THE
WeeklyTAKE
CBRE

Was construction built to survive this pandemic? w/ MATT KHOURIE + MARK WILSMANN [06.26.2020]

Spencer Levy
I'm Spencer Levy and this is the weekly take on this episode, we're looking at the nuts and bolts of the construction business at a time of uncertainty during the pandemic.

Mark Wilsmann
We're taking less speculative risk today. And because of some of the uncertainty in terms of how this plays out relative to demand and underwriting, many of our capital sources are looking to get paid a little something extra for that or are looking for a value.

Spencer Levy
That's Mark Wilsmann of MetLife, a company with more than a century of investing in skyline defining projects. And one of the most prominent financiers in the global commercial real estate business.

Matt Khourie
We are indeed doing some things different today. We have a new project that's under construction and we have decided to kind of take some actions that relate to what I would call a healthy or building.

Spencer Levy
And that's Matt Khourie of the Trammell Crow Co., the largest commercial real estate developer in the United States, two big builders and partners in construction. Breaking ground on one big question, was construction built to survive this pandemic? That's right. Now on the weekly take. Welcome to The Weekly Take.

Spencer Levy
I'm delighted to be joined by two real estate veterans and friends of mine that I've known for over a decade. Matt Khourie, CEO of Trammell Crow Co., calling in from Pebble Beach, California, and Mark Wilson, managing director and head of real estate equity at MetLife, joining us from his home in Short Hills, New Jersey. Matt and Mark, welcome. Thank you.

Spencer Levy
Thanks, Spencer. Great to be here. Great to have you guys. So, gentlemen, not a lot of our listeners know exactly what Trammell Crow companies do and what met life in real estate does so. Matt, maybe you can lead us off and tell us what Trammell Crow companies does.

Matt Khourie
Sure. We are ground up developers of all types of commercial space, but primarily industrial, multifamily and office. Those would be our kind of three basic food groups. And

then we do some other product types I would call more niche. We're active in 16 major U.S. markets focusing on the larger markets in the United States, plus London. We've got fifteen billion dollars of developments underway today and roughly four billion of developments in our pipeline. And I'm really glad to be on this with Mark, because Mark is one of our most important and biggest partners. And we do a lot of business with institutional capital partners just like MetLife.

Spencer Levy
Well, Matt, that's a great transition to Mark. We'd love to hear a little bit more about what MetLife does on the real estate side.

Mark Wilsmann
Sure. So we invest on behalf of the MetLife Insurance Company, as well as other institutional investors like sovereign wealth funds and pension funds, et cetera. We have a little over 30 billion of assets under management. And the interesting thing about MetLife, which is 150 year old insurance company, is that we've been investing in real estate development for, you know, well over 100 years. Some of our earlier notable investments were financing the construction of the Empire State Building and Rockefeller Center as examples. So we invest really for the long term. We've been working as an organization, working with Trammell Crow for over 50 years. And of course, Matt and I have been working together shorter than that, but still have done a lot together over the last decade or two.

Spencer Levy
The general question is why construction? It's the riskier end of the real estate spectrum, generally speaking.

Mark Wilsmann
So we really see investment and development as, again, a way to access high quality assets at a cost bases that is less than usually what you'd have to pay to buy something existing. So you're certainly taking some market risk, but we have been able to do it in such a way that we manage our exposure to market risk so that we're not ever biting off more than we would want to at a given point in time.

Spencer Levy
I'm going to now shift to the right here right now, shorter term. An image of the COVID-19 crisis. How does that change your point of view towards construction development risk today, Mark?

Mark Wilsmann
Well, certainly we're taking less speculative risk today. And because of some of the uncertainty in terms of how this plays out relative to demand and underwriting, as many of our capital sources are looking to get paid a little something extra for that or looking for a value proposition today. So certainly it's impacting the new starts. Today, there continues to be extremely strong. Demand for industrial and industrial development is going to continue to occur, certainly both pre-lease there, a lot of pre-leased opportunities today. And then there are also some speculative opportunities that actually makes sense. We also think that longer term that we're still underserved in housing and multi-family still makes a lot of sense. I think there's a lot of uncertainty with the office sector in terms of how things play out. We are not negative on the office sector, but I think there's a lot of uncertainty. And for

that reason, you know, I don't see us investing in a speculative office deal in the short run until we see how this plays out.

Spencer Levy
Well, Matt, same question to you. What has changed in the short term from Trammell Crow point of view towards construction?

Matt Khourie
Yeah, well, let me talk about the very, very short term, Spencer, and that is we had some issues in March and April relative to the shelter in place, orders that were in most parts of the country. So as a kind of ground up developer, we had stopped construction in some of our markets because the governmental authorities basically said, hey, until we lift these restrictions, there's going to be no commercial construction, didn't kind of comply with policies.

