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EXCLUSIVE

Top 10 CRE Investing Strategies for 2016

By Natalie Dolce | National

We see a great opportunity to invest in distressed retail assets, especially in lower priced suburban markets, says Ori.

WALNUT CREEK, CA—Where will the great opportunities to invest be in 2016? Will it be lodging? Distressed retail? **Joseph Ori**, executive managing director of **Paramount Capital Corp.** took a stab at answering that question in this commentary below.

The views expressed below are the author's own.

Sell Class A Suburban and Urban Apartments

Owners of class A suburban/urban apartments that were built at high cost and high rent structure should be considered for sale. The double digit rent increases realized in many markets is coming to an end and the huge volume of new units coming to market is the greatest since the 1980's. According to the Moody's/RCA Commercial Property Price Indices, the prices for apartments is currently 33% above their peak value in 2007. The wily Sam Zell is selling 23,000 apartment units, located primarily in "hi-beta" markets to Starwood Capital for approximately $5.4 billion. Sam Zell, undoubtedly sees the unprecedented volume of new units coming on stream and is getting out at about a 5.5% cap rate. If Sam Zell is selling, I do not want to be buying.

Quarterly Commercial Property Data Book and shows the massive increase in Permits, Starts and Completions of apartments around the country. Multifamily starts through August 2015 are 381,000 and will likely exceed 630,000 for the entire year. We are already seeing softness in occupancy and rents in various cities. For example, Walnut Creek, CA, where we are based, is approximately 25 miles east of San Francisco and has a population of about 65,000 and there have been 900 new apartment units built in the last 18 months with another 1,000 to be delivered in the next two years.

Sell Net Lease Properties

The net lease industry has been very robust during the last few year's courtesy of the Fed's ZIRP policy and abundance of capital. Many of the leading net lease REITs like Realty Capital and Spirit Realty have done very well with the entire net lease REIT sector generating an average annual return of 8.87% since 2013. However, if the Fed has future rate increases, the value of net lease assets will decline significantly and should be sold. Investments in net lease assets is really a bond spread game, by buying long term leases at cap rates of 6%-8% and financing these assets at mortgage rates of 4.5%-6%. These investments tend to have long durations which cause large price decreases if rates rise. As with corporate bonds, if rates rise, the value of the net lease assets falls.

Increase Allocation to Public REITs and Reduce Allocation to Private CRE

The year to date total return for equity REITs as shown by the FTSE NAREIT All Equity REITs Index has increased by a slim 1.34%, while the total return for the NCREIF Property Index of privately held institutional property increased 9.8% and has delivered annual double digit returns since 2009. Many REITs are trading at or below NAV value and less than comparable private CRE values and should be purchased. Allocations to private commercial real estate equity should be sold and the proceeds reinvested in public REIT stocks.

Sell CRE Assets in Overpriced Core Markets and Reinvest in Non-Core Secondary Markets

The majority of CRE investment and development activity since 2012 has been concentrated in the 24-hour city core markets like New York, San Francisco, Miami, Boston, Dallas, Houston, Chicago, Seattle and Los Angeles. Many class A properties in these markets are trading at sub 5% cap rates and should sold. Proceed should be reinvested in secondary and tertiary markets where risk adjusted cap rates are higher in the 6%-8% range.

Sell Overpriced Core Assets and Reinvest in Opportunistic Assets

Institutional investors typically focus on the risk and return characteristics for various CRE investment strategies. The lowest risk are core investments, which are typically fully leased, institutional quality, class A properties with little or no leverage. The next riskiest investment strategy are value-added strategies which are higher risk and involve some property redevelopment, tenant adjustment or leasing or with operational problems. The riskiest sector are opportunistic strategies, that involve a high degree of redevelopment, leasing, tenant relocation or change or may be in financial distress. Many core properties are still trading at sub 5% cap rates and should be old. The proceeds should be reinvested in higher return opportunistic strategies.

