EPISODE 673

[INTRODUCTION]

[0:00:00.0] ANNOUNCER Welcome to the Real Estate Syndication Show. Whether you are a seasoned investor or building a new real estate business, this is the show for you. Whitney Sewell talks to top experts in the business. Our goal is to help you master real estate syndication.

And now your host, Whitney Sewell.

[INTERVIEW]

[0:00:24.4] WS: This is your daily real estate syndication show. I'm your host Whitney Sewell. Today, our guest is Brian Adams, thanks for being on the show again, Brian.

[0:00:32.8] BA: Yeah, thanks for having me.

[0:00:34.0] WS: I'm honored to have you back and we had a great show yesterday and I hope that the listeners listened to yesterday's show and they're going to get to hear all the value that you provided. I mean, I'm still just remembering and thinking about numerous things that you said just about investor relations and what's important to them and understanding your marketing to them and what that did for you and when you changed just how you thought about those conversations but what's important to investors.

As a listener, if you didn't listen to yesterday's show, I encourage you to go back and listen to that. Brian just provided so much valuable content and he has just so much experience in this industry and has done so well. Just looking forward to this conversation today and just really about what's happening, what he expects to happen in the future moving forward and what's happening, this millennial patterns, effects of COVID. Just looking forward to getting his take on just from his experience.

But a little about Brian, I won't read everything I did yesterday but a little about Brian, he's the president and founder of Excelsior Capital where he spearheads the investor relations in capital markets on the firm, he's got 10 years in real estate private equity. He's just very well-known in the space and doing some very big things.

So, Brian, thank you again, let's jump right in and you know, let's just – get us started on maybe some of your thoughts and things we should be thinking about that maybe you know, you see other people that aren't thinking about those things and don't see what's happening?

[0:02:00.5] BA: Sure, I think the object of the conversation is talk about kind of millennial demographic shifts, patterns and how COVID is impacting all that and it's a little bit cliché and hackneyed but I think it is accurate that COVID is acting as an accelerant to pre-existing trends and conditions, right? What we saw pre-COVID was increasingly, millennials because of 2008, they had delayed their typical family formation phase, roughly five years and so there was a narrative on Wall Street that this millennial working generation which is now the largest cohort in America, it's around 75 million people total, was always going to live in Brooklyn wear skinny jeans, eat avocado toast, never have children, live in an apartment forever, right? That was kind of the image that we were all sold.

But the reality is that as they delayed that family formation, it is now happening where they are getting married, having children and they're increasingly making choices about where they want to live, work and play based on quality of life, cost of living, access to single-family homes and it doesn't mean purchasing, it just means the ability to own or rent which I think is an important distinction. Access education options for their children.

And increasingly because of COVID, just more space in general and actually, I think this is where the single-family home world and the commercial real estate world really paralleled one another is increasingly this millennial generation because of COVID, just needs more space, right? They want to get away from that density and that really urban environment and they're looking towards suburbs in secondary markets, really check a lot of these boxes and for many of us, I feel like every generation goes through this, our parents, my parents are the hippie generation and hey pushed back against their parents' lifestyle and so they would never live that way.

I know as a millennial, I barely qualify, but I do qualify, back in the 2000s, we were never going to live in the suburbs and drive an SUV and send our kids to the same schools that we went to but like most generations in the past, we yearn for that same type of upbringing that we had for our own children.

Increasingly, we're seeing this boomerang effect where you know, either one spouse or the other is moving back to where they grew up or within that same neighborhood because they want the same opportunities that they had growing up for their own children.

COVID is really accelerating this trend that we saw happening over the last five years and now you're seeing a lot of headlines about people fleeing New York, people fleeing California and moving to more tax-friendly, business friendly environments and communities.

[0:04:51.0] WS: Has this changed the same markets that you were focused on, your group's focused on or where you are spending your time?

[0:05:00.3] BA: It has, I mean, we continually reevaluate and it's interesting because you see a lot of headlines about Tennessee, Florida and Texas as being the havens for these tax refugees that are leaving LA and San Francisco and then New York and they are great jurisdictions, right? They're great places to go for all host of reasons.

