NAREIM

BEST PRACTICES SHARED | VALUE ADDED

FALL 2024

dialogues

Compensating *future* RE leaders

ALSO IN THIS ISSUE

Rethinking performance through the lens of inclusion

Using captive insurance to manage risks

Staffing and resourcing for compliance

A SUPPLEMENT TO INSTITUTIONAL REAL ESTATE AMERICAS, OCTOBER 2024


PARTNER

NAREIM dialogues

CEO
Zoe Hughes

Head of Programs
IvyLee Rosario

Editorial Director
Wanching Leong

Design Director
Julie Foster

For more information about NAREIM, contact:
Zoe Hughes
zhughes@nareim.org
917-355-3957
1021 Broad St. #1096,
Shrewsbury, NJ 07702

Cover image: iStock.com/Nuthawut Somsuk

www.nareim.org

IvyLee Rosario,
Head of Programs

"Succession planning is about creating a clear plan for the 'how' and 'who' related to mission-critical, leadership positions in the future," said Josh Anbil of Anbil Consulting, on what the growth of the real estate investment management industry means for identifying future leaders.

As the industry matures and the first generation of founders reach retirement age, the question of succession has never been more pressing. This process isn't an easy one, but managers can utilize compensation and incentives to compete in the war for talent — including salary, cash bonus, carried interest, co-investment, and, where available, firm equity or shadow capital.

For the feature on the role of compensation in succession planning in this issue of *Dialogues*, NAREIM also spoke with Kristin Renaudin of Stockbridge Capital and James Strezewski of Blue Vista Capital Management, for insights on how their firms measure value and apply cross-incentives to align all employees with the success of the firm. As it can be difficult to navigate across different departments and contributors to performance, leadership should thoughtfully and actively communicate compensation and incentive programs to employees so employees know how they can influence and control their destinies.

With an emphasis on the discussion of talent, NAREIM spoke with Clarion Partners, Ferguson Partners and Revantage on how to get CQ, or cultural intelligence, right; this is a critical tool in the armory of inclusion and DEI strategies. "Employees want to be part of organizations where inclusion is linked to business strategy and there is community involvement. People no longer merely want a paycheck; they want fulfillment, well-being, learning and growth," said Sherrida Traynham of Clarion Partners.

Additional articles in this final edition of NAREIM *Dialogues* include conversations around managing risk and common misconceptions of captive insurance programs, staffing and resourcing for legal and compliance departments to stay abreast of increasing regulatory concerns, what investment opportunities can come from intra-metro migration trends stemming from remote and hybrid work, and how data can be used in decision-making and supporting investment performance to evaluate climate risk.

After eight years of publication, NAREIM *Dialogues* magazine will be concluding its run. Over the past year, NAREIM members have enriched the magazine with their contributions, reaching an audience of over 8,000 *IREI Americas* readers and 4,000 NAREIM members and supporters. We thank you for your support of *Dialogues* and look forward to continuing our discussions via articles published online.

Ivylee Rosario

NAREIM MEETINGS

Meeting takeaways

Read the takeaways from NAREIM's meetings from March 2024

in-person meetings

Black Real Estate Roundtable

March 27, 2024

New York City

Make yourself "seen and heard" by ensuring you add value to an organization — and then always "argue for your value."

During the Black Real Estate Roundtable, members discussed how to confront feeling unseen or deal with racist and derogatory actions.

One leader was kept out of deal meetings, and only included when an underrepresented person was required. "I started cold calling, I started talking to as many people in the industry as I could and I started to get my own meetings," they said. "When that happened people started to take notice."

As one member said: "If you are not having periodic uncomfortable conversations about how opportunities are allocated, how you are promoted and how you get compensated, I can guarantee you are underpaid."

Other key takeaways include:

- It takes a village to get to the C-suite. Don't underestimate the importance of community.
- When you are losing confidence, go back to your network, your pseudo and your personal board of directors.
- Show up as yourself. Connect with people in a meaningful way.
- Argue for your value. Prepare the ground, get your mentors and sponsors involved, and test the water tactfully and thoughtfully. You need someone more senior or further ahead of you to help you navigate the journey and speak up for you when you are not in the room.

LatinX Real Estate Roundtable

May 8, 2024

New York City

How do you find career happiness? Often it's by not being the smartest person in the room, but by surrounding yourself with people who are smarter than you are.

At NAREIM's LatinX Real Estate Roundtable, industry leaders said they were the happiest in their career when they were the third or fourth smartest person in a small room.

Attendees described the challenges they had faced from racial stereotypes, offensive jokes and language barriers. One leader said there was a superpower in being different — the key was to ensure a shared vision, shared principles and similar values.

Other key takeaways include:

- Careers only look neat in retrospect. You don't need a plan for every part of your career.
- Informal mentors can be more impactful because they choose you. The best mentoring relationships are organic.
- Leadership is about having the best interests of your team. They won't work for you forever, but help develop your team as leaders themselves so they can go and run their own platform. "It's a coaching tree."
- The biggest impact you can have on the industry can be as simple as choosing your team. Create the environment you want to see in the industry, and your team will spread that even further when they progress and build their own teams and platforms.

Asset Management

June 6, 2024

New York City

‘Relationships are key’ was the overwhelming theme discussed throughout several sessions at NAREIM’s Asset Management meeting.

With borrower negotiations and requirements changing, managers must strengthen their relationships with lenders. Do so by building a story to share with them, staying in consistent contact and providing transparent feedback and concerns.

“If you’re not a good operator and we don’t like the way you do business, we will give you the worst terms possible,” said another member.

Managers that will be the most successful in navigating this changing landscape will be the ones to **craft solutions alongside their lenders**, share their motivations and are goal-oriented in reaching their end goal.

Structure & staffing

- When looking at your structure and staff, it’s not about who’s busiest, but “look at who is **happy in their role** and who is dealing with tougher assets.”
- Other **benchmarking considerations** include the geographical diversification of your asset managers, asset performance and complexity of the business plan, the strength and tenure of the operations team, support staff and sector specific experts.
- “Create a grid that will outline the scope of your team against your peer set,” said another member. To **find your strongest asset managers**, team leads should pay attention to presentation skills, who is the most proactive, who comes up with solutions or answers to team or property challenges, and who can present those in an efficient way.

‘S’ in multifamily ESG

Only 25% of attendees have a resident engagement plan. Popular services offered include energy savings, health and wellness, financial support or assistance and education.

- More than half have added a line item to their budget for **resident engagement**. Over half budgeted $5K or more. Most gauge success using resident satisfaction surveys.
- “Look into hiring a dedicated resident coordinator,” shared a member. “It might seem expensive upfront but looking at how much delinquencies, evictions or homelessness would cost, this option is more successful with retaining residents.”

Proptech

It’s a red flag if you see a start-up is working with a banker early on.

- Use your network to find out what works or doesn’t work for other firms.
- AI will be significant, but it won’t happen overnight.
- It’s not all about the technology but the **implementation plan**, and that’s driven by the people.

in-person meetings

Portfolio Management

June 6, 2024

New York City

Further declines in the US commercial real estate market are stabilizing and that the end of the current downturn is close was a key sentiment during NAREIM's Portfolio Management meeting.

Almost half of portfolio attendees believe NCREIF-ODCE Index would stabilize in Q3. A further 25% expected the downturn to end within the next 12 months.

Sections of the market are back, not least among debt platforms where one deal for a mark-to-mark industrial loan saw 14 debt funds bid versus two to three in 2023. "That's going to start chipping away," at debt fund returns, one attendee said.

The game has changed. The industry believes interest rates will be higher for longer. A manager said: "You'll no longer have the capital markets at your back. It's about focusing on the fundamentals and asset management — managing the cap-ex and getting the op-ex right."

Emerging distress & opportunities

- Office distress and delinquency will become more apparent in the next few quarters, as loan default information becomes more available.
- To understand current multifamily and industrial performance, look to deleveraged indices of REIT returns. They suggest direct investment returns in both property types are about to hit bottom.

Debt & emerging opportunities

- Debt funds are deploying capital to multifamily, value-add industrial and construction loans. Amenitized office in walkable communities on a reset basis could be an opportunity.
- More multifamily loan deals will start to come to market later this year. A potential opportunity is in bank loan refinancings.
- Office remains an opportunity despite lack of investor interest. "It provides coverage for our capital and is compelling on a reset basis."
- Sponsors should put new equity into an existing deal or debt managers will consider selling, even when loss severities are 50%.

Valuations & the dispersion of returns

- European appraisers use non-sales data when judging valuations, while US appraisers can only use arms-length transaction data. There is a need for judgments to be measurable and quantifiable, such as looking at a model cap rate or looking at CRE corporate bond indices which measure the cost of debt for REITs.

AI

One third of managers are using AI for internal communications; the rest are either reviewing or not allowed to use AI. Those who use AI use it for RFPs and DDQs.

For more information on any of our meetings, please visit www.nareim.org/event

Compensation in succession planning

iStock.com/VectorMine

This article is part of a series exploring the different facets of succession planning within real estate investment management. As the first generation of founders reach retirement age, a changeover in leadership is imminent as the industry continues to evolve and firms professionalize. Compensation is a key aspect of the hiring and retention of talent — ensuring continuity, and growth, of the firm. With compensation accounting for almost three-quarters of expenses at the average firm, how can and should firms most effectively incentivize and motivate employees?

This two-part article delves into the topic of compensation in succession planning. In Part I, NAREIM speaks with **Josh Anbil** *of* **Anbil Consulting** *on how firms should operate a succession plan, and how identifying and nurturing talent early holds the key to successful leadership.*

In Part II, NAREIM speaks with **Kristin Renaudin** *of* **Stockbridge Capital** *and* **James Strezewski** *of* **Blue Vista Capital Management** *on the firms' incentive strategies and compensation tools they have and wield.*

The feature concludes with **Josh Anbil's** *advice on effective compensation strategies.*

By Zoe Hughes

PARTICIPANTS

Josh Anbil, *Founder & CEO,* **Anbil Consulting**
Josh provides compensation and related consulting services to real estate companies. Over the past 20 years, he has worked side-by-side with his clients and has advised hundreds of real estate companies on over 1,200 compensation consulting projects. While Josh has worked with several types of companies across all industry sectors, he specializes in advising privately owned firms on compensation amounts and structures. Prior to forming Anbil Consulting in 2020, Josh was President — Consulting for Ferguson Partners.

James Strezewski, *CFO,* **Blue Vista Capital Management**
Jim has responsibility for overseeing all accounting, reporting and tax matters at both the corporate and investment vehicle levels. Prior to joining Blue Vista, he was an SVP at LaSalle Investment Management, where he was most recently responsible for the accounting and general operations of the firm's broker-dealer wholesaling entity, which served LaSalle's non-traded REIT fund. Jim serves on the Board of the NCREIF PREA Reporting Standards and is head of NAREIM's Compensation committee.

Kristin Renaudin, *CFO,* **Stockbridge Capital**
Kristin is responsible for directing Stockbridge's corporate finance and operations activities, as well as the overall strategic planning and direction for the firm. During her tenure with Stockbridge, Kristin has held various responsibilities across departments, including acquisitions, client service, capital markets and portfolio management. She joined the founding Stockbridge professionals in 1998 at PaineWebber and played a key role in the launching of the firm in 2003. Kristin is the incoming Chair of NAREIM's Board of Directors.

PART I

Start early, keep constant

iStock.com/Nuthawut Somsuk

In Part I of NAREIM's feature on compensation in succession planning, NAREIM speaks with Josh Anbil of Anbil Consulting on what the growth of the real estate investment management industry means for identifying future leaders and why it is key to find superstars at the junior level.

Let's dive into succession planning, and the compensation and incentives around the process. In the post-Covid era, there is a war on talent and cash is king among junior professionals. We are now in a cycle where carry and promote are not as valuable as what they once were. How do you advise clients as they think about succession strategies?

First, let's step back, look at the big picture, and define terms. What is succession planning? It's about leadership, and yet you'd be surprised how succession planning is viewed differently from person to person, and firm to firm.

Succession planning is about creating a clear plan for the 'how' and 'who' related to mission-critical, leadership positions in the future. Firms should set a strategic plan with a clear vision over the next few years, then work through the organizational requirements for this strategy. After that comes the leadership and compensation elements of succession.

For a long time, succession planning was a tick-the-box exercise and usually one driven by investors, consultants and other external constituents. It was done to reassure those groups; a brief document was presented and approved, then placed in a drawer because it was really an emergency succession plan meant to address the classic example of what to do if the CEO was hit by a bus. That should be part of a succession plan, but it's not a succession plan by itself.

