



USAA Real Estate Company

Recently, **Geoffrey Dohrmann**, publisher and editor-in-chief of *The Institutional Real Estate Letter – Americas*, spoke with **Len O'Donnell**, **Jim Hime**, **Will McIntosh**, **Bruce Petersen** and **Susan Wallace** of USAA Real Estate Company and **Craig Solomon** of Square Mile Capital Management LLC. The following is an excerpt of that conversation.

Tell us about the history of USAA Real Estate Company.

Len O'Donnell: USAA Real Estate Company is a subsidiary of USAA, which is a 92-year-old, \$200 billion financial services firm. The real estate division was formed 30 years ago to invest our parent company's capital in real estate. Over time it became an independently managed subsidiary, and while we continue to invest on behalf of our parent company, the real estate company also provides advisory and asset management services to other institutional investors. Today, we have a series of investment vehicles and a fully-diversified asset management platform that has grown to more than \$12 billion in assets under management.

What has driven the acceleration of growth?

O'Donnell: We have the good fortune of being an affiliate of one of the great companies in America, with a fortress balance sheet. That enables us to be a significant co-investor in everything we do. And, because we were an aggressive seller of assets in 2006 to 2008, we came out of the recession with a great track record of performance, no baggage, no losses, no foreclosures, and money to invest. We had a track record over that time period that was hard to match. We started investing aggressively in 2011, acquiring \$2.1 billion of assets during a time that we judged to be an outstanding buying opportunity. Coming out of the downturn, many institutions were, quite understandably, looking to

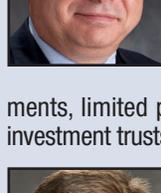


Len O'Donnell is President and CEO of USAA Real Estate Company. He oversees all operations of the company and a real estate portfolio that exceeds \$12 billion and includes office, industrial, retail and hospitality projects throughout the country.

Jim Hime, Chief Financial Officer, is responsible for various financial elements of the company's business, including financial structuring, the management of capital markets strategies, including debt and equity, liquidity management, asset dispositions and helping to ensure that the company's investments are performing at optimal levels.



Will McIntosh, Global Head of Research, is responsible for developing commercial real estate investment strategy and managing in-house global research with the objective of informing and enhancing the real estate investment process.



Susan Wallace, Executive Managing Director, Global Investors Group, has structured numerous investment transactions including credit enhancements, limited partnerships, joint ventures, securities, real estate investment trusts and limited liability companies.



Bruce Petersen, Executive Managing Director of Real Estate Investments, is responsible for transactions related to acquisitions. In addition, he is leading the development of two unique 600-acre business parks owned by USAA Real Estate Company.



Craig Solomon serves as Managing Principal of Square Mile Capital Management LLC. He has broad expertise in all facets of the real estate arena with particular expertise in structured finance, distressed transactions, joint ventures and partnerships, capital markets, foreclosures, restructurings and real estate-related bankruptcies.



do business with someone they could trust. Because of our track record and reputation, we attracted so much capital that we have gone from \$6 billion of assets to \$12 billion in three years. Most importantly, we have maintained our strong performance. We think and act like an investor first, and an asset manager second, and that is why people want to invest with us. We are driven by performance, not growth.

What differentiates what you offer from your competitors?

O'Donnell: The culture of USAA is unique in that it is built for the single-minded purpose of serving the members

of USAA. What I did not fully understand until I joined the company is how deeply USAA's culture is embedded within the real estate company. It is that culture that has driven the real estate company's performance, as well as provided us with a great track record and great alignment with our investors. I am most proud of the fact that we did not lose a single dollar of investors' capital during the downturn. While results vary, every vehicle that we managed during the crisis will have a positive IRR, and every dollar of investor capital will be returned. The other thing is our inherent culture of wanting to manage risk as well as produce results. Our risk management practices are designed to

ensure that we do not lose USAA's capital, and our investors are the beneficiaries of the discipline that culture creates. We have a great team, and our track record is pretty impressive.

Jim Hime: As you probably know, USAA derives its base of 10 million members from military families, and it is a great honor and privilege for me to spend the final part of my career working for their financial wellbeing. The core values of USAA, which are taken to heart by everyone in the organization, are service, loyalty, honesty and integrity, and they inform every decision we take as investors. This is a financially-sound, conservatively-managed institution with great leadership.

How does USAA approach acquisitions and underwriting?