But because of that huge influx of population, you're actually seeing pricing get really competitive. And so often times, you know, what was affordable for the family over the last two or three years – I know places like Nashville where I live, it really is no longer an affordable place. And so, we take a look at kind of cost of living, population growth, wage growth, employment growth and we put that all together and we have a little bit of a risk-adjusted response or matrix that we use to find new markets and sometimes not always in those three states and so we're very cognizant of the fact that this influx of capital coming out of California and New York.

Specifically, it is good for those markets but it also alienates a large portion of this workforce, I simply can't afford to go to Austin and pay those exorbitant prices. We take all that into account as part of a larger trend and because I think this is one of the beautiful things about real estate, private equity is, we had to look at things at a 10-year basis, right? What might make sense in the near term, we have to temper that with realistic expectations over the long term and how do we create kind of long-term value, have the asset stay stabilized and be able to continue to put out those distributions?

You know, we're constantly evaluating new markets, Nashville's been too expensive for us to transact over the last three or four years and I don't see that changing any time soon. We're always looking for kind of value in new markets and new opportunities that we find.

[0:06:59.4] WS: You can count on within 10-year period, you're going to be changing your focus from maybe a current market to a different market?

[0:07:06.8] BA: Yeah, I mean, I'd say that we have a matrix of probably 12 markets that we track and we re-adjust every quarter based on new economic data and typically, one or two drop out and one or two add in. It isn't me we're necessarily going to transact in those places but it does – I think it's a good practice that type of discipline because we've rotated out of Nashville, we've rotated out of Tampa, we've rotated out of Raleigh.

It doesn't mean those markets aren't great today but what I'm trying to achieve is consistent cashflow and what I found during the course of my 10 year career is when you purchase that building, even though you think it's an attractive deal day one, and that you'll grow into that on a cap rate basis maybe, the basis that you buy that at, the per square foot, per pound cost, you will never be able to escape that basis, that basis will stay with you forever until you sell the asset. And so, you've got to be really mindful on what you're paying on a per square foot basis especially in secondary markets.

We look at things not only as a discount to replacement cost which I think is a fine metric but the way we like to look at things is discount to replacement rents. What are class A rents in the market today? What rents would be required to justify new speculative development in construction?

We like to have a very wide spread there to feel protected as a landlord. That's where those markets like Austin and Nashville and Raleigh and some locations in Florida, I think the economic growth is tremendous in those places but it doesn't mean they're not very expensive to transact in. You have to be very cautious there of playing the, "Well, we're going to refi it in two years and then we're going to sell it in three years because there's going to be this crazy cap rate compression."

Maybe. But that's not the business we're in, that's not the type of risk we're taking.

[0:09:03.8] WS: Nice, I appreciate you explaining that. Since you own that, could you speak to that risk a little bit that you see others taking on the cap rate compression that they're seeing or counting on?

[0:09:15.5] BA: Right, this is where, for investors, when they see a pro forma, when they see a deck and they see a big IRR on there, this is where I think you need to be very cautious because if a sponsor of GP is buying something at a seven cap, and they're buying it for the most part, fairly stable because they want that cashflow, they know the investors want that cashflow and they're achieving an IRR that's in the high teens or even 20s plus.

Probably the only way they're going to get there on that short of a hold is by saying, "Well, I'm going to buy that at a seven cap and I'm going to sell it as six cap because that's just the way of the world, right?" We've been in this increasingly cap rate compression environment for the last cycle since '08 and if you assume that's going to happen and you can pencil in or really aggressive cap rate compression on the exit, you're going to hit a big IRR.

But the issue is, you have no control over what that cap rate environment's going to be upon sale, right? I mean, unless you're probably going to do variable debt, you're probably going to work with a local bank so you don't have any kind of defeasance cost or a breakup fee if it's CMBS or Life Co.

You have to understand, as investor that that's the risk you're taking. Because that's the game that the GP and sponsor is taking because often times, these groups only make money on the buy because they charge an acquisition fee and they only make money on the backend when they sell something and their carried interest hits. That's the game that some sponsors play and you need to be really weary of that in my opinion.

My deals, we pencil in the same cap rate upon exit than we do on entrance. If I buy something in an 8.2 cap, I'm going to model it to exit it at 8.2 cap. Unless I can hit that kind of mid to low teens IRR and the deal doesn't make sense, in my opinion because I have no control over that cap rate environment is going to be, I don't know what the debt market's going to look like, I don't know what's going to be happening on a macro-economic scale, let alone what's happening in Kansas City or Richmond or Cincinnati.

