Listening to the Market

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Having been with Bailard since the firm's founding 50 years ago, I understand that long-duration "market tops" late in the cycle can be frustrating times. We know that the deeper we are into an economic expansion, the closer we get to a correction. So with a downturn potentially lurking around the corner, we certainly don't want to rationalize an investment just before "the music stops." We've identified target markets with good population and job growth, upward trending rents and balanced supply/demand fundamentals. Yet, the vast majority of investment opportunities don't meet our return targets.

Where else should we look?

You listen to the market.

Cap rates in cities like San Francisco and Seattle have settled at historic lows of 4.9% and 4.6% (Office) and 3.6% and 4.2% (Multifamily), respectively.[1] We believe that the potential returns at these pricing levels do not justify the risks inherent in those asset types in those markets. Those two metro areas, together with San Jose, Boston, Austin and Raleigh/Durham, form an economic cluster tied to Tech ("Tech Centers"). We believe the pricing has been driven up as the larger, institutional firms have accumulated an outsized position in the cities that make up the Tech Centers cluster.[2] For the past few years we have generally steered clear of the Tech Centers in large part because of our view that assets in those cities are "over-bought" and that the risk/reward balance is not in equilibrium at this point in the cycle.

But sometimes, when you listen, a potential gem reveals itself. For example, earlier this year in the course of regular conversations with our friends, allies and partners, an interesting investment opportunity surfaced. Located on the edge of a Tech Center city was a simple but sprawling community retail shopping

ECONOMIC CLUSTERS

Bailard real estate research has developed an approach that organizes America's 128 different urban areas (Combined Statistical Areas, or CSAs) into eight groups of similarly performing cities. This is not done by the standard industry geographic approaches, where cities are grouped into broad regions of East, South, Midwest and West. Instead, Bailard has grouped the CSAs into similarly-performing economic clusters, where the economic drivers in these cities are similar from city to city, and therefore the various property types tend to move in rhythms that correlate with each other. The eight clusters include Capital Metro, Heartland, Large Growth, New SoCal, New York Corridor, Old SoCal, Sun & Sand and Tech Centers.

Using a geographic screen, Tech Center cities like Austin, Boston and San Jose would appear to be diversified all around the country. Yet, the Tech industry's continued extraordinary growth has driven rents to extreme heights that has propelled a large wave of development. This brings substantial risk of overbuilding and a subsequent downward correction in rents and market values. As a result, we believe there's less diversification protection from this risk than geographic diversification screens would suggest.

Our research has grown from the efforts of our previous work over the past 25 years. Please see Bailard's white paper, "Using Economic Clusters to Better Manage Risks and Enhance Returns" for further details.

center. The center had some vacancy and its market value had fallen well below its original development cost from just before the GFC. Yet, the market is growing, the center has outstanding access and visibility, the tenants' sales are picking up and there are no competing shopping centers in the immediate area to draw shoppers away.

To us, "listening to the market" means both a willingness to be open-minded and an eagerness to understand a complicated story. This opportunity came with myriad moving pieces to figure out... and the current owner just wanted to move on. If we and our local operating partner can resolve the issues, this investment could be a home run. We don't yet know if we will even be awarded the deal, but we're intrigued by the possibility. Retail properties right now are the least favored property type for institutional investors as e-commerce puts traditional "bricks & mortar" through wrenching change. This is especially so for properties with problems to solve. For the right deal, we view that as an opportunity to create value.

Why aren't more investors pursuing this deal? Beyond the fact that retail is an "orphaned" property type at this time, we believe it's one or more of several reasons. First, it's too small for the big players.[3] Second, it's too much work. Third, it's in a smaller Tech Center city, so it's below the radar of many of the bigger firm's acquisitions officers. Fourth, it could be "structural." That is, in most large firms, the research group is in a separate silo from acquisitions which, in turn, is separate from asset management. It's not an optimal organizational structure for surfacing and vetting opportunities that require creativity, vision, effort and energy.

We enjoy the unruly process of putting our entire investment team in the same room every Monday morning to discuss all the opportunities in the "pipeline." Issues are vetted. Concerns are raised and discussed. Questions are posed and answered. This, we believe, allows an attractive real estate deal to be revealed. Instead of the traditional "top-down" approach of filling prescribed geographic and property-type buckets, we prefer to let opportunities bubble-up from the bottom.

The beauty of investing in private transaction markets is the opportunity to find inefficiencies. We like to listen to the market. Even if a particular metro area or property type is a little outside our "strike zone," if we're willing to listen, we might hear something quite appealing.

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1 A property's capitalization rate, or cap rate, is a measure of its net operating income relative to its market value. Source: Real Capital Analytics.

2 The NCREIF Fund Index – Open-End Diversified Core Equity (NFI-ODCE) is a fund-level index reporting the returns of various open-end commingled funds pursuing a core private real estate investment strategy and qualifying for inclusion based on certain pre-defined index policy inclusion characteristics. As of 12/31/2018, the ODCE's Index had a 30% weighting to the Tech Center cluster.

3 NFI-ODCE average property gross market value was $86.4 million as of 12/31/2018.

ABOUT *THE 9:05*

Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 meeting enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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