PATHSTONE
THE FAMILY OFFICE℠

Bain Capital Real Estate's Thematic Approach

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Pathstone's "Meet the Manager" interview series features some of the passionate and committed asset managers with whom we have developed strong relationships. Our goal is to share the depth and breadth of expertise and collaboration that goes into our investment process and to gather timely insights on the investment environment across asset classes.

This installment features Ben Brady, Partner and Portfolio Manager at Bain Capital Real Estate (BCRE). After a decade-plus at Harvard Management Company's Real Estate Investment Group, Ben and team joined Bain Capital in 2018.

BCRE takes a research-driven approach in developing their investment strategies, focusing intently on identifying long-term themes that shape demand growth in the types, locations, and features of real estate assets in key sectors. The BCRE team has deep industry expertise that they use to drive operational improvements and create portfolios with consistent success across their targeted themes.

Notable real estate themes include infill industrial, life science, media/content space, horizontal apartments, medical office, residential, and self-storage. In this piece we include remarks around residential and life science.

Pathstone has worked with select Bain Capital strategies for a number of years. In this conversation, Pathstone's Dave Freudenberg, Director of Private Markets, gets Ben's perspectives on real estate markets and select investment opportunities.

Please note, this interview has been edited for length and clarity and includes excerpts from the complete conversation.

THINKING BEYOND THE CYCLICAL

Dave Freudenberg, Pathstone: *What does it mean to invest thematically in real estate?*

Ben Brady, BCRE: Investing thematically means focusing on the demand for real estate we think is going to be robust over long periods of time and is not simply cyclical. Back in the pre-credit crisis days, and even post-credit crisis, most real estate investors invested on a largely cyclical basis. There was some value add, improving real estate using expertise to increase the value, but most were not thinking broadly about demand for real estate outside of a traditional supply/demand cyclical analysis.

When we got started in 2010, it was in a period of very slow growth and people were very concerned about a double dip recession. We looked for ways we could find demand for real estate that was going to withstand those factors. That put us into senior housing, student housing, medical offices, and other strategies that would see demand from fundamental demographic and societal shifts.

DF: *How does your thematic approach work in practice? What's your process for deploying capital?*

BB: We think we've developed a very special way of creating powerful investment platforms that capture as much of the investment opportunity as we can. We do that by getting exclusivity over long periods of time with our operating partners. We are building these operating partners from, in many cases, one or two entrepreneurs on the ground with a good idea, expertise, and ability to add value to real estate. We're supporting those platforms by dedicating Bain Capital employees to the strategy. Spending all of their time on that strategy allows our team members to be in the market, develop an intuitive sense of what's attractive, and be exceptionally strong partners to those local entrepreneurs. We think this is fundamentally different to how traditional operating partner deals are pursued by more allocator fund-type models.

DF: *What's the typical time frame, if there is one, to develop the right partner and to really get into niches of the market that might be hard to access?*

BB: It can take years from developing the idea we're working on to taking advantage of some demand we're seeing in the market, to identifying a specific strategy, to identifying all of the potential entrepreneurs we could tie up with in this market, to selecting one then developing an integrated platform with them. Timelines are often quite extended.

We're really proud we're not chasing deals. It requires a lot of discipline to construct the right platform with the best partners.

CURRENT MARKET DYNAMICS

DF: *Let's turn to current market dynamics. How are the debt markets, with investors experiencing the rate hikes over the past year or so and the prospect of further action, playing into the opportunities you're seeing today?*

BB: What we're seeing today, and this won't come as a surprise to anyone, is that the higher rates required to squeeze inflation do not seem to be leading to recession, with the corresponding conclusion that rates are going to be higher for longer.

With cap rates being tied to long-term risk-free rates – call it the 10-year – with 10-year rates up into the fours, that puts a lot of pressure on cap rates [a property's net operating income divided by the value]. Transaction volume is low, but looking to the small number of properties that are trading hands, the public markets and debt market analogues, we believe cap rates have moved significantly higher and may stay there for a prolonged period. That's destructive to values for stabilized assets, and especially for assets that were trading at the lowest cap rates.