Bruce Petersen: We have a ground-up valuation approach to commercial real estate that we apply consistently and with discipline. We value each potential acquisition based on the underlying leases and the cash flows from those leases on an unlevered basis. Because each of our investment programs has unique return targets, we then determine whether the asset is a fit for the strategy of one of those programs. In a competitive environment, such as we have today, we prefer to win opportunities based on our reputation as reliable buyers, as opposed to the brute force of offering to pay the most. Some buyers — we call them hot money buyers — may overbid or overpay, and, as Len noted, our risk management practices dictate that we are not going to do that, as the greatest risk you can take in real estate is paying too much. We are very disciplined on returns required by that strategy, and we have a good reputation for closing on the deals we go after. We have never had a mentality of “just getting money out.” We have always had a mentality of investing in good real estate.

Being a reliable buyer — Is that what you mean by winning on reputation?

Petersen: If certainty of close is of importance to the seller, then we will be attractive to them as a buyer. Lastly, from the standpoint of our approach to acquisitions, it is worth noting that we tend to be a little more contrarian than most when it comes to market-cycle

dynamics. When things get too hot or too expensive, we start selling or developing, instead of buying into an overheated market.

O'Donnell: We continue to demonstrate our willingness to sell, to maximize investor returns. In 2013, for example, we sold \$1.5 billion in assets. I think managers get in trouble when they do not want to sell when the market is sending signals that they should, so we spend as much or more time talking about when we should be selling and what we should sell as we do about what we should buy. And, when we buy something, our first question is: Who are we going to sell it to, and why are they going to want it? As I said before, we have the mindset of an investor first — this is how an investor thinks about real estate.

Where are you focusing most of your efforts?

O'Donnell: Three years ago, we decided that one of our strategic objectives should be to provide our investors an opportunity to work with us across the entire range of the capital stack and risk spectrum. And, in the past year, I feel that we have reached the point where we can offer products to institutional investors on one side and to consumers of capital on the other, with respect to every position in the capital stack.

I understand you have a relationship with a company called Square Mile Capital Management.

O'Donnell: Indeed we do. We made a strategic investment in Square Mile in March 2012 as a way of advancing the strategic objective I just mentioned. To achieve that strategy, we clearly needed to expand our ability to invest our capital and that of institutional clients in the debt space. Square Mile has an enormously talented team, they are the right size, have the right principles guiding the firm, and have a culture that fits well with our own. In addition to acquiring the interest in the company, we also made a very significant investment in their opportunistic vehicle. Over the past year, we have begun to offer mezzanine loans and stretch first mortgages in a new program that is designed to take advantage of the imbalance in supply and demand for that kind of capital.

Craig Solomon: Square Mile and USAA wanted to offer products to our investors and our counterparts that would provide solutions all along the capital structure. Historically, USAA Real Estate Company's primary strengths have been development plus core and core-plus investments. Our primary strengths are opportunistic real estate, investment distress, and credit and debt strategies. As Len was saying, the combination of the two firms creates the ability to offer a suite of capital solutions that ranges from pure common equity investments all the way through providing mortgage debt.

And how does Square Mile's team work with USAA Real Estate Company's team?

Solomon: First and foremost, our affiliation with USAA facilitates the sourcing and underwriting of transactions for both of us. We are in the flow of transactions on a daily basis, as are the folks at USAA Real Estate Company. Given that there are opportunities that may not be appropriate for us may well be appropriate for USAA — and vice versa — we are constantly sharing. Then there are the underwriting strengths that the combination provides. USAA Real Estate Company has regional offices with real estate specialists throughout the country, and we are constantly utilizing that infrastructure for real-time market data, leasing comps, sales comps, understanding of submarkets and understanding of sponsors. By the same token, they often turn to us for assistance on how to structure a particular transaction or for background knowledge on a sponsor with whom we have done business. We really work together hand in glove.

How is USAA Real Estate Company positioned to accommodate current investor interest?

Wallace: We are regularly developing new strategies based on where we see opportunities in the marketplace that would make attractive investments for our own capital. We do invest our members' money pretty heavily in all of our vehicles. For example, we have an initiative to invest in buildings leased to the U.S. government, which is a very core opportunity, and one that fits well with our mission. We are also focusing on core-plus assets in some of our other initiatives.

