terrasearch PARTNERS

REIT.com
Brought to you by NAREIT

Analysis: 2014 Looking Up for REITs

By Matt Slepin
January 9, 2014

Matt Slepin

The end of the year provides an opportunity to both look ahead and look back for planning and reflection. The revised third-quarter numbers that recently came out suggest that this painfully slow recovery has finally gained traction. The Federal Reserve has expressed confidence with its tapering announcement. Congress just approved a two-year budget deal. The Great Recession is in the rear view mirror, although with equal doses of caution and amnesia. Both the fundamentals and the investment market for the different commercial real estate sectors are looking good. I am a cautious person, but I have to say that, overall, the business is fairly healthy and in a happy part of the cycle.

The recovery has come in fits and starts and been uneven – dependent on property type, geography, capital structure and other factors. As real estate recruiters, we still see a best-of-times, worst-of-times dichotomy. So, for 2014, what do we see as the trends, particularly as they affect executive-level employment in the business?

First, we must understand what happened in 2013 as the recovery began to gain traction. From a capital perspective, in a continually institutionalizing business, the order of the world is for the strong to get stronger, which in many cases just means that the big get bigger. In the REIT industry, companies such as Equity Residential (NYSE: EQR) and AvalonBay Communities, Inc. (NYSE: AVB) have broken from the pack through their joint acquisition of Archstone. Similarly, the AMB-ProLogis merger broke the combined Prologis (NYSE: PLD) company far beyond the pack in the industrial sector. We have certainly seen this in the private-equity world, where the Blackstone effect is enormous. The big get bigger, the mid-size firms struggle to hold on to share and the barriers to entry for the small competitors that are already enormous grow even more. We actually fear the challenges for the mid-sized players who can neither articulate a scale-is-better or a best-in-class, sharpshooter strategy. The other recent merger – Essex Property Trust Inc. (NYSE: ESS) with BRE – is an example of this latter challenge.

Geographically, tech centers, such as San Francisco, Seattle and Austin, and energy markets, such as Denver, Houston and Dallas, have rebounded sharply, with other markets stuck somewhere on the road to recovery. Washington, D.C., which fared relatively well during the recession, is now in a down cycle based on uncertainty and cutbacks. Hopefully, the government will find direction and stabilize, which would help both that region and the country as a whole. The recovery also has been in favor of downtowns and transit-oriented development, but increasing costs seemed to be driving some investment back to the suburbs.

It has also been a rolling recovery by property type. The multifamily sector rebounded first as it benefited from residential market crash. But multifamily is now fairly mature in its cycle; there's talk about overbuilding in some markets – even of how to weather an inevitable downturn.

There also was the interesting development of institutional ownership in the single-family rental market, where some of the biggest players in the industry (Blackstone, Colony, Beazer Homes, for example) are betting on an efficiency-scale play in that formerly mom-and-pop business. Given the slowness of job growth overall, it will be interesting to see if the interplay between multifamily and for-sale residential is a zero-sum game where multifamily gives back as residential recovers or whether both can grow as employment continues to recover. Finally, the evolving multifamily business echoes our theme of a business moving more and more towards institutionalization of capital and operating platform.

Among other sectors, single-family home building remains spotty, with big early 2013 gains in sales and prices in many of the markets hit hardest by the housing crash that largely evaporated in the second half as prices rose too far, too fast. Office development, retail and hotel development are likewise spotty, with these sectors still one to two years behind multifamily in terms of recovery. There are secular changes, particularly in the office sector where both technology and space efficiency have driven down the overall demand for space. Specialized sectors also have increased importance in the industry. These include data centers, self storage, senior housing and now the "REITization" other sectors, such as cell towers and document storage.

In December, NAREIT reported to its members that Fitch Ratings posted a “stable” outlook for REITS in 2014, with the greatest downside risk being posed by a 1970s-like possibility of rising interest rates coupled with little or no economic growth. As Fitch put it, interest rate increases that result from stronger economic growth would be positive for REITs, whereas a stagflation scenario would “almost certainly be detrimental.” It also said that a more gradual increase in interest rates would benefit property sectors with longer-lease tenants, such as net lease, health care, retail, office and, to a lesser extent, industrial. REITs with more fixed-rate debt on their balance sheets would likely better withstand rate increases than those with more floating-rate debt, Fitch added.

On the jobs front in the industry, we break employment at our level of work into cyclical roles, non-cyclical/stable roles and roles driven by new trends in the business.

The cyclical roles of development and construction are on fire in markets like our home base of San Francisco, where building is booming and development and construction manager positions are at a premium.

Hiring among the stable roles - from property management to asset management to finance and C-level positions - are on a routine basis, although there is increasing demand for an institutional skill set and experience among senior professionals in all disciplines. Overall, the balance has definitely shifted to an employee’s market. Where several years ago, everyone was up for grabs, either because they were unemployed or because their long-term compensation programs had no value, employment is more sticky in this upswing. In particular, the value of many executives’ long-term compensation programs is now prohibitive for them to entertain a move.

There are also secular shifts in the industry causing increased hiring in some areas. One is in marketing and sales, in which social media has fully taken over from print advertising and the customer base is a new demographic. Demand is now for new-school thinking among prospective hires. Another evolved role is in sustainability, which is increasing in importance in multiple sectors, from owners and developers to the big service companies to home building companies.

We also are seeing increased focus on bringing diversity – gender, race, sexual orientation, age and other factors – into the real estate workforce. Having a workforce at all levels, including senior management and in the boardroom, that reflects a company’s clients, a company’s investors and the company’s future market is increasingly critical.

A final and increasingly evident trend is the graying of real estate entrepreneurs. Numerous titans of the industry are working past age 65, often well into their 70s, and they have yet to develop succession and estate plans. There will be increased demand for executives who can both assist in that planning and serve as successors to the legends who built the business.

At Terra Search, we have developed a philosophy that serves as a roadmap to success for companies in the real estate industry. Companies with strong leadership teams, strong operating platforms, strong balance sheets, and a portfolio and strategy that resonates within a particular sector are poised for long-term success. To be sure, a company can fall short in one of these key attributes and still find success, at least over the short term. Lacking in two or more, however, suggests it is time for meaningful change.

All in all, 2014 should be a strong year for the industry. We are at the early to mid stages of the recovery. Companies will need to plan for an inevitable cycle turn, but now is that virtuous time in the cycle for some predictability, some opportunity and making the hay while the haymaking is good.

About Matt Slepin
Matt Slepin is the Founder and Managing Partner of Terra Search Partners, a retained executive search firm helping real estate companies build great teams. Terra Search Partners serves many of the country's foremost REITs, private equity firms, pension fund advisors, private developers and owners, family owned businesses and non-profits. Matt writes frequently on matters pertaining to human capital in the real estate business. To see additional articles written by Matt and others at Terra Search, click through to www.terrasearchpartners.com. Contact Matt Slepin at matt@terrasearchpartners.com or 415.433.2244.