A succession process, whether mandated or not, should be orderly, ongoing, alive and programmatic, not episodic and not entirely built around what to do in the event of an emergency. It's not a subject that you can jump in and out of. You should be continually talking about both the leadership piece and the compensation piece. It also means having a backup plan because things can change.

What role does compensation play in succession planning?

This is where the economic part of succession planning comes into play. Independent private companies need to think through equity and ownership over time. How will that be transitioned? Will equity be granted? Will the firm be purchased? Perhaps the plan is to sell to a larger company; I've heard more than one firm talk about an outright sale as their answer to succession planning. An effective equity plan is required in all scenarios.

Then there are firms where issuing equity is not possible or realistic. At those firms, the economic part is about long-term incentives and providing a clear roadmap for compensation. This requires a compensation strategy and clear communication about how compensation is structured.

Retention of top talent at all levels of the organization is an important goal and part of succession planning. Compensation is a useful tool for retention, but it isn't a silver bullet. Strategy,

> "Succession planning is about creating a clear plan for the 'how' and 'who' related to mission-critical, leadership positions in the future."

culture, management, mentoring, and professional growth and development opportunities are also important when it comes to retention. Succession plans don't work without retention, and retention isn't all about compensation. Sometimes firms fail to realize or act on this.

THE LEADER OF THE FUTURE

The first generation of real estate investment management leaders are reaching retirement age. What should firms look for in the leadership of future generations?

The real estate investment management industry is still a relatively new industry; it's only about 30 years old. And, not only that, it's a cyclical industry. It used to be a deal-by-deal business that developed into an investment platform. Now to go from an investment platform to a real business sounds easy, but it's not. It's hard to make it sustainable, to have momentum for the next series of cycles and changes.

As we look forward, is the type of leader — skill set wise, background wise — the same one that got you here? I believe this is the first time in the history of real estate investment management where you can't default to the best dealmaker or capital raiser. The industry has matured and issues have become more complex. As a result, the ideal leader is one who can steward the organization across those two very important functions, and can also add value in other areas like portfolio management, asset management, operations and HR, to name a few.

How do you find someone who can wear all those hats?

Firms need to be intentional about evaluating and finding talent, both internally and externally, and making it a top priority alongside other objectives and parts of the business plan. It requires developing a programmatic approach to talent, and making sure there is high-quality recruiting and coaching resources on the team.

The challenging part isn't evaluating talent in the context of the current state of the business and industry, but rather the future state. That's why starting with the end in mind is optimal. What does the business look like in three, four, five years? What does the industry look like in the future? What organizational structure is required to support the business?

The key is finding superstars early in their career. This allows you to groom internal candidates and to demonstrate the firm's desire to develop talent internally, as opposed to consistently looking to the outside for senior roles. How you find these superstars is multi-faceted. Strong performance measurement systems, leadership development programs, mentorship programs, and working with outside coaches are a few tools; these apply across the organization, from young, rising stars to top C-suite executives.

How do you develop young talent that can run the real estate business of the future?

That's a good and big question. Very carefully, I suppose. Time and resources need to be invested; these things don't happen overnight or by accident.

What comes to mind is the GE model that was established decades ago, although GE isn't the only firm that used this model. My understanding is that they hire top talent out of school, and put them on a two or three year rotation across different functions to learn how the entire business works. These employees experience how different parts of the business impact each other and come together, what makes them different, what makes them the same, etc. To my knowledge, there are not many real estate investment management firms that do that. Intentionally or unintentionally, I think most people get pigeonholed early, which leads to a narrower range of growth and makes leadership development more challenging. Adopting the GE approach may not be feasible for some firms, but adopting a version of that approach is.

Hiring on the front end, the training and the ongoing selection of top performers is important. In some cases, companies struggle in this area because they don't start paying attention until an employee has elevated from new or junior to middle management. That's too late in many cases and I don't think that model is built to last in our industry today.

Identifying and nurturing talent early also helps with retention.

Absolutely. When you give young people real opportunities, you invest in them and make them feel they're part of something. Those things go so much further than people realize. And it's symbiotic because a firm that truly invests in talent makes it easier to identify star performers and helps retain that talent because it tells them that the firm sees them as part of the fabric of the business. Others can then see this in action and notice the tenure of leaders, the examples of promotion from within, and the career paths possible.

The common mistake I see is cynicism around the younger generations, whether it be Millennials before or Gen Z now. The view is that young folks only want to be at a company for two or three years. That view impacts how firms invest in young talent. But is that view actually true? Or is that perceived pattern the outcome of firms not nurturing their young talent?

WIELDING COMPENSATION TOOLS

Do we rethink compensation for junior staff? The common refrain is 'cash is king.'

Based on data, observation, intuition and experience, I agree that cash is king. I believe in the policy of using the right currency for the right people. I've seen many firms suffer due to layering in long-term incentives at the expense of market cash compensation.

The part that should be revisited is not the form or currency for compensation, but rather how compensation is determined. This is where HR, performance measurement, and ongoing and year-end reviews come into play. It's powerful when someone can understand that they can influence their bonus and earn more. Although the process is never going to be perfectly scientific or objective or quantitative, it's also not an arbitrary rating. They know they can control and influence their own destiny next year.

Similar to succession planning, compensation should be ongoing and programmatic; neither episodic nor emergency. When you give somebody an answer to something as sensitive and as important as their career, their money and their livelihood, it better have rationale and that rationale better be reinforced by the actions firms take and the compensation that follows.

What about compensation for senior staff? Carry is the main tool, and, in a cyclical industry, sometimes the carry disappears.

Carry is the main tool, but it's not a silver bullet either. With carry, there aren't too many levers to pull because most carry plans have been vetted and adjusted to fit market best practices. Remember that carry only aligns interests in one scenario: when you're in the money. If not, the alignment and retention are effectively gone. Also, a good portion of the real estate investment management industry is comprised of firms that primarily focus on strategies that are further down the risk-return spectrum and don't provide that same type of carry or equivalent incentive or performance fees. You can't allocate what's not there, so those firms can't turn to carry.

All of this helps explain some recent compensation trends. An increasing number of firms have implemented what I call

How should smaller and mid-size firms, which may not have many resources, implement a succession plan?

Those firms are more likely to sidestep, delay or punt when it comes to succession planning and similar leadership and talent initiatives. The list of reasons is long, but the one that is cited the most is, "We're too small to need all that" or "This isn't a priority right now." Even if you have 10, 15 or 20 employees, each of those individuals have people in their lives that are impacted by the success of the firm; for instance, the families of those employees. Succession may not be a priority now, but it's a matter of when, not if, it will become one. Starting late after getting larger and when the stakes are even higher doesn't make it easier; it actually makes it harder.

Other reasons that aren't necessarily said out loud but are inferred include "This is my company and that isn't going to change," "That stuff doesn't put points on the board," or even "I don't know how to do that." I'll never forget asking the founder & CEO of a mid-sized company how they think about succession planning; their response was: "as little as possible." Obviously that was a joke, but it was also honest. They went on to say that it's important, but too intimidating and sensitive internally to push forward.

The answer is to get started. That applies to succession planning, leadership development and grooming talent. The details are going to be different from firm to firm, as they should be. There are best practices to leverage, but the approach you take should reflect who you are as a leader and your firm's culture. Topics like succession planning make us think we need big, fancy answers. Most of the time I actually don't think you do. Sometimes difficult things can be solved with simple and elegant solutions. Complexity isn't a requirement. Just get started because, as the saying goes, the only way to eat an elephant is one bite at a time.

'bridge' or 'multi-year cash' incentive plans to help address challenges associated with industry cyclicality and the need to retain senior talent. These plans can be performance-based incentive plans or simply a pay-to-stay retention plan, although the latter is less appealing and not exciting. Usually the plans capture two, three or four years, and there are payments made at the end if performance is achieved and the individual is still with the company.

These plans can bridge the gap between points in the cycle and in fundraising. However, they can also be an ongoing part of the overall compensation package by being the fourth leg of the compensation tool, in addition to salary, bonus and carry.

Firms that are able to introduce equity at the enterprise level can use that as the fourth leg of the stool. That can help address compensation challenges for senior executives while also helping with the economic part of succession planning and business continuity. Among independent firms, equity is really the fourth leg of the stool and the vast majority of those firms have already issued equity to non-founders.

What about co-investment?

Co-investment can also be the fourth leg of the stool. It's an investment, not a form of compensation, yet when loans are provided, those lines start to get blurred. The power of co-investment extends beyond compensation, much like the power of equity and ownership extends beyond compensation.

I continue to be surprised at how effective co-investment in real estate funds and purchased equity in the company are in retaining senior talent. Having executives invest their own money in real estate or the company doesn't put the same kinds of hooks in people, but it helps with retention in other ways. Those individuals feel tied into the business in a fundamentally different way because they are. That leads to what I see as a 'partner mentality' whereby the individual does not see themselves as a hired gun but instead part of the business itself. And when that happens, it's very hard to pull them out.

That's the overlapping theme for junior and senior people. You want them to feel connected to the firm, like they are part of the fabric of the business and organization. It's not just about giving them more or different compensation; it's about investing in them and allowing them to invest in you. Without one or both of those things, people will feel like they need to leave to be part of something when they could or should already be part of something.

PART II

It's not all in the carry

iStock.com/lemono

An important part of succession planning is compensation. While certain tools of salary, cash bonus and carried interest are standard across the industry, firms employ different strategies and pull different levers depending on their own culture, objectives and needs.

In Part II of NAREIM's feature on compensation in succession planning, NAREIM speaks with Kristin Renaudin of Stockbridge Capital and James Strezewski of Blue Vista Capital Management on how their respective firms are using carried interest, applying cross-incentives and measuring value, as well as the limits of compensation.

Compensation is an important means of incentivization. What is in your firm's toolbox?

Kristin Renaudin, Stockbridge Capital: We have a broad combination of tools at our disposal. We focus on base, annual cash bonus and a deferred cash component. In addition, there is an opportunity for carry and co-invest, which often go together. And then we have firm equity plans, which we established last year as we brought a new shareholder into our corporate ownership.

James Strezewski, Blue Vista Capital Management: We incentivize employees by developing longer-term incentive plans. We develop communication around their role going forward, what we think it looks like, why we think it's important and what their contribution would be. We want people with multiple skills; if we were to choose a head of acquisitions to run the firm, they can't do just acquisitions, that would likely be setting them up for failure. The head has to be able to relate across the firm and be multidisciplinary.

For employees we have identified as having leadership potential, we expose them to other facets of the business alongside their regular job. We want them trained across all platforms to know what goes on in other parts of the business. We start including them in company-wide conversations to make them multidisciplinary.

THE CARRIED INTEREST OPPORTUNITY

What role does carried interest play in incentivizing professionals? Is it changing?

JS: Carry is very important for us as a smaller firm. We actually decouple that from a co-investment requirement. We're finding it more important to remain communicative about carry since it tends to be out of sight, out of mind. That's where our compensation statement system comes into play; communication with employees is important to make sure carry is always on the mind and included as a piece of their compensation.

KR: Retaining top-level talent often requires some form of equity-based incentive opportunity. We view carry incentives as key to retaining an entrepreneurial mindset and to engaging our professionals. While many firms distribute carry across their teams, everyone has a slightly different way of doing so. Through carry awards, organizations foster the engagement, accountability and thoughtfulness they want from their staff.

Carry has a long-term, permanent role in our total compensation structure. Our goal is making sure folks are incentivized and tied to the work they do every day. If they're working on something that doesn't have a carry opportunity or incentive fee opportunity, we look to incentivize them through a different long-term tool. The optimal structure is for everybody to be tied to performance, with performance being both qualitative and quantitative depending on what they're working on.

As we look at the current market environment, we think the opportunity for carry is very compelling. For organizations deploying capital today, we view this as one of the best vintage opportunities we've seen in a long time. While the carry payouts over the next couple of years might be more limited, the longer term carry opportunity for our professionals is incredibly attractive. So, we have not shifted our balance between cash and carry.

Which levels within your organizations receive carry?

KR: Our carry and other similar incentive opportunities generally start in different forms at the VP level and up. We aim to make eligibility clear across the organization in terms of who becomes eligible for different programs at each level of leadership or title.

JS: As a smaller organization, carried interest is very important for us as an incentive for our lower- to mid-management levels. We dig a little deeper into the organization and begin a little earlier. Our struggle is to avoid all the tax issues associated with carry based on the way we handle it, and it has also prompted us to get more creative in how we structure these awards.