That's where I think sometimes investors take a risk without realizing it because they're banking on debt becoming cheaper, cap rates going down just because they have over the last 10 years. But that's not written anywhere, that's not a given. That is a risk factor you're taking on the deal.
[0:11:40.0] WS: You know, you're going to have the same exit cap that you know as your entry cap, where in your deal or are you underwriting are you adding the value or where's that coming?

[0:11:52.8] BA: Yeah. It's typically right size in the deal to market rents, market rate, and market credit in terms of term and user profile, right? What we typically find is I'd say the average, the typical fact pattern for us is buying a property that's 85 to 95% occupied, we're buying it at somewhere that's seven to eight cap range and we're putting on long-term fixed debt and you can gauge based on the fact that that's a 10-year fixed loan with the historical occupancy and NOI has been on that asset.

If you look at my cash reserves and what I'm putting aside for 10 permit dollars and leasing commissions, after all of that in debt service, if I'm able to achieve an 8% cash on cash yield on average, that's how we're doing it and if I can bring rents up, a dollar, a dollar 25 a square foot, improved credit quality and improved term to just what market within that sub market, these are simplistic things but I think often times, you look at value-add as we're going to reskin the building, we're going to put in new HVAC, new elevators, new roof, we're going to blow out the lobby but the problem with that is, those are not necessarily day one revenue generating expenditures.

We only like to spend money on things that are going to result in higher NOI and more cash flow to the investors. That's why we think of things as kind of a more of a stable cash flow oriented investment and frankly, most of my investors, unless it's going to be a really big IRR or very big multiple on invested capital, they would rather have that quarterly coupon and that income production than they would the capital back. It's just a different way of looking at invests for us.

[0:13:42.4] BA: Nice. I'm grateful for you going into that. I know a lot of the listeners are wondering the same thing and there's tons of questions that we could talk about there. I wanted to back up just a little bit though, we're talking about where to find or just talking about market data and things that you were going over in like quarterly or you're analyzing specifics, eight, 10 or 12 markets and watching them.

Where are you finding the data that you count on that's accurate for those markets?

[0:14:08.9] WS: Yeah, I mean, anywhere and everywhere. We are datacentric and that's where we spend a lot of our time, that's how I spend a lot of my time and there's some great resources if you go to, just within the federal government, the Department of Labor and some of the economic indicators that you see sent out manufacturing index, et cetera. That's on the high-level states.

Also, typically we'll have economic community development or chamber of commerce for city specific markets and you can really dive into that data and those folks are obviously in the business of trying to get corporate relocations. And so, you got to take some of it with a grain of salt but it is a really good resource to see, "Okay, well how has employment growth looked? How is wage growth looked?"

"What are the underlying economic drivers for this marketing in Kansas City per se? What is the average house income look like within five miles of the asset?" those are the type of things that we look into and then we are subscribed to all of the Cushman's and the JLL's and the CBRE data providers that are typical and we can really look and see, "Okay, well what are our average asking rents look like over the last 10 years?"

And really one of the things that we dive into the most on the submarket level is how did these neighborhoods and often times these specific assets, how did they behave in a way because that is the best stress test that we have in the modern era is what happened during '08. How did the asset performed in 2009, 2010, 2011, how did the submarket perform? And if it did well, which we say is if it didn't go above call it a 12% vacancy rate then that's a pretty resilient submarket in our opinion.

Because if you take a step back and look at places like Atlanta today even pre-COVID when things are really humming, they still had submarket vacancy of 25 to 30% in some neighborhoods, right? So, you need to be really weary about exciting markets that are interesting like Austin but they are not a landlord friendly market necessarily, right? Because you've got so much construction going on, so much development, a lot of spec that your tenants, you know they'll get picked off.

And the cost of replacing a tenant is exorbitantly more than it is keeping a current tenant that they like and so you always want to just blend and extend the current term unless there is some outside reason you want to move on from that user, it is always going to be more economical decision.

[0:16:46.5] WS: You can't just say like Atlanta as a whole, right? Like you were saying because that is something incredible the higher percentages like you are talking about that are current right now, right? In some submarkets.

