 2000, and the postwar period of 1949 to 1956. So what does all this mean? It means you are likely inundated with more headlines and media than you can stand.

Before GPS systems, the navigational aid for maritime pilots at sea or inland waterways was the lighthouse. The lighthouse would mark danger and guide travelers to safe entries to harbors. John and I have many conversations on what we aspire to be as real estate investment managers and what we want Rockstreet to stand for. My favorite visual image is the lighthouse – the sturdy structure that people can consistently rely on to deliver.

In this memorandum, we want to share what we are currently learning on the streets and trends that we are finding with respect to commercial real estate. As you have read in past client memo's, we do not attempt to predict the future. We believe to do so is in exercise in futility. Instead, we make investment decisions based on our investment and underwriting principles.

Pressure is Growing

At Rockstreet, we spend an incredible amount of time listening to people. Our network includes other investment managers, developers, investment sales brokers, tenants, landlord and tenant brokers, investment bankers, pension advisors, pension investors, private investors, lenders, subcontractors and general contractors. Here are our general takeaways and the general challenges each category is facing based on our research:

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Real Estate Investment Fund Managers: Have had extremely strong capital raises recently but are now faced with deploying into a very low cap rate environment. Most of them (the honest ones at least) are asking: *What are we going to invest all this money into and are we really going to be able to achieve our targeted returns?* Pressure to invest capital.

Developers: Hoping that the sales market stays hot and trying to find good sites. Going in yield on costs to develop a project are lower due to higher costs to develop. Exit cap rates and rent assumptions are already on the aggressive side. *Most of the best sites have been put into play and there are fewer good sites available. How much higher can rents go to offset cost increases and lower development yields?* Pressure to find good sites and deals where underwriting doesn't have to be pushed.

Investment Sales Brokers: Hoping the market stays hot; past few years have set record sales. Pressure from owners to keep getting higher exit prices. Will leverage stay at or better than 70%? *Will interest rates stay low and interest only periods stay where they are to fuel buying? Hard to imagine we can keep getting higher sales numbers than this, be careful on what you get into right now.* Pressure to keep selling assets at higher numbers.

Tenants: Hoping that rent growth slows down and trying to find the best value for their needs. On the residential side increasing rents put significant pressure on affordability and ability to save. On corporate side, finding ways to be more efficient with space needs. Pressure to absorb higher prices.

Landlord and Tenant Brokers: Trying to set realistic expectations on both sides. For the tenant if they are renewing they are going to pay more and in some cases a lot more. For the landlords, they want the most rent for the least amount of TI's and they want the best credit. Easier said than done. Deals with fundamental problems (parking ratios, locations, etc.) are extremely price sensitive. Pressure to make deals at today's higher rent numbers and meet expectations.

Investment Bankers: Lenders and buyers seem to be taking a small step back, could be hitting a pricing plateau or a point where some aren't comfortable transacting. People still have to do business, just have to find the right mix of those that are active. Pressure to find lenders and investors willing to transact under tighter underwriting.

Pension Advisors and Investors: Need yield badly for obligations. Overall increase in allocation percentage to commercial real estate. However, also cognizant of tighter investment conditions leading to caution. Pressure on underfunded pensions and shortfalls.

Private Investors: Cautious. Feel that cycle is long in the tooth. Willing to invest in sound strategies or opportunities but generally very cautious. Pressure to generate yield on savings and not getting into poor investments.

Lenders: Waiting for interest rates to rise, really worn out on regulation. The best borrowers can get deals done but spreads are thin to win deals. Hard to find good deals to lend on. Regulatory pressure and generating profits.

Subcontractors and General Contractors: Extremely busy and being cautious to not over extend themselves by taking on more jobs than they can handle. Hard to find skilled workers to take on more jobs and costs overall are rising. Pressure on pricing and not getting over extended.

Underwriting is getting more aggressive

Annually at Rockstreet we underwrite approximately 300+ deals that someone is going to do. These are well vetted opportunities that are sourced through experienced operating teams across the US. Over the past 6 months we have generally noticed a meaningful decrease in project-level returns to the tune of 200-300 basis points. This is predominantly due to increased pricing. By keeping our underwriting standards and keeping realistic assumptions with respect to rent growth, and reversion cap rates, we glean a clear picture: a number of investors are either willing to take lower returns for the same risk, or are aggressively pushing underwriting to hit return targets.

For example, in the multi-family space the deals we like are very hard to buy in major MSA's at or above a 6.00% cap rate. Once closing costs and capex are included most deals we see are closer to a 5.00% cap rate going-in, with a price per-unit above replacement cost. This gives us concern, as we are seeing fixed-rate loans today from the GSA's (Freddie and Fannie) priced around 4.15% to 4.30% for 7-year term and 4.30% to 4.40% for 10-year term. When we see going-in spreads (all-in cap rate less debt rate) under 100 basis points it screams deals are priced to perfection. If you miss on any of the variables (economic vacancy, tax rate on reversion, rent growth, cap rate, etc.), most will miss their return targets. Many believe we are in for low interest rates for the foreseeable future and thus are electing to float (achieving a lower interest rate than fixed options). This too is fueling the asset price increases. In our experience over the past 13 years, whenever we have seen this "all-in" cap rate to fixed debt spread under 100 basis points, along with the pressure mentioned above, it is the lighthouse signal to us to be extra cautious on what investments you make.

In closing, we hope that Rockstreet can serve as your lighthouse and shine light on the issues that we see in real estate. As John and I have stated from the start, as long as we put the interest of our clients first, communicate honestly and openly and be patient for worthwhile investments Rockstreet will be the sturdy organization that people can consistently rely on to deliver information and results.

The Lighthouse Joke

US Ship: Please divert your course 0.5 degrees to the south to avoid a collision.

CND reply: Recommend you divert your course 15 degrees to the South to avoid a collision.

US Ship: This is the Captain of a US Navy Ship. I say again, divert your course.

CND reply: No. I say again, you divert YOUR course!

US Ship: THIS IS THE AIRCRAFT CARRIER USS CORAL SEA, WE ARE A LARGE WARSHIP OF THE US NAVY. DIVERT YOUR COURSE NOW!!

CND reply: This is a lighthouse. Your call.