So we took. Hit in some markets, you know, Seattle comes to mind, Pennsylvania comes to mind. Others, fortunately, since then, construction is basically back in full swing.

I'd say we're 90 percent plus operational on all of our developments underway. So I guess that's good news. We're a bit concerned, obviously, if there's further shelter in place, restrictions if they come back.

Second wave, etc, could impact us as it relates to product types. Pretty much in sync with Mark on that.

And we talk a lot about this, by the way, as we had a lot of deals working in each of the food groups, but industrial has gotten through this.

It induced recession very well overall. So it's almost in a category by itself - multi-family. I agree with Mark that it's a good solid product type. There's going to be an impact. And, you know, values are likely to go down. Rents are likely to go down. But I think overall that they'll recover fairly quickly. So we're still actively looking at compelling new multi-family.

And as it relates to ORCA's, we'll still do some office. But it's primarily going to be build to suit office or heavily pre-leased office.

Spencer Levy
I'll take it one step further. Have you made any changes in the design of buildings because of the cold crisis for wellness or otherwise? It's evolving.

Matt Khourie
We are indeed doing some things different today. I think of a project that we're doing now in Seattle where we have a new project that's under construction and we have decided to kind of take some actions that relate to what I would call a healthier building. And some of the things that we're either doing or considering doing on that project, just to give you a flavor for how we're addressing some changes is air circulation and using outside air. We're going to be using 100 percent outside air on that project in downtown Seattle. Not gonna be recycling air. We think that's a healthier approach in that in our air ducts system, we're gonna have some ultraviolet lights in the return air area that kind of disinfect and kills various pathogens.

We think that's a kind of a smart approach to this. And then there's a whole technology developing now and already had started, but it's going into overdrive on touchless. Everything's so touchless doors. And that's not just the main entry door. That's the garage lobby doors. That's restroom doors. All of those become touchless and probably effectuated by kind of a mobile phone device. We're moving towards a 100 percent touchless restrooms. We're doing things on elevators. Elevators can be a kind of a hot spot. So elevator cab purification systems are kind of in process. Their mobile app called Features for elevators, so that don't have to touch an elevator button.

I'd say the last thing we're thinking about is some kind of infrared temperature taking devices at building entries so that if necessary, we can make sure everybody who comes in is in kind of the right bracket of body temperature. So those are some of the things. It'll be interesting to see how they evolve. But I think to build the lease office space in the future, you're going to have to address the safety issue big time.

Mark Wilsmann
I was just going to add, you know, we've been actually very pleasantly surprised that the projects that we have underway have really been very minimally impacted as most really all of them have been deemed essential work. And the other thing I just mention is that I've been very impressed with how sophisticated the contractors have become, you know, really very early on in terms of screening people, you know, coming onto the site. Health questionnaires, temperature screening, getting a little bracelet that entitles them to work on the site for the day and then the social distancing that occurs, you know, certainly outdoors, it's easier indoors, wearing masks and other protective equipment that was instituted, you know, very early on in this process. And in many ways, you know, kind of was a forerunner to what we're seeing now with opening office worker space.

Matt Khourie
The general contracting industry has really responded well. We've got over 100 projects under development around the country, and very few of those have had any kind of coded outbreaks, shutdowns, et cetera, which is to me amazing. I thought that would be a big issue for us. But so far, so good.

Obviously, we'll have to see how that pans out. But they have done a masterful job. The GC business.

Spencer Levy
Let me dig into two aspects of about. One is short term costs associated with different procedures on the job site, and the second is long term cost with changing your building systems. How are those costs being addressed? And I'll start with you, Mark, and all harking back to a conversation I think you and I had 10 years ago talking about change that needed to be made for sustainability purposes and the investment case wasn't made yet. Today, I think it has been made for sustainability. Is the case black and white now being made for wellness in a short and long term?

Mark Wilsmann
I think it is an end. And interestingly, it's easier and less expensive to incorporate features into buildings at the time you're developing them than retrofitting existing properties. But I think that, you know, more and more major tenants have been focused on everything in

ESG and health and wellness, certainly at the top of the list. And right behind that is sort of, you know, how you're building, in essence, is contributing to the community around it. And it's easier to make those enhancements and to make those changes and most cost effective at the time that you're developing.

Spencer Levy
Well, I know that change orders are the bane of the existence. How do you deal with those types of change orders? Start with you, Matt.

Matt Khourie
There have been some cost implications. Interestingly, though, it hasn't been a runaway cost implications.