KR: We try to avoid the tax complexities as well. Taxable income is allocated before cash is generated, making it complicated to award carry to individuals below the VP level.

“Retaining top-level talent often requires some form of equity-based incentive opportunity. We view carry incentives as key to retaining an entrepreneurial mindset and to engaging our professionals.”

> "At the junior level, identifying that future talent is also important. Our challenge is designing the right program that allows our management team to assess and then deliver a succession plan."

JS: We have some mechanisms to try and compensate for those difficulties, but you don't want to give somebody $5,000 in carry one year just for them to have to pay $3,000 to prepare their tax return. It's a difficult balance and we're working on ways to remedy that.

INTRODUCING CROSS-INCENTIVES

What about co-investments?

JS: We offer a separate co-investment program that our professionals can elect to invest in products. We do not require those who are awarded carry to participate in co-investments. We also have a loan program for participants with an outside bank so they can finance part of their co-investment. That's another added incentive to participate.

KR: We view co-investments as the ultimate alignment opportunity. Across the firm, there is an expectation that senior team members will contribute personal co-investments to the vehicles they work on, as well as other vehicles they may not work on.

Has there been an evolution in the levers within your toolset?

JS: The most recent tool that we've added is a shadow equity program. It's a type of share in the overall business. It has a profits interest, additional carry, co-investment in every product, and a share in the value of the company.

KR: Jim, your shadow equity plan sounds very similar to our equity plan and shared carry pool, which we put in place last October. The equity plan has allowed us to create broader participation opportunities for senior individuals across the firm. We have spent a lot of time evaluating opportunities to ensure that senior professionals focused on an account without an incentive structure or a carry payout can be cross-incentivized from another product or from a broader mix of our carry across the business. Our hope is that the equity program is an alignment tool that encourages everyone to contribute to the success of the broader firm. Ultimately, we want to deliver attractive returns to all our clients, not just the ones that have carry structures to them.

From a tax standpoint, we've designed our programs to minimize day one tax impacts. We have both flexibility and the intention of adding a direct equity opportunity over time, but first we are trying to facilitate the wealth buildup that folks can then use to reinvest into the business.

JS: We have that issue too, balance across the entire firm. We're working on making sure everybody is aligned with a carried-interest-type compensation and we're trying to figure out how to do that from both a tax standpoint and an equality standpoint.

COMP CHALLENGES

Carry is still your primary tool. What have been the biggest challenges when it comes to comp?

JS: The challenges are between the labor market and your retention. The aim of all our programs is to retain top talent. At the junior level, identifying that future talent is also important. Our challenge is designing the right program that allows our management team to assess and then deliver a succession plan.

Where we may not be as competitive on cash compensation, we know we can compensate in other meaningful ways. The NAREIM Compensation Survey is very helpful in that respect. The Survey helps us keep a tab on the balance between our compensation package and what is considered competitive in the market. I've had instances when an employee has been offered a compensation package elsewhere that seemed too good to be true. But when looking under the hood via the Survey and being generally knowledgeable about compensation packages, it was, in fact, the case. We support employees being informed and encourage them to ask questions — the right questions.

KR: As Jim noted, the goal of all our incentive programs is to retain our top talent. Over the past few years as the market has been more competitive, at the top of the list of our challenges has been helping our employees understand everything available to them at Stockbridge before exploring what else is out there.

Measuring value is a challenge. How are you thinking about it?

KR: Measurement certainly is, as Jim said, a key problem. How do you measure value out of different departments and different contributors to performance? For a transactions professional, it's easy to say that their target was X hundred million dollars of acquisitions and they achieved a Y. You can measure that variance. With asset management, you can still include some hard metrics. For leadership roles that don't directly translate into quantitative measures, it becomes more difficult — the overall performance equation is not as obvious.

A good bit of our time is spent talking through the relative contributions of value to make sure we're incenting the right team. There's no formula. Our leadership is actively engaged in conversations throughout the year, as well as a substantive reflection at the end of the year.

JS: In addition, if you want to incentivize your leaders to focus on those areas, you have to reward them for having done a good job in some of those same areas. We're developing a compensation statement system that values out everything so that they know each component at all times. We found those statements have been very helpful in conversations.

LIMITS OF COMPENSATION

As firms are looking to diversify capital sources, specifically into private wealth, how does this affect how you think about incentives?

JS: Your capital source directs the strategy. In our case, we are focused predominantly on value-add strategies. Carried interest is a common component of that type of investing. For core-plus funds, carry may not be a major component for that strategy, so you have to figure out some other way of creating rewards for your employees.

KR: I agree that capital sources dictate the incentives structure. Layered over that, we work to make sure we have cultural consistency across incentive and equity opportunities. Incentives need to be anchored in creating long-term value for our clients, which in turn drives long-term value for our business and its stakeholders.

Any final comments?

JS: As people have moved around across firms with more frequency in the last five to six years, succession planning has become increasingly difficult. We are moving to annual updates of our succession plan, which we did not do before. You can get the compensation right and if you don't get the path right, as Kristin pointed out, you'll still lose the best people; it follows that compensation considerations are necessary but not solely sufficient.

KR: But not solely sufficient. I like the idea, Jim. When we think about succession, and to us the progression of the firm, the focus on incentivizing future leaders of our business is of course economics, but it's also opportunity. It's progression, professional development and value-add, as well as culture. We like to say that culture often doesn't win the business, but it certainly can lose it for you. Maintaining a positive culture and an open dialogue is equally paramount for us as the progression and the professional development piece.

The view over the long term, of course, is to maintain flexibility because, as Jim mentioned, people do move, life circumstances change and skill sets evolve. Our goal is to make sure we have that broader bench of talent, the right incentive tools, the right culture and the right growth opportunities to retain that broader bench over time.

> “You can get the compensation right and if you don't get the path right, you'll still lose the best people; it follows that compensation considerations are necessary but not solely sufficient.”

CONCLUSION

Keep going and have conviction


iStock.com/Nuthawut Somsuk

With the various tools and levers managers have to incentivize and retain talent, getting compensation right is one piece of the puzzle, as is communicating clearly and well. And as Josh Anbil says, it's also about having conviction around eligibility and, importantly, getting started and keeping momentum.

What can managers do to compensate more effectively?

It's a shift in perception: managers should view compensation as a tool for going on offense, not for playing defense. When compensation is or feels defensive and reactive, it normally doesn't function well. They send a message that the organization is just winging it, even when that's not true. Frequently perception is reality with compensation.

Going on offense means, in order:

1. be proactive and establish a clear compensation strategy; then
2. create the right compensation structure and incentive plans that support that strategy; and after that
3. develop the amounts, performance and HR-related process for compensation.

Doing those things in reverse and taking a more individualized approach to compensation is what causes the defensive and reactive compensation practices. The order matters. Otherwise, you're left with organized chaos.

Simply put: have a point of view, establish compensation that supports that, and stick to it. Be open to adjustments along the way, but avoid consistently making exceptions to the rule and instead consider holistic adjustments from time to time as your business evolves and industry conditions change.

Last, but certainly not least, make sure your communication around compensation is rock solid. I see lots of great compensation plans tank due to poor communication and implementation. I also see mediocre plans succeed because they were rolled out successfully and the messaging across the organization is consistent. The last inning of the game is implementation and communication. Substance trumps form, but form matters. You can win the first eight innings and lose the game, and vice versa. ◆

" Make sure your communication around compensation is rock solid. I see lots of great compensation plans tank due to poor communication and implementation. I also see mediocre plans succeed because they were rolled out successfully and the messaging across the organization is consistent. "

NAREiM

Benchmarking research

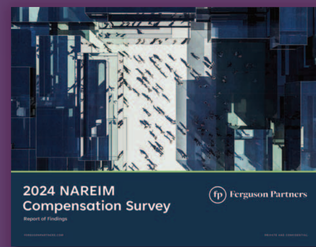
Global Management Survey

Released in May

Produced in collaboration with Ferguson Partners

Covers more than 65 individual data points broken down by AUM and risk strategy, including:

- *Revenue:* Capital raising and net and gross AUM growth, new commitment trends, investor concentration ratios, dry powder and subs lines.
- *Expenses & organizational metrics:* Headcount growth, employees per $1bn AUM, employee breakdowns per function, per function and seniority, functional group trends.
- *Financial metrics:* YOY financial performance, EBITDA (pre- and post-bonus) margins, bonus pools, revenue and expense breakdowns.
- *Fund/Account T&Cs:* Target returns, fees, carried interest, co-investments.
- *Governance:* Composition of executive committees, board of directors, management and investment committees, SEC registration.



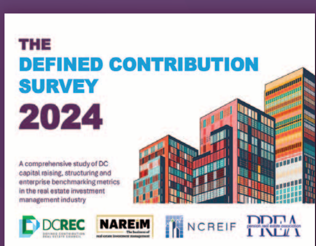
Compensation Survey

Released in September

Produced in collaboration with Ferguson Partners

400+ pages of individual position compensation reports, plus annual trends relating to base, bonus, long-term incentives, promote/carry, co-investment and benefits including functions within:

- Executive management, accounting (corporate, portfolio/fund, property), asset management, capital markets, corporate marketing and communications, due diligence, engineering, environmental, finance, human resources, investor relations, capital raising, leasing, legal and compliance, portfolio management, property management, risk management, technology, transactions, valuations, debt and REIT securities.



Defined Contribution Survey

Released in October

Produced in collaboration with the DC Real Estate Council, NCREIF and PREA

The annual Survey benchmarks:

- Capital flows of DC capital into private real estate strategies.
- AUM growth YoY.
- Target allocations and liquidity sleeves.
- Resourcing and staffing to support private real estate DC products.

DEI Survey

Released biennially in January

Produced in collaboration with NCREIF, PREA, REALPAC, ULI, Ferguson Partners and 14 other leading CRE associations

Only corporate benchmark for DEI metrics and best practices in commercial real estate globally. This report covers data points including:

- *Employee demographics:* Gender and ethnicity composition by seniority and job functions.
- *Best practice metrics:* Relating to the implementation of DEI strategies and initiatives across investment management organizations, including issues relating to ownership & staffing, accountability, tracking & measurement, retention & recruitment, external partnerships & activities, pay equity & transparency.

For more information, please visit www.nareim.org

You may know your IQ and your EQ, but what about CQ? As real estate investment managers focus on talent retention through the next cycle, conversations are moving towards how companies focus on inclusion and employee engagement for everyone.

CQ, or cultural intelligence, is a critical tool in the armory of inclusion and DEI strategies, and should come before affinity and employee resource groups are established. It is the building block of not only DEI or talent strategies, but also how you drive performance across key talent and leaders in your firm and in your assets and portfolios. NAREIM speaks with* Clarion Partners*,* Ferguson Partners *and* Revantage *on how to get CQ right.

By Zoe Hughes

Rethinking performance *through the lens of* INCLUSION

iStock.com/VectorMine

PARTICIPANTS

Sherrida Traynham, *Senior Vice President, Senior HR Business Partner,* **Clarion Partners**
Sherrida provides human resource management support to Clarion's Acquisitions, Portfolio Management, Asset Management and Client Capital Management groups. Sherrida is also responsible for Talent Management, Employee Engagement and DEI strategy/partnerships/programming. She is a member of Clarion's DEI Council and ESG Committee. Sherrida has 20 years of financial services industry experience.

Dionna Johnson Sallis, *Head of DEI and Director, Leadership Consulting,* **Ferguson Partners**
Dionna's primary area of focus is to lead strategic initiatives — based on industry best practices — informed by her subject matter expertise. Creatively, Dionna offers customizable inclusivity solutions while also providing consultative services for clients. She develops leadership strategies and she also guides key stakeholders in her clients' organizations by coaching and developing senior leaders to create more inclusive work environments.

Jami de Lou, *Vice President of Diversity, Equity and Inclusion,* **Revantage**
Jami is a passionate leader driving cultural transformation and inclusive leadership. With over 15 years of experience in DEI, talent management and learning, she has a proven track record of creating inclusive workplaces. As VP of DE&I at Revantage and founder of de Lou Strategies LLC, Jami pushes beyond the status quo, tackling systemic change with her unique blend of cultural intelligence and change management.

What do you consider to be an inclusive strategy?

Sherrida Traynham, Clarion Partners: An inclusive strategy focuses on whether employees feel like they belong, have access to opportunities, and can grow, learn and have a successful career at the firm. We have several focus areas in building an inclusive workplace at Clarion; these range from embedding DEI into talent management processes to increasing inclusive leadership capabilities to engaging employees in ways that celebrate differences.