[0:16:58.3] BA: Yeah, these secondary markets they typically don't have any geophysical barriers, right? So, Kansas City is a really good example. It is a good city but to drive from the airport to the part of town that we invest in, which is the South Johnson County area, it is about a 45-minute drive on a good day. So, you know, like any place that you live the difference between 10, 15, 20, 30 minutes away it's a completely different neighborhood, a completely different dynamic.

And so, the high level MSA data has to make sense but you really got to jump into what that submarket data tells you because that is what's going to dictate how well the asset performs or not.

[0:17:36.5] WS: So, you know you were talking earlier too just about the matrix, to find the markets that you are looking at and that you're analyzing these 10 or 12 and tracking that data.

Could you elaborate on just the method of doing that? Do you all just have an Excel sheet and you have somebody that okay, every month they are looking at this data and pulling it from specific places or what is your process of doing that?

[0:18:01.8] BA: Yes, so we actually do have an Excel that one of our colleagues or one of my associates keeps current and we think month to month data is too volatile. So, we look at things typically at a quarterly basis and we readjust but we start from MSAs or that is the fancy word for cities, right? Markets that have above a million people who are in the general metro area but that aren't in the top 10 gateway markets.

So, the top 10 gateway market would be like Chicago, Seattle, New York, LA, Houston, big cities. So, we look at that kind of 11 to 50 type metro-sized area. And then we look at did it experience over the last call it five years pretty consistent wage population and job growth and then we look at, "Okay, well what are the underlying economic drivers there? Is it very tied to the energy sector? Is it very tied to financial markets?" So, you know Oklahoma City checks a lot of boxes for us.

But we can never get comfortable with the fact that it is so closely tied to energy, the same with Houston even though it is a big city. We just didn't want to take on that kind of risk because those are often times very volatile markets depending on the price of oil. So, we like to see a diverse economic base and usually that means eds and meds, right? So, education, healthcare, government and some kind of learning or knowledge environment economy.

So, tech for the most part I guess would be the proxy. Those are the things that we like to see. We love cities that are also capitals and cities that are in close approximation to a large university especially if they have a medical center attached to it. Those are the things that we like to see because we think they are counter cyclical and very resilient. So, if the MSA checks all of those boxes, we look at generally where cap rates are.

If cap rates are below 7% on average for class A office, we're probably not going to be able to afford to go there because unless I take on a ton of debt or a ton of risk, I can't solve for that 8% yield, which I am trying to hit. If cap rates reasonable, then we look at price per square foot. So, we like to be, you round a $150 a square foot on purchase price. New construction typically for surface parking is 325, $350 a square foot. If it checks the per square foot number, we look to cost on a replacement rent basis.

So, if class A rents are in the mid to high 20s that is a good sign for us because to justify new construction on a speculative basis considering where our construction cost are, you probably need to be 35 to high 30s a square foot rent. So, if class A rent are 20 to 25, I feel very well protected. There is a big gap there between where the market is and where the market needs to be for some developer to come in, throw up 250,000 square foot spec and steal my tenants.

If it hits that metric then we look on the submarket basis. We typically will only go to two submarkets per MSA and these are submarkets. This is a fancy word for neighborhood and so we like to see neighborhoods that never experience more than 12% plus vacancy during the downturn. They have no new construction speculative, maybe some corporate relocations or build the suite and we like to see rents increasingly ticking up, call it with inflation over the last 10 years.

And so, if the submarket data checks the boxes and then we go into a price point where we like to transact between 10 to 20 million. This is our sweet spot and so if there is deal flow there in that 10 to $20 million price range that is when we will green light and start canvassing the market for opportunities.

And so, it is very much a top down analysis and it only allows us – I think it is good for the most part because it takes a ton of effort on the front end. But once you get all of the way down to that submarket data, you can really look at a smaller opportunity set and really dig in and then you can build a portfolio of these ten to $20 million deals and then eventually get to scale within that submarket.

[0:22:21.1] WS: Nice, well we just have a few minutes left Brian but I wanted you to also elaborate on your thoughts of the market say over the next six months, a year or even further what you see or expect as you are looking at properties to purchase now?