You know, we have healthy contingencies in our budgets and we haven't seen any of those short term costs eat up all of our contingency and pretty much any projects. So, yeah, it's going to be more expensive. The delay actually is oftentimes more expensive. So at an interest costs from your construction lender, et cetera, are not being at 100 percent efficiency. The costs related to having kind of covered procedures on the sites. Isn't that material? I'd say in the scheme of least our projects, talking about some of the costs on just making a healthy building. So the long term costs, I mean, kind of monitoring that Seattle CBD building I mentioned earlier and all those initiatives there.

And we just think the total of all those initiatives may add about one percent to the total project cost. So a lot less than you'd probably think.

And again, manageable. So far, we're not having a lot of budget buzz related to either short term or our long term cost issues.

Mark Wilsmann
I would just add that in the two large office buildings that we have underway are both substantially pre-leased and the tenants have asked for some modifications and they are you know, they're paying for those modifications. So it isn't always the developers or the landlords. Nicole and the other thing that that matches touched on that is a benefit with this situation is that, of course, livor has come down significantly and our interest costs have come down, you know, related to that. So that has helped make up some of the difference.

Spencer Levy
And Mark, you're actually MetLife worth a lot of hats. You're on the equity side and we have the debt side. Any additional color you can give on where the you're the borrower or the lender in situations that you've had to deal with over the last three months? Yeah.

Matt Khourie
You know, certainly in the construction loan market, the large banks have pulled back over the past few months. And, you know, they've been very, very big in supplying some of the relief to the broader economy in terms of, you know, the Keres Act and the PDP. And on smaller projects, smaller development projects with more regional banks, that is a much more liquid part of the market today. Putting together a syndication of banks to do a big deal is very difficult today. But if you're in a smaller situation dealing with regional banks, it's actually quite liquid.

Spencer Levy
Let's shift now and talk a little bit about markets. And I know you've done many projects together. So let's talk about product. You did a couple of years ago in Dallas, the park district deal.

Tell me a little bit about that deal - and - has your point of view changed on CBD versus suburbs really over the last since the global financial crisis?

Mark Wilsmann
We've been directing a lot of our investment in what we believe are sort of the growing, demographically attractive sort of next tier markets. And so those are, you know, the Seattle's, the Denver's, the Dallas, the Austin and the Charlotte, the Nashville, Atlanta type markets. Our view is that the aftermath of COVID-19 is going to make those markets even more attractive going forward. So, you know, I think I do think that the big cities are going to recover. I think that people are social animals and they're going to be attracted to everything that big cities provide again once they feel safe. But if you look at quality of life, cost of. Living in a lower tax burden and certainly the easier ability, at least at the margin, to kind of get around some of these smaller next tier cities. We think that they're going to continue to be the beneficiary of movement out of California, out of the northeast and good markets to invest in front of it. In terms of the question of CBD versus suburban. I think in the short run, this is going to create an interest in suburban space. But I think that it isn't going to significantly change our view, at least as it relates to suburban office, for example, in places like Chicago or the metro New York area. We think that's going to be maybe an attractive short term play. But longer term, you know, we like these growing cities.

Spencer Levy
Matt, what's your point of view?

Matt Khourie
Yeah, well, I'll start with the park district. And the reason I like that deal is it's a mixed use projects and right on an urban park. Our mantra is, "The best site in the best submarket." We gravitate towards those even if we have to pay more for the dirt. And I would say that applies either in a CBD setting or in a suburban setting.

I'm not a big believer. I may differ from Mark a little bit on this. I'm not a big believer that this is going to really change in the mid-term or long term, the dynamics of suburban versus CBD. If we go suburban, which occasionally we do, we're gonna try to go in an environment that's kind of a work, live play environment where there's a lot of amenities. You're probably next to some kind of transit center and it's almost of an urban slash suburban location.

Spencer Levy
But has transit oriented development gotten less valuable today because of it? Yeah. In my mind, I don't think so.

Mark Wilsmann
I think that there's always value to being able to provide, you know, multiple modes of getting around. And the younger generation, many, many folks have no interest in owning a car. And so I think it's always an advantage to be close to translate our research group a year or two ago. Did a study in San Francisco and basically showing sort of the relative cost

of using a ride share service, a pooled ride, share service versus public transportation, and then comparing that to being, you know, the higher expense of renting an apartment next to a transit location versus a more outlying location. But I think in most cities around the U.S., there's still a great advantage to being close to transit.

Matt Khourie
Yeah, I'm with Mark on this one. I think that obviously you're going to take somewhat of a pause, will be less over the next six, eight months.

But I just think it's temporary and folks will get back on mass transit again and the same numbers that they used to. It's less costly for those commuters to go on transit than it is to use a car and drive on a freeway and pay a bunch of gas. And the amenity cluster. Marc mentioned that a little bit earlier. That is a pretty compelling lifestyle situation, too.