Sell Mortgage REITs and Reinvest in Equity REITs

There are 41 singlefamily and commercial property financing REITs and investors should sell these REITs and reinvest the proceeds in a diversified portfolio of equity REITs. If the Fed raises interest rates into 2016, these REITs will experience large stock value losses. For the last year, singlefamily financing REITs have had a negative total return of -14.47% and commercial property mortgage REITs a total return of a miniscule 1.77%. Many of these mortgage REITs finance their long term investment portfolios with short term repurchase agreements or bank loans. This mismatch in funding will be under duress as interest rates rise and the cost of funding these long term assets increases, thereby shrinking the interest rate spread and reducing the value of the real estate mortgage assets.

Decrease the Allocation of US CRE Assets and Increase Allocation to International REIT Markets Like Europe, South America and Australia

The FTSE EPRA/NAREIT Global Ex US REIT Index is a benchmark return of global REIT stocks, excluding the US. The average annual US dollar return for the last three years was 9.77% for the Americas and 11.33% for Europe. Institutional investors should increase their allocation to these international markets to generate higher risk adjusted returns. Many of these foreign REIT markets have a low or negative correlation to the US. REIT market and thereby will increase portfolio return and low the standard deviation of risk.

Redirect Investments in Private REITs to Public REITs

The private or non-traded REIT sector is comprised of 69 equity and 20 mortgage REITs with total assets of $77 billion per NAREIT. Private REITs are a “sold” product, meaning they are pushed by financial advisors to their clients. The fees are very high, with loads typically 6%-12% of the total equity offering. Their return performance is difficult to determine, however; we suspect that 2015 will be a negative return year for investors in a number of private REITs. Our recommendation is to reallocate funds from private REITs to public REITs, with many of the public REITs trading at or less than net asset value, as discussed in strategy number three.

Invest in Hotel Assets with Expected Higher Inflation and a More Robust Economy

According to NAREIT, the lodging sector of CRE has produced solid gains with average annual returns of 14.69% and 8.57% for the last three and five years, respectively. The growing economy, higher inflation, expected increases in RevPAR in 2016 of 5%-6% and positive fundamentals, make investments in the lodging sector very attractive.

Invest in Distressed Retail

Although there is more than seven billion square feet of retail space in the US or 22.5 square feet for all 310 million inhabitants, the retail market is showing strengthening fundamentals. Many consumers believe erroneously that online shopping will decimate the brick and mortar retail business, but this is short-sighted and incorrect. Today, online sales make up only 8% of total retail sales and the portion of those sales from brick and mortar retailers like Walmart, Target, Macy’s, Best Buy, Kohl’s and many other big box stores is their fastest growing sales channel. Some of the larger brick and mortar retailers are reducing their store foot print to reduce space and overhead costs and supplement the increase in online sales. Walmart and Target are reducing store sizes from about 180,000 square feet to 160,000 square feet and Best Buy from 50,000 square feet to 30,000 square feet.

We see a great opportunity to invest in distressed retail assets, especially in lower priced suburban markets. For example, various cities in the East Bay of California are littered with distressed, high vacancy and rundown retail centers that are prime candidates for a value added or opportunistic rehabilitation, renovation and retenancy.

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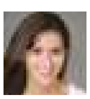
About Our Columnist



Natalie Dolce, national executive editor of GlobeSt.com, is responsible for working with editorial staff, freelancers and senior management to help plan the overarching vision that encompasses GlobeSt.com, including short-term and long-term goals for the website, how content integrates through the company’s other product lines and the overall quality of content. Previously she served as editor of the West Coast region for GlobeSt.com and *Real Estate Forum*, and was responsible for coverage of news and information pertaining to that vital real estate region. Prior to moving out to the Southern California office, Natalie was Northeast bureau chief, covering New York City for GlobeSt. Dolce's background includes a stint at *InStyle Magazine*, and as managing editor with *New York Press*, an alternative weekly New York City paper. In her career, she has also covered a variety of beats for *M* magazine, *Arthur Frommer's Budget Travel*, FashionLedge.com, *Co-Ed* magazine and the *Daily Orange* newspaper. Dolce has also freelanced for a number of publications, including MSNBC.com and *Museums New York* magazine.

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