O'Donnell: Susan is making a valuable point about our range of products. We offer opportunities to invest in core, core-plus and value-add strategies. We have vehicles for value-add strategies that focus on smaller transactions and value creation. Development is also a significant part of what we are doing today. As Bruce noted, we increased our focus on development in response to diminishing returns in core. Finally, thanks to the Square Mile platform and a new whole loan program that we have kicked off together with USAA's life insurance subsidiary, we offer debt strategies from whole loans to mezzanine through opportunistic debt strategies.

Hime: We are taking this suite of investment opportunities and using it to raise money outside the United States today for many of our U.S. initiatives, but we are also beginning to look at opportunities to do in Europe what we have done here, which is provide capital to market situations that are currently underserved with capital. We are mindful of the fact that, to perform our function effectively for our members' capital and also for that of our investor clients, we need to have a product offering that is not limited to the United States.

O'Donnell: That is correct. This month we launched our European operation, which is our first non-U.S. investment platform. We have set up shop in Amsterdam, and initially our interest is to provide capital to the development community in Europe, which we think is underserved by institutional capital.

Hime: I think it is important to note that, as we have done with other new strategies in the past, we will first risk our own capital to make sure that we get it right before we ask others to invest alongside us. This is an example of one of the things that attracts investors to

us — that we have our own members' money at stake, as Len and Susan have mentioned. I like to say we do not just have skin in the game; we have muscle, flesh and bones.

How is the current capital-raising environment?

Wallace: It is a much improved environment compared to that which we experienced after the economic downturn. Many investors are now back in the marketplace making investments in pooled vehicles, as well as direct investments into commercial real estate here in the United States. Recently, we are finding quite a number of European investors who are now planning major commitments in the United States. We are also finding that kind of interest on the part of Middle Eastern and Asian investors.

What is your view of the acquisitions market today?

Petersen: It is as competitive today as we have seen it since before the recession. Transactions are occurring in the major markets at pricing that is close to previous peaks, and we are even seeing some secondary markets start to get that kind of pricing.

Some institutions have been shying away from secondary markets, and yet you are committing to them. What do you see that they are missing?

O'Donnell: That is a great question. Many of our institutional clients have asked us: What is the risk of secondary markets? When you invest in secondary markets, there are some fundamentals to which you must adhere. First, you have to buy high-quality assets, and you have to go after the best properties in the best locations. Second, we only buy at attractive returns, so we are not at risk

of being compelled to sell during times of reduced liquidity. Especially in secondary markets, we are a low-leverage buyer that buys high-quality real estate at prices well below replacement costs. That said, we do not like every secondary market, and we do not like every product type in every secondary market. A good investor has to be discriminating as to both markets and product types.

Are there specific regions where Square Mile is seeing opportunistic investment plays?

Solomon: While we obviously see the same pricing trends that Bruce referred to, we continue to source transactions in the gateway cities. However, because competition is heated and values are indeed peaking, we have expanded to some select secondary markets. But, by and large, because we are so transaction-specific and circumstance-specific, we do not target any particular region or any particular asset class for opportunistic investment.

How do you view markets today, and where do you see the opportunities and risks?

O'Donnell: Currently, we are fairly cautious. I know that it might seem strange for a firm that does a lot of development and opportunistic investments to say we are cautious, but we really are in regard to pricing right now. There is so much capital targeting U.S. real estate that it has driven prices beyond market fundamentals in some areas. Interest rates are creeping up, and historically that means prices will begin to recede. In gateway markets and core properties — the best locations in New York City and Washington, D.C. — we believe pricing is going to remain at elevated levels because there is so much demand. But other markets have also been running strong; with demand being driven more by leveraged buyers, private buyers, private REITs and non-traded REITs, and that pricing may move downward. For example, the net-leased market and the industrial market have seen robust sales, but they are not necessarily being driven by institutions and sovereign wealth funds. We believe that we have already seen prices move down and cap rates move up in some of those markets. In our build-to-suit business, for instance, there have been

CORPORATE OVERVIEW

USAA Real Estate Company was founded in 1982 as the real estate investment arm of USAA. With over \$12 billion in assets under management, the company provides co-investment asset management services to U.S. pension funds, as well as to foreign and domestic institutional investors. USAA Real Estate Company also provides capital to partners for development. The portfolio consists of office, industrial, multifamily, retail and hotel properties as well as investments in real estate operating companies. The firm's commitment to service and integrity reflects the core values put in place 92 years ago by its parent company, a trusted worldwide insurance and financial services organization.

transactions that initially were awarded to another bidder because we would not compete at certain pricing levels that then came back to us because the other bidder was not able to capitalize those projects at the rates they were quoting.