Spencer Levy
So let me ask one more construction question. So a lot of times the United States is a leader in certain things in commercial real estate. Sometimes it's a laggard. And one of the areas where I think we are a laggard is some of the green technologies that are used in Europe to build buildings. And these are things using natural building materials or modular construction. Do you see some of those construction techniques from Europe, green or otherwise, coming here? And some of them, like Modular, might be cheaper? Matt, what do you think?

Matt Khourie
Well, let's divided between those two. I'd say as it relates to sustainable buildings.

And as I said, we've bought a multifamily developer in London and I was really surprised to see how committed and how much effort they spend on sustainable building and kind of ESG area. So, yeah, absolutely.

Europe is leading the charge on that, primarily because a lot of the big pension funds over there are the Dutch funds and others just demand that they say, hey, we're not going to invest in a new project unless it ticks all these boxes. So they're much more adamant about that than, I would say, the pension funds over here in the U.S.

So that's helped drive that sustainability evolution there. I do think that that's going to migrate over here over time because it's the right thing to do. And we had Trammell Crow committed to sustainability and probably going to continue to lag.

To Europe, but it's ultimately going to get over here in a similar fashion with maybe two, three year delay relative to modular. You know, I've never been a big proponent of modular. I've been hearing about modular and how it was gonna be a game changer literally for my entire career, 40 years in the development business. And it had just not really taken off in any.

You see it? I'm not a believer, at least thus far.

That modular construction is going to be a game changer over here if it's proven it's effective. I could change my mind, but right now I just think it's overhyped.

Spencer Levy
Mark, similar question I just asked, Matt, which is, look, MetLife is not just a U.S. investor. You're a global investor, your global lender. What are some of the global trends you might have been seeing in some of your lending in Australia or in Mexico, where I'm friends with many of your colleagues down there as well. Are they thinking. Might be instructive. It might be coming here?

Mark Wilsmann
Well, that's a great question. You know, I think I think in a lot of cases and ESG is probably the notable exception where the U.S. really lags Europe. But I think in a lot of areas of technology and building design, I think the U.S. is a relative leader. And when I travel outside the US, I often get asked about things that we're doing here in the U.S. One that has been talked about a lot is sort of multistory industrial, which is something that, for example, is very common in Japan but really hasn't been executed in any significant way successfully in the U.S. And there's some reasons for that, mostly because we like big trucks and we like a lot of space and we're just not used to dealing in smaller, more compact kind of environments. But I think overall, you know, the U.S. is a leader in technology. And oftentimes I get asked about what we're doing in the U.S. and the application outside the U.S..

Spencer Levy
Let me wrap up this with a mentoring question, because all of us have been in this business a while. We all got a few gray hairs, but there are many of the younger professionals in our business who don't. This is their first downturn. And quite candidly, many of them are scared. Matt, what advice would you give younger professionals about how to cope through this crisis and how it might compare to prior ones?

Matt Khourie
Good question. We have continued to hire young people into our business despite this environment. And the reason is you get into the real estate business for the long term, not the short term or the medium term. It's a as they say, it's a marathon, not a sprint. So the advice I would give young people is be resilient. You're going to take some body blows during this cycle. You're going to work on a lot of problems. I mean, there's going to be some tough stuff to have to get through, but be resilient, feel confident that you're going to get to the other side of this. And also, to the extent you can do a really good job on the really tough assignments that aren't fund, that will separate you from the pack.

Because I know as we look at promoting folks at Trammell Crow, those folks that have taken on the toughest assignments that aren't exactly funded. If you do a good job on those, you're going to have a more favorable career path than the folks that kind of veered away from that.

Spencer Levy
And Mark, same question to you. What advice would you give younger professionals who are dealing with a crisis for the first time?

Mark Wilsmann
Well, I think this is just a wonderful learning environment.

I think the most valuable lessons I learned have been in times of challenge, not in times where literally anything you touch, you know, works out because the market is strong and the tide is raising. All boats don't get distressed and change creates opportunity. This is a long term business and a long term asset class. There's certainly lessons learned when times are better in terms of managing how far you get over your skis, how far you push leverage, how far, you know, test markets that are unproven, etc. because those are usually the circumstances that cause you to endure the biggest challenges when things soften. We're going to come out of this. There's no doubt in my mind, and I think there will be some lasting changes. But I think that a lot of the fundamental things that make the real estate business successful are going to still. Be there when we get through this.

Spencer Levy
Well, that's those are words to live by a lot of the things that made the business successful. We'll be there once we're past this crisis. And I agree with that completely. So on behalf of the Weekly Take, Mark Wilsmann, Matt Khourie, thank you for joining us.

Mark Wilsmann
Thanks, Spencer.

Spencer Levy
For more information, go to CBRE, backslash the weekly take until next time. I'm Spencer Levy. Be smart. Be safe. Be well.