Real Estate Finance & Investment

For Cycle-Resistant Investment, Focus on Resilient Demand Drivers

By Amy Price and Paul Zemla, 11th of October

Picture a road sign that reads "Proceed with Caution." It's a good metaphor for the current real estate investment cycle. The sector *is* awash in capital, cap rates are getting squeezed, and many people are concerned that the U.S. and Canadian economies are due for a recession. In these conditions, resiliency—of a building, a city, a submarket—becomes a critical factor in investment decision-making.

We're not convinced that a downturn is imminent; however, we are late in the economic up-cycle, and if the economy of either country goes south, occupancy and rents will follow suit. Fortunately, this time real estate markets aren't overbuilt or overleveraged, but it's important for investors to make prudent decisions nonetheless. A good long-term investment strategy accepts the inevitability of cycles, and focuses on properties and markets that are most likely to thrive through good and bad times.

Competition for core assets—stabilized investments in major markets—is intense, as the North American property sector offers favorable yields compared to alternatives like bonds. As growth and appreciation moderate, core returns are reverting to historical levels, creating an upsurge of interest in core-plus and value-add investments that present opportunities for net operating income (NOI) growth.

Rolling through cycles unscathed

We believe there are still compelling opportunities across the risk spectrum from core to value-add, but whatever strategy investors pursue, a key consideration should be the asset's ability to hold its value throughout the market cycle. By understanding the current and likely future drivers of space demand, investors can identify resilient markets and assets that will endure in both good and poor economic conditions.

A building in a resilient market poses less cycle-related risk than the same building in a market with a less attractive overall economy. In the last recession, a few cities like Toronto, Vancouver, Austin and San Francisco were more modestly impacted, and these same markets were the first to spring back. It's not a coincidence that these cities have been magnets for strong job-growth fields like technology, or that their highly desirable labor forces are drawing employers.

For core investors, one strategy is to focus on a handful of markets where your assessment of their strength is more bullish than that of other investors. For example, some investors may view the Bay Area as overheated based on high asset trading prices, but we believe the strength of the technology sector and the strong labor pool will keep fundamentals relatively solid regardless of an inevitable economic cycle. Other investors may skip over Pittsburgh as too small to offer a steady flow of institutional deals, which may enhance acquisition opportunities for others who like the market's educational drivers and labor pool.

Resiliency, brought to you by diverse demand drivers

Markets that are more resilient generally feature a high number of ultimate demand drivers: elements that attract well-educated young people. These highly resilient markets share the following characteristics:

- Knowledge cities – University students in cities often remain in the area after graduation, creating a highly educated workforce and a concentration of startup ventures. In determining which cities to focus our efforts on, we look at the percentage of residents with advanced degrees, as well as the number of patents issued to local firms. These factors correlate strongly with job growth and innovation, and by extension with growth in space demand.
- Live-work-play communities – Mixed-use neighborhoods with good transit options provide a convenient and social lifestyle for the talent companies are pursuing. These communities have flourished in recent years as new and redeveloped properties have added high-rise multi-family, street-level retail and loft office space, largely absorbed by surging demand. With Millennials still entering the workforce and living in cities longer than previous generations, the appealing lifestyle of live-work-play communities will continue to strengthen these markets.
- Active lifestyle and health features – Sustainability and wellness play an increasingly important role in attracting and retaining residents, employees and tenants—to communities as well as to buildings. Bike lanes, jogging paths, dog parks and bits of greenery can greatly increase a neighborhood's vibrancy and attraction to residents and businesses. Investors can tap into this appeal by offering building features and amenities that promote health and well-being. Many young people want apartments and workplaces that reflect a commitment to minimizing environmental impacts. Others just want an on-site fitness center and indoor bike storage to support active lifestyles.

Enhancing NOI—the long game

Investors and property managers can greatly enhance a building's appeal, and thereby likely increase NOI—with features and programs that promote sustainability. An extensive third-party analysis of Bentall Kennedy's office portfolio proved what we already suspected—green building certifications (including LEED, BOMA BEST and Energy Star) generally correlate to higher occupancy and retention rates. That's why we see value in investing in systems to improve operational efficiencies, while at the same time adding amenities that occupants value. Working with office tenants to create workplaces that promote the wellness and well-being of their employees can enhance NOI and cycle resiliency.

We believe these trends will be relatively recession-proof. Technology and other innovation sectors will continue to drive economic growth, educated young people will continue to congregate in convenient neighborhoods, and both apartment renters and office tenants will continue to place value on sustainability and wellness.

Consider the capital stack

For certain investors, an intriguing alternative to direct equity investments in real estate could be to invest in a more defensible part of the capital stack. One possibility in the current environment is to provide mezzanine financing or preferred equity, particularly for transitional properties or development. This can be a compelling, late-cycle investment strategy, trading some of the potential upside of an equity position for the less risky position further down the capital stack.

The ups and downs of the economic cycle are inevitable, but it is possible to build a resilient portfolio that weathers the volatility. An investment strategy that focuses on dynamic job-growth cities, provides leadership on sustainability and helps tenants attract a highly desirable employee base is likely to emerge from any economic downturn relatively unscathed.

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