What is your view on the current direction of the U.S. economy?

Will McIntosh: Despite some soft economic data in the first quarter, we believe that the U.S. economy is poised to see accelerated growth for the remainder of 2014. GDP growth jumped in the latter half of 2013, reaching 4.1 percent in the third quarter and 2.3 percent in the fourth quarter, despite a significant drag from the government shutdown, although early indications are that severe weather nationwide held back GDP growth in the first quarter of this year. Nevertheless, employment continues to strengthen, with the unemployment rate down to 6.3 percent. Office-using employment is expected to be strong over the next few years, resulting in solid performance for many office properties. The generally improved economic outlook has allowed the Federal Reserve to begin winding down its monthly bond purchases. Another factor aiding the economy is the housing market recovery, which should significantly stimulate the economy. In addition, the banking system is well-capitalized, and both consumers and businesses have stronger balance sheets. We see the improvement in consumer and business confidence starting to ripple through into investment activity and spending activity. So, for all these reasons, we are fairly bullish on the economy, and we think that 2014 is going to be a good year, and that should extend right on to 2015 and 2016, as well.

Are investors factoring in changes in interest rates and inflation?

McIntosh: Inflation is currently running around 1.5 percent to 1.7 percent, so it is still relatively low. But because of all the money that has been put into circulation, through efforts such as the Fed's bond-buying program, many investors are expecting that inflation may take off at some point. It is well understood that one hedge against inflation is real estate. Part of the demand we are seeing today

for commercial real estate investments is driven by people who are preparing for a point in time when inflation becomes more of an issue.

O'Donnell: With interest rates likely to increase over the next 24 months, as Will mentioned, we are going to see some pricing regress. So in our underwriting of acquisition or development opportunities today, we routinely analyze how a 50 basis point increase in cap rates could affect the performance of our investments. Now, by no means do I think a crash is coming. This is not 2007, but I do think we are going to see some growth rates slow. In some markets we expect to see multifamily vacancies begin to rise slightly. Given these market conditions, we will continue to focus with Square Mile on the credit space and on helping people recapitalize assets. We think these will produce great risk-adjusted returns.

What else will be driving real estate?

Wallace: As population and jobs have increased, so has demand for all different property types. That has also contributed to investors' confidence in the recovering economic climate, so they are more comfortable making investments.

McIntosh: There are several key factors on which we are focused. One is significant demographic changes. The U.S. population is aging, which is creating opportunities in the healthcare sector across a broad range of markets and various property types. The echo boom, combined with the aging of the U.S. population and an improving labor market, will continue to account for a strong tailwind for household formation and multifamily demand. Another major factor is that new supply remains well below historical levels for office, retail and industrial. The muted levels of delivery of new space over the next couple of years should continue to allow for significant positive net absorption even if demand does not grow as strongly as in previous recoveries. When you look at the fundamentals across office, industrial, retail and apartments, what you see is improving demand. And, finally, debt capital availability is improving and becoming more broad-based.

The capital markets are going to be a significant factor in the marketplace.

Where do you see USAA Real Estate Company five or 10 years from now?

O'Donnell: First, many things are not going to change. Our mission, our values, our conservative philosophy toward leverage, our risk management processes — these are in our DNA and are simply a permanent part of who we are. For us, being the best is not about growing assets under management by any percentage. It is about investing our own capital wisely and about our investors feeling good trusting their capital to us, and demonstrating that by continuing to return to us for multiple investments. Nothing is going to change in terms of the culture at USAA Real Estate Company. We are always going to be an investor first. I think it bears saying again — we are always going to be driven by USAA's core values of service, loyalty, honesty and integrity. We have no doubt that USAA will continue to be one of the strongest companies in America. We are also committing a tremendous amount of resources to recruiting and developing our people. We have an incredibly talented core team of people who have been here 20-plus years, but we also are very focused on developing and adding people who will lead this business 10 years from now. We have some extremely bright and able young people who will be ready to step into leadership roles when the current team departs the playing field. I think we will continue to expand our co-investment platform. A decade ago, USAA owned \$2 billion of a \$2 billion real estate portfolio. Today, we own \$3.5 billion of a \$12 billion real estate portfolio. We will continue to look for inefficiencies in the market and be willing to dial up or dial down strategies. We have flown below the radar a bit in the past, but we are less of a secret today, and I am OK with that. ♦

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