Jami de Lou, Revantage: Inclusion strategies are crucial for creating environments where all individuals feel valued, respected and empowered to contribute fully. What are the things employees can see, feel directly, and engage in and be a part of? And what are the inclusive systems and workflows behind the scenes that benefit them passively?

At Revantage, our inclusion and action strategy focuses on three pillars: ensuring inclusive talent processes, building cultural intelligence, and cultivating engagement and allyship. We consider inclusion not only what we can cultivate internally, but also the impact we have on communities.

Dionna, how are investment managers thinking about inclusion?

Dionna Johnson Sallis, Ferguson Partners: In 2020 many managers created ERGs and employee resource groups to address inclusion. As markets toughened in the past two years, a third of groups have pulled back on DEI efforts as they pivoted to focus on performance and time allocation within their organizations. DEI is still important, but organizations have gotten more creative with how they 'hide the veggies.'

Inclusivity is the entry point. It has a humanistic component that brings all teams and people together, even homogenous ones, because of shared experience. Inclusive leadership primes a team or an organization to become more diverse in the future. To run a successful program, you need a clear mission. Establish operating goals and purpose, define leadership goals within DEI committees — will there be a chair, a co-chair? — and engage executive sponsorship so the DEI committee or ERG is able to drive change and track and measure progress.

BIG VS. SMALL

What are your organization's efforts to achieve inclusion goals?

ST: Our inclusion efforts include the launch of our DEI Council, which helps foster a welcoming environment, values diversity of life experiences and perspectives, and encourages innovation.

One of the key focus areas for the DEI Council is DEI programming and education opportunities. An example that has worked well is the celebration of cultural heritage months across our offices. Cultural heritage months provide an opportunity for employees to recognize and learn about the experiences of their fellow colleagues, which increases cultural awareness.

JdL: As a smaller organization growing out of the start-up phase, the question for us is: do we have enough people to lead engagement with multiple ERGs, or is there a creative approach we can apply? For example, some organizations have inclusion accelerators, which are modernized councils to foster community connection and representation. These small working groups of about 20 early adopters, advocates, allies and people bring representation across different demographics. It's thinking about different communities in your organization and asking: how are we advocating for their distinct needs and how is everyone interacting across those identities, cultures and experiences?

If inclusion accelerators can create a sense of community, should smaller and mid-sized managers aim to create ERGs?

JdL: What is most important is to make an informed choice. What DEI strategy are these groups connected to? Smaller organizations may only have the capacity to support or have enough representation for one or two groups. People who don't belong or identify but are looking for connection while feeling underrepresented may feel left out and isolated when you focus on one group over another.

Employing an inclusion accelerator can be a great step for smaller organizations before establishing ERGs or affinity networks. Inclusion accelerators help at all organizational, departmental and demographic levels by bringing forth ideas and advocating for those people engaging in and coming to the table. They are directly tied to DEI initiatives and strategic pillars, and support the unique needs of the collective.

DS: The truth of the matter is you can have a positive impact in the space of inclusivity without having ERGs or DEI committees. Jumping forward too far without the right structure can do more harm than good. You can add value in different ways. You don't have to create specialized groups; having a broader mindset and operating in the spirit of inclusivity could achieve the same end. This is why I say inclusivity is something that's going to save us all.

GETTING THE FOUNDATIONS RIGHT

Let's take a step back. How do you begin this journey of inclusion?

JdL: First, assess and understand where you are in your DEI journey. From there, create a strategy, get clear on what you need, what exists and what doesn't, and how you build the infrastructure. While inclusive leadership often focuses on a top-down approach, I prefer a top-down, middle-up. Middle managers are frontline leaders in this effort; they are the individuals that have the greatest impact and, usually, the biggest head count. Through them, we close the gap faster.

Importantly, your DEI strategy must connect to your business and people strategy. At Revantage, we have a

Jami de Lou

"The biggest unlock we can create in the workplace is helping people understand each other cross-culturally and building EQ skills to navigate challenges, tension, discomfort and conflict. If you combine cultural intelligence and behavioral science, mesh them together, and give people those skills, we will unlock innovation and belonging faster than ever before. We often hear that organizations are trying to solve inclusion through ERGs or affinity networks, but why are we not solving for belonging where people spend the majority of their time, within their departments and projects teams? We should be solving on a collective whole."

connection pillar focused on building the cultural intelligence of our employees and developing inclusive leadership skills. We call this CQ — some call it cultural competence. We employ a multi-prong approach, including dialogue sessions for employees and on-demand learning, and we use an assessment with workshops and 1:1 coaching rolled out by department. We measure CQ and give people the language to talk about it. We're also building, assessing, and ensuring inclusive systems and processes. So, we're affecting behavioral change and systematic change simultaneously.

ST: Jami, you're right about the impact of mid-level managers. They are at the forefront of DEI efforts as they interact with employees every day. It is important that managers model inclusive behaviors as this sets the tone.

For Clarion, inclusive leadership encompasses diverse representation to ensure that various perspectives are represented in decision-making across the firm. We also think about the construction of teams in an inclusive workplace; as there are various dimensions of diversity, simply being open to mobility within the organization is also a great way to bring diverse teams together.

DS: We start many of our conversations with data and an understanding of what our clients want to achieve. There are organizations that recognize they need to be more diverse and understand the need for training and workforce readiness before bringing in diverse talent. When there is reflection and maturity, plans are often well-thought-out and sticky.

Programs that are focused around culture IQ or cultural competency are extremely important in these spaces. Ensure your leaders are ready and understand the importance of this effort. Make sure inclusion is properly placed within the organization to maintain its importance to any sort of business objective. It shouldn't be an island of its own.

To add to Jami's and Sherrida's excellent points, while you're allocating resources, don't hesitate to train the leaders that you have. Underrepresented talent shouldn't be forced to lead ERG or affinity groups. Don't be afraid to equip the workforce, either. Part of equipping is training the leaders in this space. Only 3% of managers are investing in training their leaders to manage diverse teams, so train leaders on how to lead ERG groups. Help them to understand what it means to be an executive sponsor.

What does cultural competency or CQ training look like?

JdL: It's taking and embedding some of the core concepts about what it is to lead effectively and the inclusive habit that goes along with it to better understand each other. What knowledge across differences do you need to know? For example, what do you do when there are high deference and low deference team members working together? It's about understanding how we show up differently and interrupting negative shorthand habits and behaviors that many of us have had all of our lives.

ST: CQ training incorporates real-life scenarios to help employees think differently and change their preconceived notions and trained behaviors. We offer trainings and programs that promote cultural competency and foster engagement among employees from different dimensions of diversity.

DS: Those are great practices of inclusivity. Whether a company has DEI initiatives or not, it's not a matter of giving special treatment, it's a matter of taking a step outside of self,

Dionna Johnson Sallis

"The missing piece of the puzzle is that diverse teams are led well. You can't just put a group of people together and expect them to be successful and thrive without a sense of belonging or some sort of cultural carrier to guide them — that's not how people work. We see in the Global Real Estate DEI Survey that retention is slowing; people are leaving companies at much higher rates than they're hired.

Cultural readiness or cultural intelligence starts at the top. High performers who are put into managerial roles solely based on their performance as an individual contributor, without the proper training to lead diverse teams, often do not yield good results. It doesn't have anything to do with the fact that the team was diverse — it's the lack of readiness of our leaders in this space."

Sherrida Traynham

"In order to attract and retain diverse talent at Clarion Partners, we ensure our commitment to DEI is clearly stated through various channels of communication, such as our company website and LinkedIn. We have expanded our partnerships with DEI focused organizations where we play a role in educating and mentoring individuals. We continue to provide training on topics such as allyship, unconscious bias and inclusive leadership. The range of inclusion work that we implement is crucial; it takes varied efforts to truly build a culture of diversity and belonging where all people feel respected, valued and included."

taking a look at your team and saying what needs to be adjusted to provide the most value to those people in the room.

IMPROVING CQ

Individual groups like ERGs may not be the first solution needed; cultural intelligence is. How do we connect CQ to business strategy?

JdL: It's holding people accountable and saying, 'This is the culture we're creating. This is what matters to us here, and we'd like you to be a part of it.' As your company evolves, your DEI strategy should evolve with it and be communicated and embodied within individuals at your firm. At Revantage, our values are LLEAP: learners, leaders, enthusiasts, achievers and partners. You do need C-suite buy-in, and you have to keep equipping them to be the leaders and advocates modeling it.

ST: To your point about evolution, Jami, the social contract between the employer and employee has changed. Employees want to be part of organizations where inclusion is linked to business strategy and there is community involvement. People no longer merely want a paycheck; they want fulfillment, well-being, learning and growth. Employees now expect a more holistic social contract with their employers which includes a focus on DEI.

DS: Inclusivity is the destination. Cultural intelligence and cultural competency are the road and highway we take to get there.

How do you measure CQ?

JdL: The intercultural development inventory or IDI is an effective measurement of cultural intelligence. It measures where you think you are and where the assessment plots you. What's the gap? If you have enough data across your organization, you can look at it by department or level. You can plot results on a continuum. Most people plot in minimization at the midpoint because so much of our society is about downplaying differences.

DS: The IDI is one of my favorite assessments. There's no right or wrong. Instead, it measures one's level of understanding of sameness and difference. Your journey of cultural maturity is a personal one, and we all have unique experiences that have helped to define our perspectives.

I encourage clients to look at their own engagement survey data and actually do something with their results. Your employees have told you what it is that they want, what they see and what they need — use that as your starting point. Create that plan and then communicate. Say to your organization: 'We hear you; this is something that we are going to visit. This is our plan of action. We understand that budget is tight across the board.' Acknowledging the fact that you have taken time to analyze those results and doing something with your own organizational data is powerful.

Lean on tools like the Global Real Estate DEI Survey. What is happening in your industry? What are you doing in comparison to your peers? Employ the resources and tools at hand until you are ready to create a DEI committee, an inclusion accelerator or an ERG. ◆

iStock.com/Olga Kurbatova

Managing risks *through* CAPTIVE INSURANCE

The cost of insuring portfolios and assets has been rising with increasing changes in climate and incidences of catastrophic events. For real estate investment managers looking for alternatives to traditional carriers to manage risks, one option that has been garnering interest is captive insurance. NAREIM speaks with **KKR, Marsh** *and* **Pretium Partners** *on the different types of captives, common misconceptions, and operational considerations in creating and managing this type of vehicle.*

By IvyLee Rosario

PARTICIPANTS

Mona Sullivan, *SVP of Insurance Risk Management,* **AMC Insurance of Texas (a Pretium Partners wholly owned subsidiary)**
Mona oversees insurance, risk transfer and mitigation, captive management and other related risk management areas for Pretium Partners and its operating and portfolio companies. In this role, she leverages over 20 years of experience as a risk manager and insurance broker who has successfully developed, optimized and integrated holistic risk management and insurance strategies for clients and internal stakeholders.

Karen Hollinger, *Managing Director,* **KKR Capstone**
Karen is focused on value creation and operational enhancement for KKR's real estate portfolio in the Americas across all sectors and she contributes to the creation of investment ideas and evaluation of new investment opportunities. Prior to this position, she was an executive for AvalonBay for multiple departments in operations, strategy and technology. As part of her involvement in real estate, she has served as the Chair for several national association committees and often speaks at many conferences.

Julie Patel, *Senior Vice President,* **Marsh Captive Solutions**
Julie is a senior captive consultant who works with companies in exploring the captive concept as well as providing strategic advice to captive owners looking to optimize their captive. Her responsibilities include program design and overseeing feasibility studies, implementations and strategic reviews for existing captives. She also serves as the captive senior relationship officer on several large accounts. She currently serves as the Central Zone Captive Consulting Practice Leader for Marsh.

Can you give us a brief description of captive insurance?

Julie Patel, Marsh: Captives are a risk financing tool that helps managers develop and strengthen their insurance program. Some of the value drivers in utilizing a captive include financing an organization's corporate retained risks, accessing reinsurance markets, and using the captive as a profit center to underwrite a third-party business. It is a risk financing mechanism that can be utilized in various ways for first-party or third-party risks.

A captive can be a conduit to access reinsurance markets, or it can provide additional capacity. The commercial market does that: it accesses and lays off risk to the reinsurance market, which results in frictional costs to the insured. With a captive, you have direct access to the market.

