

# A Conversation with Terry Ahern

*Rachel McMurdie, assistant editor of The Institutional Real Estate Letter, spoke with **Terry Ahern**, a principal and founder of real estate consulting firm The Townsend Group, to get the scoop on the opportunities and challenges for real estate investors in today's marketplace.*

*Given that the economy and the real estate market have had a rocky past few months, what's the mood in the investment marketplace today?*

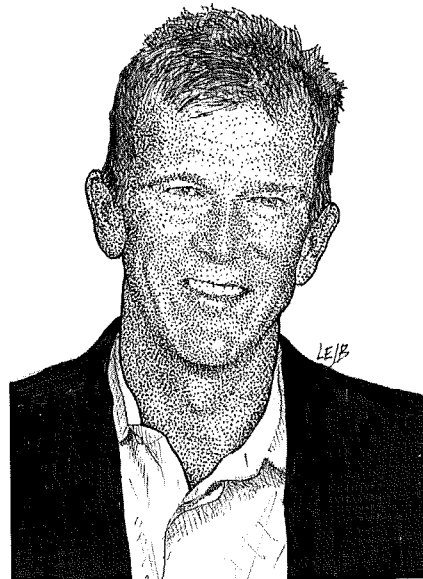
Investors are generally optimistic. They are focusing on capitalizing on the current conditions. We've had a long and successful run in the asset class, reaching back all the way to the early '90s. It was an exceptionally long period of time of favorable returns where risk was being rewarded.

The current data is not robust as to the amount of valuation loss there may be. The public markets indicate there should be some. I believe when we have more clear evidence later this year, the extent of a correction may impact investor sentiment. But bear in mind several recent events in the asset class: Real estate has earned a permanent allocation in an increased number of institutional portfolios as a diversifier, a source of alpha and in some respects an inflation hedge. It is now global, both in where capital is sourced and where it is invested, which increases the investment opportunity set through all cycles. And capital flows are global as evidenced by the emergence of the sovereign funds, so relative value decisions come into play.

*Whenever there's change in the marketplace, the challenges and opportunities change for investors as well. What new opportunities are arising in the current market?*

The debt markets provide rich opportunities. As one manager said, "Anyone with a wallet can make money

now." There are multiple strategies by which an investor can capitalize on the disintermediation, including taking out distressed positions, purchasing



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off the lenders' balance sheets and originating at all levels of the capital stack. Spreads have widened, and there is little capital available for the high LTV space.

These recent events in the U.S. will also benefit offshore markets, particularly the emerging markets. Investors will focus more on understanding these markets. I also believe that the events in the credit markets are good for the asset class. It will take some of the froth out of the markets, and it will separate the best managers from the rest of the pack — both of which benefit investors.

*What impact has the economy had on property values?*

The credit market was the first shoe to drop. The economy is the other shoe. The economy has slowed. It affects demand, which in turn affects occupancy and rental growth.

Transaction activity has slowed dramatically. I expect it to pick up during the third quarter of this year. By that time we will have a better understanding of the effect of the economy and a more accurate measure of values. I believe the secondary and tertiary markets and the lower quality properties will be most affected. This is in contrast to recent history where one of the interesting phenomena that occurred was the convergence in acquisition cap rates of properties in top markets and properties in secondary and tertiary markets — that is to say investors were not distinguishing between "quality," which was likely due to the availability of cheap debt finance.

*You mentioned optimism among investors, yet there are quite a few uncertainties in the market ahead. What do you think this means for capital flows through the year?*

Capital flows during 2008 will remain strong. What happens with respect to valuations later this year may affect capital flows in 2009. As transaction activities pick up later this year, and with the adoption of fair value accounting, we will have better data later this year. This is a global asset class with global capital flows including a growing public sector. Relative value and preservation of capital are increasingly becoming a driving force in investment decisions, and there is a general trend toward alternative asset classes more broadly, which many expect will have superior inflation protection benefits in some respects. Both of these events will benefit the capital flows and mitigate the level of a correction.