In terms of deal flow, unless things really turn around, 2023 is likely going to be a shockingly low volume year. I think it's hard to understand how far things have fallen from the volume perspective. It started off with a lack of forced sellers and a lack of people that were willing to sell at the new price. I think that is starting to resolve itself with at least some set of real estate owners acknowledging new pricing and being willing to sell.

There's a lack of debt in the market and the debt that is available is expensive. It's at lower leverage, it's available primarily for existing, stabilized assets, but less so for assets with more complicated strategies around value-add. This creates an interesting buying opportunity for Bain Capital Real Estate.

MULTIFAMILY SEGMENT INNOVATION

DF: *Let's focus on the multifamily segment for a moment. We have some clients who feel most secure investing in multifamily as the safest part of the real estate spectrum. Aside from buying too high is there anything else that presents a challenge to that notion of safety within multifamily?*

BB: Multifamily real estate is operationally some of the least risky real estate in terms of keeping your building occupied. There is a science and art to keeping buildings full, even at times of weakness, and obviously keeping it full goes a long way to being able to pay for your operating expenses and, when interest rates were low, your debt load. However, there is going to be distress in the market from people who bought near the recent peak at high leverage as interest rate caps burn off and loans reach maturity.

DF: *Just to wrap up the multifamily discussion, can you give us a quick summary of how you operate in this segment?*

BB: We've actually found it really hard to play in the multifamily space because it's so well known. We felt we had to invest in multifamily in a way other people weren't doing. It took us a couple of years to get up and running and build a significant pipeline, but we now have a strategy we believe we were the first to institutionalize.

So what is it? It's horizontal apartments. It is an apartment community built with apartment-sized homes. We wanted to provide a rental community where people could park in front of their front door, have 10-foot ceilings, at least three sides of light and air, and a little backyard. What we believed, and we've proven out, is that we can charge about a 20-30% premium in rents over typical garden-style apartments, and that our cost basis is about the same. (It is actually much cheaper to build these houses because they're all stick-built, whereas garden apartments are going to have some component of concrete and steel. We are less dense, though, so our land cost is higher.)

We think it's very difficult for people to compete with us because you have to have expertise in the entitlement process. Additionally, it requires experience with horizontal development of communities, which is an art as well as a science, and finally the lease up and management of the finished community.

WHAT ABOUT CONVERSIONS?

DF: *Switching gears a bit, let's discuss the concept of conversions, which is getting a lot of interest. Is this really an opportunity and what are the challenges that get in the way?*

BB: Conversions are a real thing. You'll see conversions of office to multifamily and in select markets of life science. There's been a ton of press around the office to multifamily conversion, but a lot less activity, for a few reasons. A pretty small percentage of the total office stock has the right floor plate layout and vacancy. Even if you're only a quarter full, it's hard to convert a building if you've got three or four floors still in business use for a period of time. This situation conspires to make conversions a difficult way to help solve the over-building of office and the under-building of multifamily. But you'll definitely see some activity.

LIFE SCIENCES AND THE LONG TERM

DF: *One more question. We can't forget about the life science sector and certainly that's been a big part of the portfolio. What is going on in that part of the market?*

BB: Life Science real estate exemplifies our strategy of investing in real estate benefiting from long-term, secular demand growth. The rapidly declining cost of sequencing of the genome has led the life science industry to become more productive in producing pharmaceuticals that extend and improve life. That has led to huge growth in company formation and funding from public and venture capital sources. Life Science assets are insulated from the work-from-home trend since the scientists who are our tenants generally must be in their labs to do their work.

We have been impacted somewhat by a slowdown in the venture funding cycle that drives these companies. Like other asset classes, biotech company valuations have been in flux and there have consequently been many fewer funding rounds, which means there are a lot fewer leases being signed, putting pressure on some markets. Although the life science markets have eased off of the low vacancies of 2021, the VC cycle will likely return for successful companies. Recently, leasing activity is picking up in the core markets where we are active.

WRAPPING IT UP

Pathstone appreciates the collaborative relationship with Ben Brady from Bain Capital Real Estate. We were able to highlight Bain Capital's real estate philosophy and process, capture Ben's insights around current market dynamics, and provide perspectives on commonly asked questions regarding traditional and specialty sectors such as residential and life science.