There are different types of captives, including single parent and cell captives. Single parent captives are wholly owned subsidiaries of the parent organization that typically ensures or reinsures its own corporate risks. Cell captives are very similar to single parent captives, but, instead of being a wholly owned subsidiary, you rent a cell within a sponsored facility.

One question we hear a lot is, is there a minimum size for a captive?

JP: I don't believe there is. Managers may question if they may be too small for a captive, or if a captive is right for them. Captives are not a one-size-fits-all tool. You have to look at them individually and assess what the needs of the organization are.

For some managers, the operational value is worth the captive operational cost. That may come as a surprise to risk managers that a captive doesn't have to produce material financial savings — sometimes it may be a cost or it may break even. Breaking even may be part of the organization's long-term strategy; markets are cyclical and, at some point, it may be difficult to get insurance for certain limits or at a competitive rate. During these times, your captive can be a great solution. Alternatively, when markets are soft, you have the flexibility of continuing the captive program as is, or you can adjust it and go back to purchasing a portion or all from the commercial market.

What I would advise is for clients to speak with a captive consultant to identify opportunities, and then potentially do an evaluation such as a feasibility study to determine if there are financial and operational benefits of utilizing a captive.

Karen, Mona, can you speak about your experience with captives?

Mona Sullivan, Pretium Partners: We recently established a captive at Pretium. In my experience, captives have been a great platform to demonstrate to carriers we have the ability to take on losses and to build our own program. With a captive, we're asking markets to help us in terms of pricing, coverages and markets we can approach.

JP: That's a great point, Mona. Over time, as the captive gains financial strength, you are able to leverage the captive against the markets; your dependency on the commercial market reduces. If carriers know you have a captive and you're not afraid to take risks, they may be more willing to work with you on pricing as well as capacity.

Karen Hollinger, KKR Capstone: We do not currently have a captive but we reassess frequently. Some view captives as either a scale play that doesn't apply to them or as a quick path to added risk when that's not the risk we want to take. We want to take real estate risk, not insurance risk.

We have a master plan for property & casualty. However, given the tightening of the insurance market, and particularly in some states, we're not only thinking about costs, but also the availability of insurance. We must have tools in the toolbox to continue to insure our assets, not only for P&C but also for DNO and ancillary lines like renter's insurance.

JP: We've seen an increase in ancillary lines in the past five years. The beauty of a captive is you can put multiple types of coverages in it and you can structure it any way you wish.

GETTING FACTS RIGHT

There are a lot of misconceptions about captives. What should a risk manager who wants to explore this tool know?

JP: Having internal buy-in from your various stakeholders is very important. Part of that is educating different groups within the firm. Captives are not limited to insurance and risk management; they also impact tax, finance, legal and accounting. It is important to make sure everyone is on the same page.

> "Some view captives as either a scale play that doesn't apply to them or as a quick path to added risk when that's not the risk we want to take. We want to take real estate risk, not insurance risk."

MS: The simplest way to get that buy-in is to sit with leadership and explain that the firm is already paying, say, $4 million in claims each year; so why don't we try to aggregate that amount into a spot where we can leverage ourselves in terms of capacity and pricing with our carriers?

Carriers will do a feasibility study for you. They break it down into layman terms of, 'You are spending this much and this is how the captive can help you.' It's incredibly helpful and eye-opening to see it presented like that.

With real estate, the challenge is the industry doesn't think of insurance until there's a catastrophic loss. You want to create a captive before losses happen.

JP: Historically, clients have been reactive; they wait to see what happens in the market and, based on that, they may set up the captive. As markets hardened in 2020 through 2022, we saw a lot of clients interested in getting the captive up and running as soon as possible, especially as they got closer to renewal dates.

Now that some market conditions are improving, we are surprised that the interest has not let up. We still have clients just as interested because they know the market is going to turn again. It takes time to do a feasibility study and to establish a captive. If clients already have a captive set up, they have this tool in their tool chest they can rely on at any time.

There is an investment in time and money to get the captive set up. Then there is the ongoing cost to operate the captive. I think a lot of people are surprised that the cost is really not as expensive as they would have anticipated it to be. It's figuring out what's a good starting point and then building on to see, 'Is it worth it to invest X amount so you have this tool readily available to you?'

> “We looked at captives to: one, look at our claims; two, go with what the market was telling us; three, manage the risks of our single-family rental assets; and four, address concerns of our lenders. It has worked tremendously in our favor.”

Mona, tell us about your captive. What does it cover? What aspects of traditional insurance does it replace?

MS: We looked at captives to: one, look at our claims; two, go with what the market was telling us; three, manage the risks of our single-family rental assets; and four, address concerns of our lenders. It has worked tremendously in our favor.

We are examining the company’s plan and determining other asset classes we wish to acquire. Our considerations are our long-term holds on our assets and lender requirements. We are also reviewing our structured layer program on our property side, how much risk we can absorb, and best practices around our internal operations.

KH: Have there been any changes in how you manage assets because you are taking on more risk?

MS: In practice, captives can also be a way of managing deductibles by keeping attritional losses low. In the past seven years, however, deductibles have been increasing. Carriers want to see 250, 500 property, casualty, auto deductible amounts.

JP: You bring up a good point about keeping those deductibles low, Mona. Deductibles levels are increasing and carriers are not giving any credit for those increases. The fee is going to stay the same, but you need to increase the deductible — in some cases double.

If you are forced to increase those deductibles or retention points, you can use the captive to buy down the deductible or retention for the local assets. Many local properties may not be able to take a $1 million deductible or retention, but with the captive you may be able to buy it down to, say, $50,000. Fifty thousand is much more doable on an individual basis. The captive fills in that gap and, for the properties, the structure is as it was before, even though the structure has changed quite a bit in reality and the organization is taking a higher deductible or retention.

Can you walk us through the process of creating a captive?

MS: The process can take six months to a year, including getting buy-in. Creating the actual captive takes three to four months because you have to go through one renewal cycle, depending on the line of coverage you want to take on. For example, with renter’s insurance, you want to figure out what you can absorb, what line of coverage you want, what you want to deal with, the education — and then go through a renewal process and get quotes from various coverages.

JP: That is in line with a lot of our clients. A key element is doing the assessment and education upfront. It can be through dialogue as well as a feasibility study. Once that is completed and the business plan is finalized, setting up the captive takes two to three months on average, depending on the domicile.

We have some clients that set up a cell captive in a much shorter timeframe — about two to three weeks. Although the

What are the top lessons you’ve learned from going through this process?

MS: Do not be afraid to ask questions and do not be afraid to gather resources or get the resources or find out where the resources are. Everybody's captive is different.

KH: The most difficult thing is the feasibility. It's hard to get a sense of the real benefits, risks and work to establish a captive.

JP: Captives are an investment. Have the right people involved from the very beginning and make sure everyone has a clear understanding of the value and considerations of a captive. The captive will morph over time, and it is important everyone evolves with it.

set up is much faster, I believe doing the feasibility study is still important. The study will explore options such as, 'Do you want to do a single parent captive?' 'Do you want to do a cell captive?' 'What makes sense to put into the captive?' 'What's the funding going to look like?' Cell captives are lower in cost.

With a cell captive, if you decide you no longer want to use the cell and want to exit, that's typically easy to do. However, captives are intended to be a long-term tool for managers. We see many clients starting off with cell captives, and then they either stay within a cell captive or they may decide they want a single parent captive and transition to that type of entity.

MANAGING FUTURE RISKS

Karen, what are some of the challenges you're facing with traditional insurance products that is making KKR consider a captive?

KH: One consideration is a growing asset base that includes housing. We are buying very new Class A assets with very few claims, but any insurer is going to be insuring us based on the average of multifamily claims or student housing claims, rather than our experience in a Class A environment.

The second consideration is the bumpiness of the property & casualty market, particularly in high-risk geographic areas. We need greater certainty about insurance costs. Third, our asset base is sufficiently large that we want more tools for determining who the insurer will be or for which insurance we will self-cover.

Many managers are moving to Sunbelt states for opportunities. Can captives be created to manage specific geographic risks?

JP: There are markets unwilling to offer or provide insurance in specific areas; we are seeing more exclusions for extreme or catastrophic weather in certain geographies. There is an opportunity for a captive to be able to provide coverage for these exclusions. It is important to note that the captive is a subsidiary of the parent company, so ultimately this risk is part of the organization. However, with the captive, managers are able to formally fund this risk and put aside dollars in the event there is a loss.

In real estate, most clients insure property & casualty in their captives, followed by professional liability. Some growth areas for captives include extreme weather event risks, as well as third-party P&C insurance, like contractor or vendor risk. We also see trade credit or public liability.

What are operational considerations when managing a captive?

JP: Your captive manager, which is a third-party service provider, typically oversees the captive. The manager will also select an auditor, actuary and local attorney for the captive. The majority of captives don't have full-time employees. Organizations that have multiple or very large captives may have dedicated captive resources internally that work together with third-party service providers.

From a timing perspective, there is a heavy lift at the beginning of the process to establish the captive. The first year is when you get all processes and best practices in place. Once it's operational, there should be an easy cadence that follows year after year. From a captive growth perspective, you also want to think about strategy like Mona said earlier, thinking about doing other things with it. There's a strategic conversation that will continue with your captive manager and consultant.

MS: I agree. The first year is the heaviest lift in educating and getting internal buy-in from all relevant parties within the firm. In addition, if you have a fronting policy, certain carriers only work with certain banks. ◆

"There are markets unwilling to offer or provide insurance in specific areas; we are seeing more exclusions for extreme or catastrophic weather in certain geographies. There is an opportunity for a captive to be able to provide coverage for these exclusions."

Complying with legal and regulatory requirements is an essential part of operating a business. Despite legal and compliance being a key role within an investment management firm, obtaining appropriate resources to keep abreast of increasing regulatory scrutiny can be challenging. NAREIM speaks with **Broadshore Capital Partners**, **Cabot Properties** *and* **Unico Properties** *on hiring versus outsourcing, 'crossing the street in a crowd', and using technology, including AI, to help with compliance.*

Staffing & resourcing *for* compliance

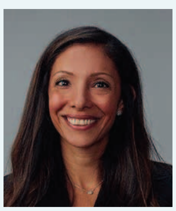
By IvyLee Rosario

iStock.com/Nuthawut Somsuk

PARTICIPANTS

Elena Branzburg, *General Counsel and Chief Compliance Officer,* **Broadshore Capital Partners**
Elena is responsible for managing legal and compliance affairs for Broadshore, a majority owned subsidiary of the Guardian Life Insurance Company of America, advising the Board of Directors and CEO on legal and compliance matters pertinent to the firm, and serving as primary liaison to the firm's external counsel and regulators. Elena also serves as Assistant General Counsel of the Guardian Life Insurance Company of America.

Kara Brown, *General Counsel, Chief Compliance Officer & Secretary,* **Cabot Properties**
Kara draws from over 15 years of experience with SEC-registered investment advisers to oversee Cabot's compliance program and legal activities, alongside its HR and IT teams. She has managed compliance programs for RIAs and counseled private fund advisers through regulatory exams and investigations, both while in-house and in private practice. Before joining Cabot, she was a counsel at Sidley Austin and a member of their Investment Funds, Advisers and Derivatives and Securities and Derivatives Enforcement and Regulatory practice groups.



Marjan Foruzani, *Legal Counsel,* **Unico Properties**
Marjan oversees a diverse and complex portfolio of legal matters for Unico Properties, including real estate, financing, construction, private equity and regulatory compliance. She manages and supports outside counsel, and draws from her diverse practice to advise Unico's board and executive committee on strategic matters. Before joining Unico, she was counsel at Davis Wright Tremaine where she represented landlords, developers and tenants in a variety of commercial real estate transactions.

Can you describe your experience with staffing and resource planning within the legal and compliance departments?

Kara Brown, Cabot Properties: As we tend to be more of a cost center than a revenue driver for our firms, it can be a challenge to advocate for resources in this area. We're probably lower down on the list to get additional staff in comparison to some of the other groups that do drive revenue. However, the SEC and other regulators stay relatively present and vocal, which can help in these discussions.

Elena Branzburg, Broadshore Capital Partners:
I would echo those sentiments. Even if you get headcount for one or two additional staff, how do you allocate those? For what role do you hire?

I encountered this problem when I first joined Broadshore to build out its legal and compliance program. We weighed the benefits of hiring a junior compliance associate vs. outsourcing the function to a third-party firm and decided to outsource to Kroll (formerly Duff & Phelps). As a larger firm, Kroll had a team of various experts we could tap from; if we had instead hired a single associate, that person would have had to wear many hats. It would be hard to find this one person on a constrained budget. The way I looked at it was, how do we do more with less? Sometimes that means outsourcing.