[0:22:35.8] BA: Yeah, I mean it is August 4th today. So, what I say today will probably change tomorrow. So, take everything I say with a grain of salt but you know honestly it is a pretty wild time to be a market participant the NASDAQ hit an all-time high yesterday. The big tech trend is real and it is increasingly taking over the world but there is certainly a huge dislocation between what you are seeing in the stock market and what you are seeing in the economy today.

The economy is going to face some real pain points over the next six plus months and because the fed and congress have pumped all of this liquidity into the market that money needs to go somewhere and so it is gravitating towards the stock market because it is the lowest cost in terms of friction to put money to work immediately.

I think one of the things to really pay attention to is if you are holding onto cash like a lot of us are, you're looking to deploy that money.

You know the market is expensive and there is a lot of volatility and heading into the election I only expect more volatility. Fixed income is just brutal right now. Yields are terrible, I personally think rates are going to go negative. You have to understand that even though it doesn't necessarily you don't hear about it, you may not feel it immediately, inflation is real and inflation is a tax on your dollars.

So, if you are holding onto cash where you have it you know money market account, which is giving you nothing and again, I am biased but if you take a step back and think, "Okay, what should I do with my capital from an allocation standpoint?" long duration real assets that have some kind of inflation hedge, in other words an operator or somebody can actively push pricing. I think it is still one of the best places on a risk adjusted basis to put money to work. I do see inflation coming down the road. I think yields are going to go negative.

I think the market will continue to kind of chug along but there will be some volatility heading into the fall and there is a lot going on leading up to the election. I don't think congress is going to get their act together to put together a CARES Act 2.0 or another PPP group. Nobody wants to take on that political liability heading into the election.

They are about to break up and go on their summer break, which is I think pretty pathetic that the European Union and Brussels, which is just a bureaucratic mess that they can get their act together but that we can has become this political football with people's lives in danger. It is disappointing to say the least but it is a political reality that we have to deal with. So that's my view on the world. I think people are underestimating the ability for congress to enact legislation that would impact big tech's business models. And so, I think I don't know how much more runway is left there.

But again, one of the beautiful things about real estate is there is no scoresheet. There is no score board every day and so you've got to hold it long-term. And if you take a look back and see what asset classes that performed best over the last 100 years, it is hard to beat real estate.

[0:25:43.1] WS: No doubt about it. I love that explanation and I am grateful for that. Do you want to share with us how you like to give back again and then obviously that will be all we'll have time for?

[0:25:53.4] BA: Yeah, so on a company level, we have partnered with a local food bank in Nashville to help. In Nashville, specifically, we have a bunch of issues in terms of tornadoes that hit pre-COVID, and now, obviously we're in the middle of this pandemic and so I think eliminating hunger or addressing hunger is something that we can all get behind and it is not controversial and so there is a local non-profit that we partner with. Unfortunately, we can't do a lot physically right now because of social distancing. So, we have been doing food drives or just donating and we will continue to do so.

And then personally, I am on the board of a group in Nashville that is a swim and dive program for children and adults with special needs and developmental delays. And so, again, hard to manage that coaching process right now with social distancing but there is still a lot that we can do in terms of fundraising, etcetera and so those are the two things I am passionate about.

[0:26:51.0] WS: Nice, well, grateful for you sharing that again, Brian and giving back in that way, and you have just been an amazing guest and extremely knowledgeable in this space and experience. So, thanks again for just being a great guest and how can listeners get in touch with you and learn more about you?

[0:27:05.0] BA: Yeah, I am very active on LinkedIn. So, you can look me up, Brian C. Adams or Excelsior Capital. If you message me, I am happy to set up a call or help anyway that I can. I will respond to you and then the website, excelsiorgp.com is how you can, you know if you want to learn more about our investment opportunities or get on the distribution list, etcetera, happy to go from there. So those are the two best ways to get in touch with me.

[0:27:29.3] WS: Awesome Brian, thanks again. Grateful for your time. That's a wrap.

[END OF INTERVIEW]

[0:27:33.4] WS: Don't go yet, thank you for listening to today's episode. I would love it if you would go to iTunes right now and leave a rating and written review. I want to hear your feedback. It makes a big difference in getting the podcast out there. You can also go to the Real Estate Syndication Show on Facebook so you can connect with me and we can also receive feedback and your questions there that you want me to answer on the show.

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[OUTRO]

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