*What challenges are investors facing in today's marketplace?*

The asset class has changed dramatically. It is global. Nearly a third of all commercial real estate is offshore, and that is without accounting for the

opportunities to develop in the large emerging economies such as China, India, Russia and Brazil. Most offshore markets are less transparent than the U.S., and many traditional investment managers lack significant track records and roundtrip experience in them. Which means it is more difficult to understand, or to simply "know what you don't know." Last year, we visited approximately 20 countries underwriting funds. Investors are challenged with understanding and underwriting a global marketplace given the constraints in staffing. Plus there are more sophisticated and complex fund structures and unique issues such as tax structuring and currency hedging. It is a far cry from underwriting U.S. core and value investments with managers that have 30-year track records and established processes.

Investors are adopting different models to address the challenge. A few larger investors are developing large and specialized staffs to direct the investing. Most are adopting a form of outsourcing. The allocator funds were an early form of outsourcing. More recently, investors are assigning discretion for all or part of their real estate programs to third parties. And the fund of funds model is gaining increasing acceptance consistent with the model that has been successfully used in private equity.

*How are investors confronting the challenges of a tightening credit market and a slowing economy? What strategies are they using to insulate their portfolios?*

It depends on how tactical the investor is. The more tactical, the more the approach will be to capitalize on the opportunities presented by current events. There is a general trend toward alternatives; this is to provide alpha. Its effect is to make real estate investors more alpha oriented, which means they are generally looking to be more tactical than in the past. So generally, the question is: "How do we capitalize on the challenges?" rather than "How do we defend against them?"

There are two risks against which one can defend. If the primary risk is that the economy is slowing and will enter a sustained period of low

growth, then properties with strong leases such as core properties are attractive and will benefit from a sustained flight to quality. But if the primary risk is a credit crunch — and not the economy — then defensive means a different strategy: It means to mitigate loss in your existing portfolio by focusing your efforts on capitalizing on the investment opportunities created by the credit crunch. A structured program that is not concentrated by fund or vintage year will provide the capital flows to invest opportunistically.

*Many plan sponsors are saying they're paring down manager relationships at this time. Are they favoring new managers or existing managers?*

Generally, the focus is on identifying managers that have made money in up or down markets as investment staffs are increasingly constrained in their ability to add new manager relationships due to staff level constraints and moving closer to targeted real estate commitment levels. Investors are interested in emerging managers, but the vast majority of capital is going to existing managers. There are excellent opportunities to invest offshore with emerging managers. I referenced our due diligence in approximately 20 countries last year. We uncovered some excellent opportunities with emerging managers. Unfortunately, the desire by investors to limit the number of managers precludes a number of them from capitalizing on these opportunities.

*What does the universe of funds look like today?*

Our database contains more than 500 funds that are currently available for investment. The growth in that universe has been in the high-return sector, in offshore strategies and in related sectors such as debt, infrastructure and timber. The breadth and depth of the funds available for investment by strategy and region create a tremendous opportunity for an institutional investor to target their investment strategy and capitalize on market dynamics. But thoughtfully underwriting that universe is challenging investors, most of which have relatively small staffs. For relative comparison, we formally

reviewed 315 new funds in 2007, but we have a team of 47 individuals to assist in this effort.

Also, those funds are being offered by a number of manager models. There are the traditional managers that bought, managed and sold properties for institutions. Certain of those managers are now partnering with local, regional and national operators with which they competed in prior years. A number of these operators, including public REITs, with the help of investment banks, are offering their own funds. Then there are the global and regional allocator opportunity funds who partner with local experts. Even now, some of those same allocators are developing vertically integrated asset management platforms for part or all of their strategy that compete with the local operators with whom they previously invested. In other words, they are becoming more like traditional managers. And their former operator partners are offering funds based upon their track record with former allocator partners. They are not only from the developed markets but also from the emerging markets.

The investor must not only know a global investment market and sophisticated fund structures but also complex issues such as structuring taxes, hedging currency exposure, and understanding the different political and economic environments in which they are investing. And then there is understanding the different managed models and which is best and when. It's a much different world than it was a few years ago.

*Any final thoughts?*

I am very pleased with the evolution of real estate as a global asset class and the development of a range of strategies. It remains a relatively inefficient sector. With the appropriate resources, hard work and thoughtfulness, attractive returns can be achieved through the market cycles as evidenced by the opportunities we are seeing today in the U.S. and offshore.

I have been advising institutions for more than two decades regarding their real estate programs, and it has never been as challenging but as exciting and fulfilling as it is now. ♦