Marjan Foruzani, Unico Properties: I agree with Kara and Elena. You have to make the business case for adding resources. There is also the question of short-term versus long-term planning. We prefer to train in-house resources from other groups and potentially outsource temporary hires in the near term.

INTERNAL RESOURCING VS. OUTSOURCING

How do you decide which resources to allocate internally, and which to outsource if hiring is not an option?

KB: It depends on your objective. Sometimes you want someone who really understands your business. This could be someone with an expertise in reviewing marketing materials, or whose institutional knowledge would be crucial in drafting policies. Sometimes you want more of an external regulatory perspective, which is where outsourcing can be helpful.

For our firm, it has been helpful to outsource things like email review or social media review, because we do want that outside perspective. There's also an element of privacy. We want to keep the compliance group outside of employees' emails and social media accounts as much as possible. Unless there's a need, it feels intrusive, and so is better done by an external group with an algorithm than by one of our employees.

EB: Especially for some of the review components, I think it is helpful to have an unbiased third-party working with you at arm's length.

Alternatively, there are benefits to internalizing the function. It allows the in-house personnel to have full ownership of whatever process or issue they're addressing. However, when you are resource-constrained, and you can't build out a full team, it is nice to be able to access the diverse perspectives of an outsourced third-party team.

MF: It is striking a balance between the institutional knowledge of the company and the breadth of experience that you get from outside resources. This has been our challenge with temporary hiring decisions and outsourcing.

Even when making a temporary hire, you invest quite a bit of time in getting them up to speed with company and institutional know-how. By the time they have begun to add value to the firm, you may already be looking at how long their engagement will continue for.

EB: A big factor for us with outsourcing is the need to supervise, as such third parties won't have institutional knowledge. It then becomes a question of bandwidth.

KB: That's a great point, one that is sometimes lost on other decision makers at the top of the firm who view outsourcing as a perfect solution. It often requires a lot of resources, especially if you want a quality product from that review or outside engagement.

Elena, you mentioned best practice and market. That's really important. Investors probably have expectations around what can be outsourced. One of my favorite sayings when it comes to compliance is 'crossing the street in a crowd'; if you're the first one to begin outsourcing, you might get more scrutiny around it, whether from investors or regulators. But if it's common practice, it's more acceptable and likely helps with ancillary issues like cost allocation.

TECH TOOLS FOR COMPLIANCE

Which technological tools and platforms do you find most effective for managing resources and ensuring compliance?

EB: We use ComplySci for reviewing personal trading, approving outside business activities, and political contributions and quarterly/annual certifications. We also use Moody's BVD for know your customer (KYC) checks. It runs continuous checks and sends alerts. It has been helpful to not have to do those checks manually.

KB: We use a similar product from ACA called Compliance Alpha. When I joined Cabot, all of this was manual, and that worked at the time, because the company was a lot smaller. As we've grown, having a platform like ComplySci or Compliance Alpha is necessary.

It amazes me how many new pieces of technology are coming about to address the rules and things coming our way. Vendors are developing technologies as fast as we're trying to get our heads around some of these new rules, like the Corporate Transparency Act. There are many more choices in terms of vendors today than ever before.

Still, I'm always thinking about the cost of implementation, not only financially, but also regarding the burden on the team. It's a lot to integrate a new resource,

“It is striking a balance between the institutional knowledge of the company and the breadth of experience that you get from outside resources. This has been our challenge with temporary hiring decisions and outsourcing.”

Helpful tools and platforms for legal, risk and compliance

- BVD (a Moody's company) for know your customer (KYC) checks
- Compliance Alpha by ACA for reviewing personal trading and approvals, outside business activities, and personal training and political contributions
- ComplySci for reviewing personal trading and approvals, outside business activities and political contributions, and quarterly/annual certifications
- Egnyte for document management
- Juniper Square for investor management and investor communications
- Salus GRC for annual reporting services

whether it's you working on it directly, or someone on your team, or a different team, such as the accounting folks. You want to vet the technology thoroughly before you bring it on, because oftentimes the vendors can't anticipate all the issues that'll come up. It creates more work upfront, although hopefully not for the long term.

MF: We use Salus GRC for annual reporting services and Juniper Square for investor management and investor communications. We also just implemented Egnyte for document management.

KB: It's also important for senior compliance, legal and risk professionals to be talking frequently with our IT people and the people who are bringing on new technologies for the firm. Some of the tools that seem really helpful to me right now, from the outside, might be similar to things we're thinking about internally as we grow, such as moving content to the cloud. Wherever possible, we're trying to consolidate, and to avoid bringing on new things just because they have a few more bells and whistles.

How are you thinking about AI?

MF: We're always considering efficiencies and I think AI could be a big part of that. A couple forms of AI technology that immediately come to mind are abstracting and vendor management technologies. I think those would be helpful to our teams.

EB: As Broadshore is a subsidiary of Guardian, our cybersecurity, IT and AI policies and procedures are handled by the parent company. Guardian is looking into ways AI can be used in all its businesses, from insurance to investment.

KB: We're dipping our toes into AI. We've done certain things with it, like drafting job descriptions when starting to hire for a new role. It doesn't relieve the human interaction and the need for review — that's always going to be important —but it certainly can speed up some processes if it doesn't involve sensitive data.

STAYING UPDATED

How do you stay updated on the latest tech trends and tools that could benefit your resource planning or potentially hiring people in the future?

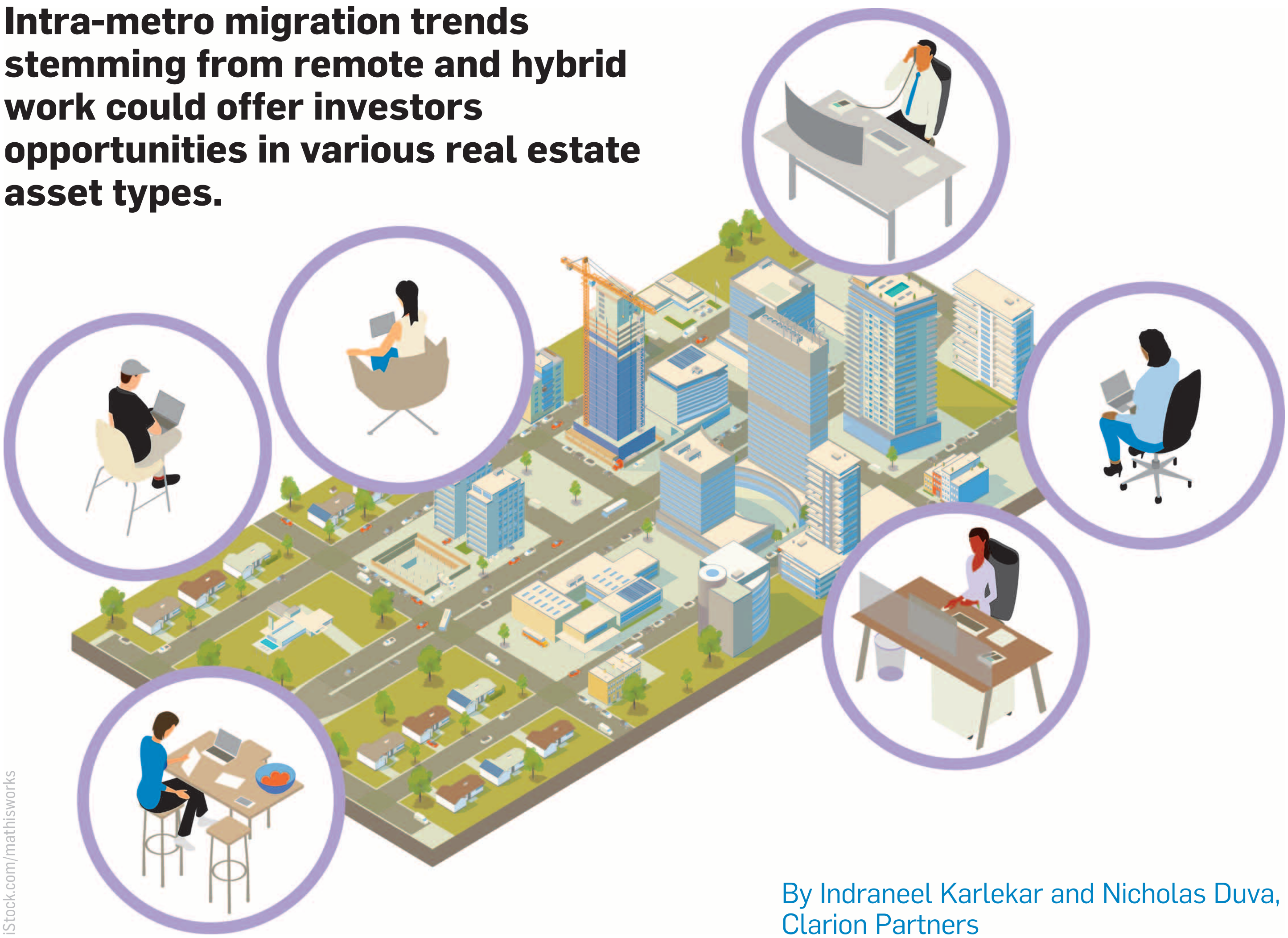
EB: As Kara said, it's 'crossing the street in a crowd.' We're thoughtful and measured about technology. It's thinking about our needs and resources. With any new technology, it might seem like a great solution at first, but it is often harder to onboard new technology efficiently than most sales pitches make out.

KB: I completely agree. It is very helpful to speak with other networking groups about which technology or vendors we're using for certain things. To Elena's point, vendors don't know the ins and outs of your business. Oftentimes they don't have as solid of an understanding of some of the intricacies as our peer firms do, particularly if those peers have worked through some of those issues as they implemented the technology or have worked with the same or similar vendors. I appreciate the vendors that give you references that are similar to you — that's a very good strategy and mutually beneficial.

MF: I 100% agree that your networks are the best way to find out what works and what doesn't. ◆

Moving *within* metros

Intra-metro migration trends stemming from remote and hybrid work could offer investors opportunities in various real estate asset types.



iStock.com/mathisworks

By Indraneel Karlekar and Nicholas Duva, Clarion Partners

In real estate investment, investors have so far mostly focused on *inter*-metro movements, the shifts of people and capital between metropolitan areas. Recent examples include the well-catalogued migration tailwinds to major Sun Belt metros. Looking ahead, *intra*-metro migration trends — movements *within* metros — might be an especially useful, and possibly underappreciated, tool for investment decision-making.

The extent to which intra-migration patterns shift from pre-2020 levels depends on:

1. *Demographic shifts.* Millennials are entering peak household formation stages and prioritizing schools and spacious housing.
2. *Increased remote and hybrid work patterns* that significantly impact where people choose to live, influencing local real estate markets and creating new investment opportunities.

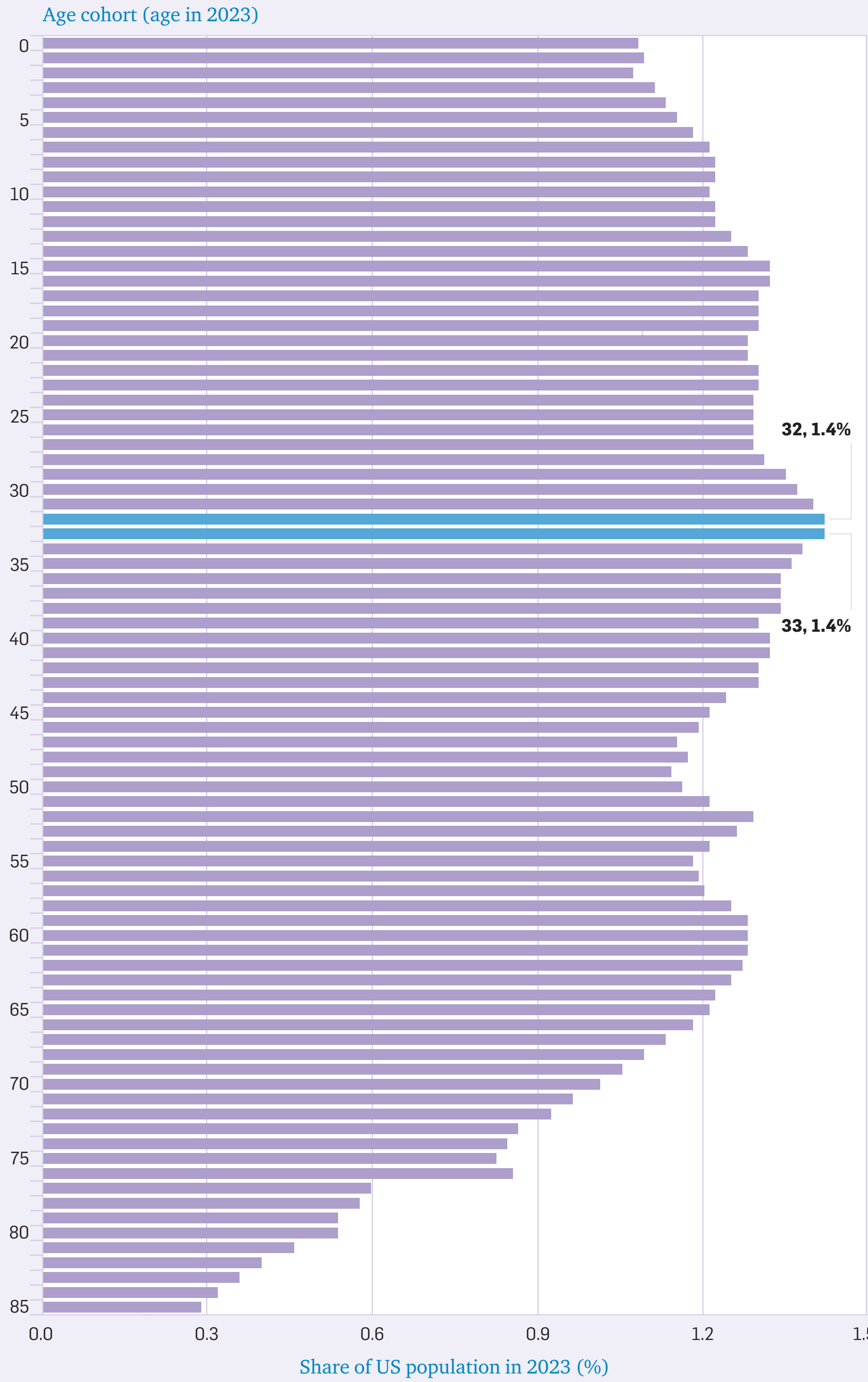
In short, we believe that persistent remote and hybrid work and demographic shifts together amplify a suburbanization trend that could offer a variety of real estate investment opportunities.

Changing age structure

While not as widely discussed as the baby boom period following the Second World War, there was a spike in birthrates in the early 1990s.

As of 2023, according to the Census Bureau, the largest age cohorts in the United States were aged 32 and 33 years old, respectively — this group is just beginning to enter peak household formation years (see Exhibit 1). In 2018, those same cohorts were aged 27 and 28, and by 2028 they will be aged 37 and 38.

Exhibit 1: United States population age



Source: US Census Bureau, Clarion Partners Investment Research, June 2024.

> “ Considering that Americans are having children later in life, demand for residential space in suburbs with strong schools and near job opportunities can be expected to accelerate in the near term. ”

Charlotte: Well-off suburbs see post-2022 growth

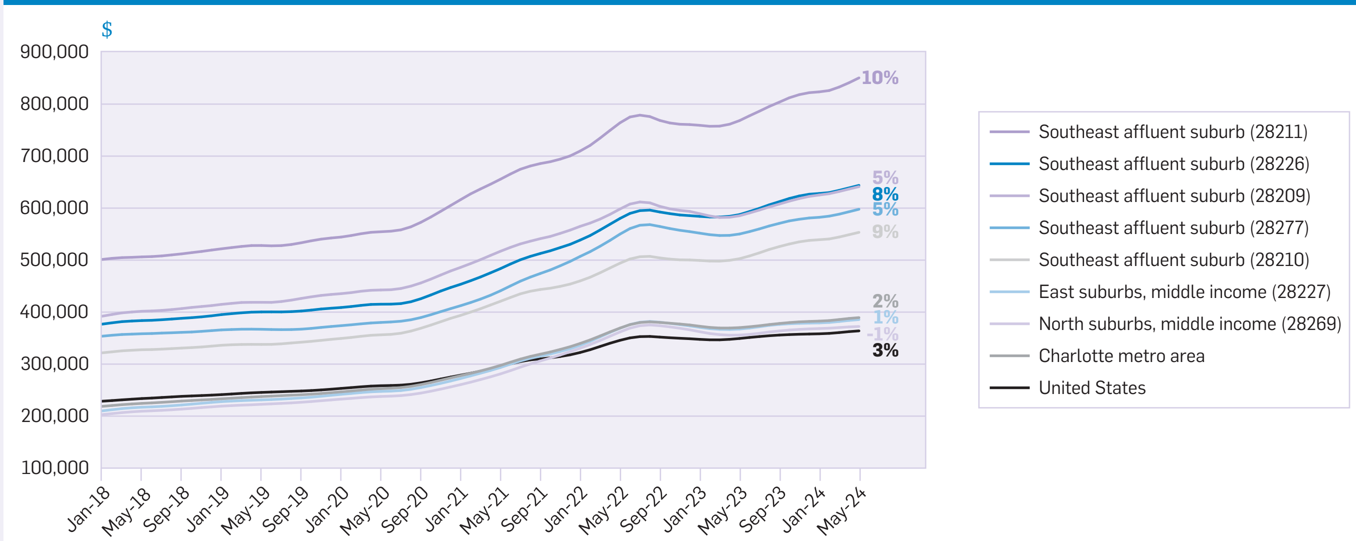
Interesting shifts in locations where households lived, worked and consumed goods and services occurred in Charlotte, North Carolina. These shifts have been driven by the way Americans increasingly work (hybrid and remote), as well as aging demographics.

Public use microdata areas (PUMAs), which have no fewer than 100,000 people, are the smallest geographic units for which the US census offers a variety of employment and commute statistics — including whether a resident worked from home in the last week.

In 2022, the Charlotte City (South) PUMA had a WFH rate of 33%, well above the Charlotte metro (22%) and national (15%) averages. The largest occupational categories in this PUMA include chief executives, financial managers, software developers, lawyers and judges, and management analysts — all overrepresented relative to the metro and nation — as well as retail salespersons, cashiers and registered nurses. Census data clearly suggest that a disproportionate number of professionals live in zip codes such as 28211 and 28226, which are almost entirely contained in the Charlotte City (South) PUMA.

Such neighborhoods and other zip codes mostly or partly in the Charlotte City (South) PUMA also have high incomes, home prices and public school ratings relative to the rest of the metro. They also have much stronger home price growth since the previous mid–2022 peak; current prices average between 5% and 10% above their respective mid–2022 levels (see Exhibit 2). This compares to 3% above for the United States, 2% above for the metro, and 1% above and 1% below for two other middle-income Charlotte suburban zip codes at comparable commuting distance from Uptown. Crucially, this story of recent growth is not about suburbs generally, but a very specific type of suburb.

Exhibit 2: Single-family home price trends within Charlotte metro



Note: Uses Zillow Home Value Index (ZHVI). Please see https://www.zillow.com/research/data/ for full ZHVI methodology. There was a methodology change from August 2022 to May 2024.
Source: Zillow, Clarion Partners Investment Research, July 2024.

> “Only about 4% of hospitality jobs are fully work from home and only 16% are hybrid.”

Considering that Americans are having children later in life, with a mother’s average age at first birth rising to 27.3 years old in 2023, up from 25.6 in 2011, demand for residential space in suburbs with strong schools and near job opportunities can be expected to accelerate in the near term.

Structural shifts in the labor market

In a February 2024 study titled *Americans Now Live Farther From Their Employers*, data from payroll and HR solution provider Gusto found that the average distance between small- and mid-sized employers and their employees’ homes has increased sharply since the Covid-19 pandemic. This is especially the case for the highest earners and for those aged 30 to 39. Such increases were primarily driven by new hires post-pandemic; this group tends to live much farther away from their employers than those hired prior.

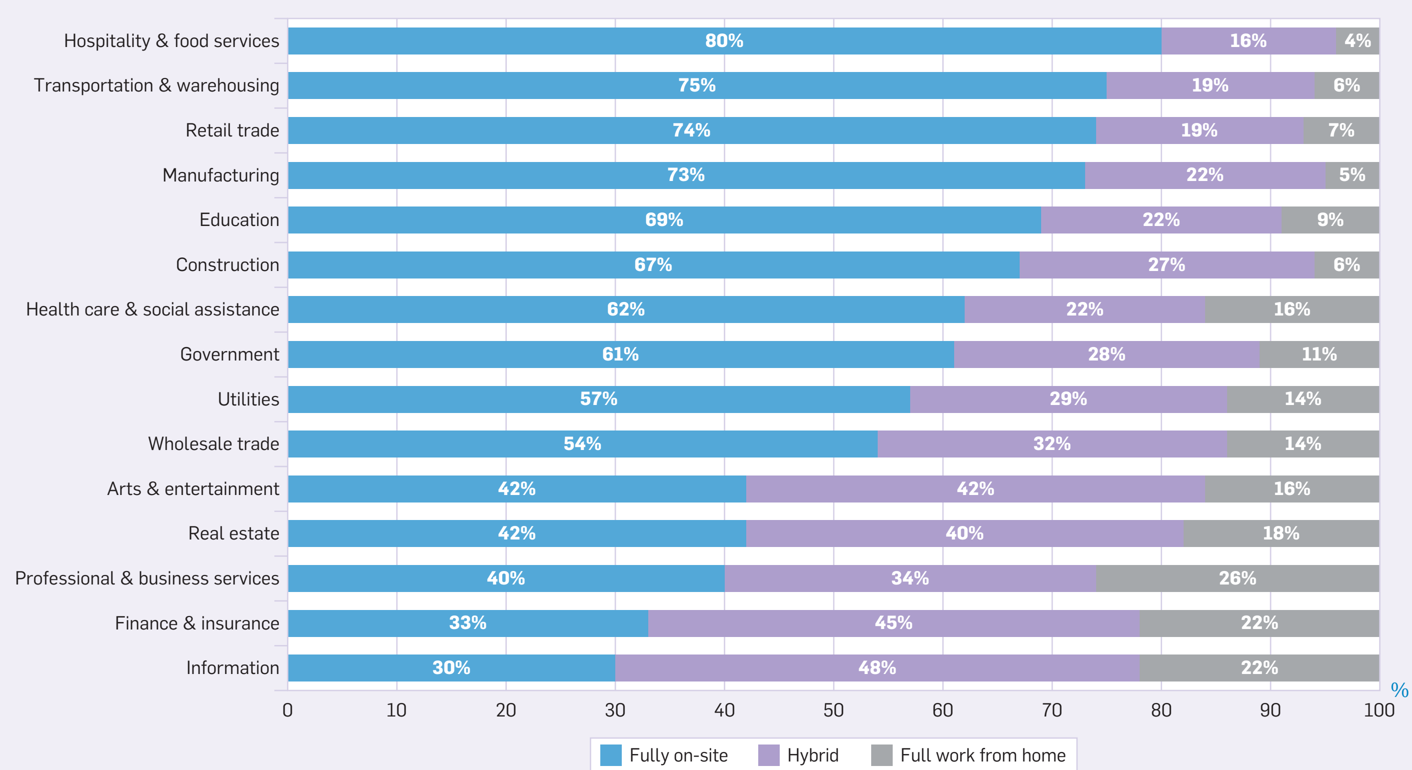
Smaller businesses in industries like technology, marketing and consulting may see competitive advantages in arrangements with a higher share of remote work, such as widening the scope of recruitment and retention, as well as cutting overhead costs.

Implications for investment strategy

So what do these shifting intra-city trends suggest for real estate investment strategies? As workers in WFH-sensitive industries spend more time near their homes, demand for local services and amenities should increase.

According to the Survey of Working Arrangements and Attitudes, only about 4% of hospitality jobs are fully WFH and only 16% are hybrid, compared to 22% and 45% for financial jobs, respectively (see Exhibit 3).

Exhibit 3: Share of major employment categories performed fully on-site, hybrid and fully work from home



Source: Barrero, Jose Maria, Nicholas Bloom and Steven J. Davis, 2021, *Why Working From Home Will Stick*, NBER Working Paper 28731, Clarion Partners Investment Research, June 2024.

> “While recent trends favoring the affluent suburbs may reflect other, temporal factors such as mortgage affordability, we believe that less-frequent commutes, combined with the US age structure, point towards relative outperformance in affluent suburbs for some time to come.”

Quick-service restaurant chains, for instance, are targeting affluent suburbs. This, to us, suggests demand from a variety of income cohorts will shift towards places where hybrid workers live. Crucially, this demand will not come just from relatively affluent hybrid workers themselves. While certain occupations are more ‘location-bound’ than others, that does not mean such jobs are necessarily going to be in the same locations as in 2018 and 2019. Just as a management analyst is more likely on a given day to be working in such affluent suburbs, so is a bartender or physician’s assistant.

Home price data represents the aggregate decisions of where people choose to put down roots. While recent trends favoring the affluent suburbs may reflect other, temporal factors such as mortgage affordability, we believe that less-frequent commutes, combined with the US age structure, point towards relative outperformance in affluent suburbs for some time to come. The recent evidence at our disposal suggests that residential pricing is beginning to reflect this.

Assuming they wish to capitalize on such trends, we suggest that real estate investors can pursue:

- Professionally managed garden-style and low-rise multifamily (including workforce housing) and single-family rentals (including build-to-rent).
- Shopping centers hosting gyms, restaurants and health/medical offices in such locations.
- Medical office buildings and other healthcare-related facilities.
- Self-storage facilities in and near such suburbs.
- Warehouse properties serving such locations.

Our analysis of Charlotte as a case study of a fast-growing metro suggests that investors should assign the same strategic importance to intra-metro dynamics as they do to inter-metro shifts. It is necessary, we believe, to abandon the sometimes latent assumption that metro areas are homogenous across all neighborhoods, and to consider to a much greater extent where within each metro is likely to see the greatest relative increases in residential and commercial demand. Our initial research on Charlotte suggests that affluent commuter suburbs are likely beneficiaries of the new economic geography and are worthy of broader investment consideration. ◆

Indraneel Karlekar, Ph.D. is Managing Director, Global Head of Research and Strategy, and **Nicholas Duva** is Senior Associate at Clarion Partners.

Using data to evaluate physical climate risk

LaSalle and ULI's new report provides an industry-wide framework for commercial real estate that addresses how data can be used in decision-making and supporting investment performance.

By Julie Manning, LaSalle Investment Management

> "The first challenge in evaluating physical climate risk is understanding what the data is, and isn't, telling you."

Measuring physical climate risk is of growing importance to institutional real estate managers and their investors, at both the individual property and portfolio levels. Of the $850 billion of commercial real estate assets tracked by NPI, LaSalle estimates $285 billion, or 34%, is situated in high and medium-high climate risk zones in the US. Increasingly, being able to accurately assess whether or not assets are at risk, and knowing how to price that risk into management strategies, are essential parts of operating a portfolio.

While data is key to this assessment, understanding how to leverage the right data is even more important. With so much climate risk data available in the market, how can organizations manage and find data that gives them manageable, impactful and usable insights? And more importantly, what should managers do with these insights?

Report overview

This question is at the heart of managing physical climate risk, and what led LaSalle to partner with the Urban Land Institute (ULI) on a report, *How to Choose, Use and Better Understand Climate-Risk Analytics,* to evaluate climate risk data providers and outline how to source and standardize reliable climate risk data. From this initial research, published two years ago, LaSalle found many firms were reporting data to their internal colleagues, and sometimes externally, yet often were still unsure of what a given dataset was saying about an organization's particular climate risks.

To help address this industry-wide issue, LaSalle again partnered with ULI earlier this year on a second report, which aimed to go deeper in developing an industry-wide framework that addresses how data can be used in business decision-making to ultimately support investment performance. The new report, *Physical Climate Risks and Underwriting Practices in Assets and Portfolios*, builds on the initial paper by highlighting how organizations can properly leverage good data to evaluate the costs of both action and inaction when it comes to investing in resilience.

Report contents

The first section of our latest paper outlines the industry's current status with respect to physical climate-risk analytics, discussing implications of the dichotomy between leading and early-stage firms. We also describe some of the inherent challenges in using emerging approaches to decision-making and shed light on the rapidly evolving regulatory environment.

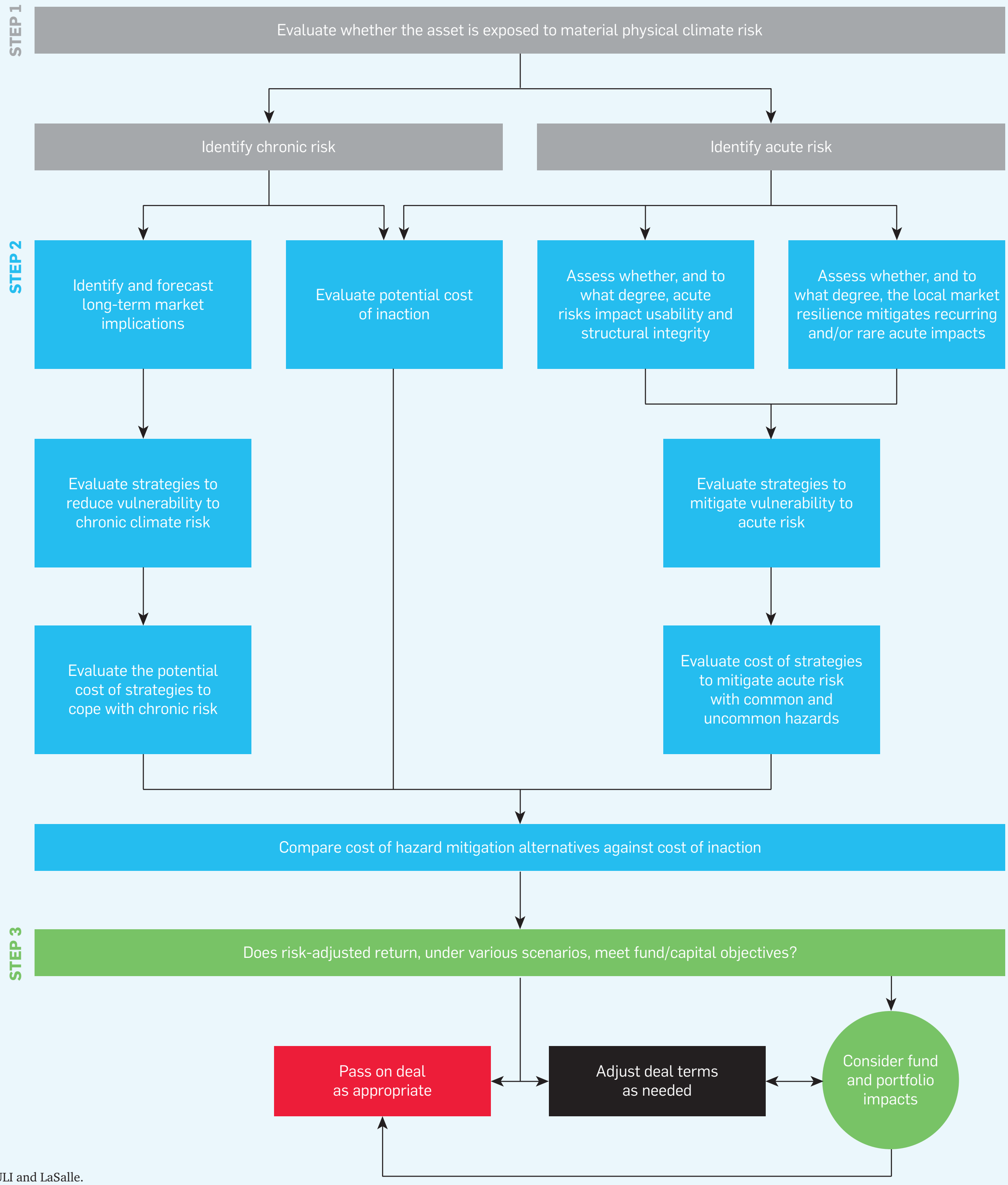
The second portion of our new paper shifts focus to the process of gathering physical climate-risk data, and the practical application of that data in decision-making processes. It discusses the ways firms are beginning to approach portfolio assessment for managing physical risk at the investment level and examines, at a high level, how leading firms weigh and measure underlying risk factors.

In particular, our research goes into great detail regarding our methodology and the state of monitoring physical climate risk across the industry. The framework is summarized in the flowchart depicted in Exhibit 1 overleaf. The process works as follows:

1. Use industry climate data to identify properties susceptible to physical climate risk and whether the nature of the threat is chronic or acute.
2. Evaluate what strategies could be employed to mitigate those risks, the costs of those investments, and what the potential cost of not acting might be. Compare those calculations.
3. Once you've evaluated the costs of any possible mitigation efforts, and weighed those figures against the projected costs of damages that could occur without those upgrades, you can determine whether the risk-adjusted return under these scenarios meets both your fund and capital objectives.
4. Once you've evaluated how these potential mitigation efforts for an asset will affect your broader portfolio in light of its long-term aims, you can decide whether to proceed with a transaction, or whether deal terms need to be adjusted to justify the underlying risk.
5. Once these factors are weighted across an entire portfolio, you'll have a much healthier picture of where your portfolio stands, including considerations like geographic concentration, and whether your portfolio needs additional diversification.

LaSalle has used this framework to make decisions about assets in its own portfolio.

Exhibit 1: Asset risk resilience and underwriting flowchart



Source: ULI and LaSalle.

> “We recommend using data as a warning system, rather than as part of a precise equation.”

As an example, we can cite a logistics property we own in Osaka, Japan, which is a flat coastal city where buildings are required to be 3 meters above sea level. On top of the height required by local regulations — we determined, based on our analysis of the costs of investing in mitigation measures compared with the potential of what a flooding event might cost in losses, that the coastal flood risk warranted raising the buildings an additional 1.5 meters, and relocating essential building equipment and mechanicals to higher levels of the building.

Report in action

In practice, the first challenge in evaluating physical climate risk is understanding what the data is, and isn't, telling you. Data from a tracking system is not going to reveal all answers; in reality, it is only directionally correct.

Simply put, there are no empirical numbers you can plug into your valuation model or business plan. Managers need to apply a serious dose of judgment, not only in interpreting the data, but also in evaluating how an asset is resilient to the identified risks, both physically as well as operationally.

As a first step, we recommend using data as a warning system, rather than as part of a precise equation. Managers will need to spend time understanding the data, the buildings where it applies and its place in a broader portfolio, and then apply insights gleaned to better inform their portfolio management.

Take, for example, real estate in the city of Amsterdam. Simply looking at sea level and flooding potential, the city would be among the highest risk places to own real estate. However, Amsterdam has been working to mitigate flooding for centuries. They have placed generations' worth of infrastructure, dikes and levees to maintain dry land for building. They have a forward-looking plan in place to address future climate risk. This is a prime example where the data doesn't say everything, but does serve as a warning signal to help identify areas that might be problematic and allow the evaluation of risks at the regional level.

Once portfolio managers have determined that a region is in line with their risk parameters, they should evaluate risk at a property level: look at a given building and its existing resilience measures, including the immediately surrounding area. By coupling this information with an understanding of portfolio goals and tolerance of climate risks, managers can make informed decisions about if and how to invest in resilience strategies at a given property, or, even more fundamentally, whether to purchase or divest an asset.

At a portfolio level, ask: do you need to build in a risk premium or return hurdle into your underwriting to justify the investment?

Even the property class of a given asset can make a difference in a climate risk evaluation. Say you have a large multistory building in a flood-prone area; even if the individual building's resiliency is maximized, what happens if the surrounding area becomes impassable for a period of time? Is your building an office where most tenants can work from home for a few days? Or is it an apartment building where tenants need access to essential services and basic access? Is it a grocery-anchored retail center that provides food for residents? The structure's intended use becomes a serious point of consideration when pricing in climate risk under our framework.

Conclusion

Knowing where real estate risks are at a portfolio level is essential to being able to properly and transparently demonstrate the state of your investments. Whether or not you decide to make an investment in response to a hazard is an individual firm's decision, but we view being aware of the risks facing our investments as an essential part of our fiduciary responsibilities to our stakeholders.

Looking ahead, the market disruption that climate change is causing, and will continue to cause in the real estate industry, is something that creates not only risk but also potential opportunities. Knowing the risks at hand is critical to properly managing a real estate portfolio, and understanding how to properly interpret and implement data will be critical to successfully managing properties for years to come. ◆

Julie Manning is the Global Head of Climate and Carbon for LaSalle Investment Management.

> Technology brings accuracy, efficiency, transparency. It changes the way people interact with data. When technology is paired with fund administration, it benefits institutional LPs, giving them real-time access to information that they need.

Wesley Wilson
CFO
avanath+

junipersquare.com/drivers-seat

Juniper Square