Brookfield's contrarian view

Chief executive of real estate Brian Kingston tells Kyle Campbell why the $550bn manager remains keen on retail and New York offices despite the many questions raised by covid-19

PHOTOGRAPHY: JUSTIN SHOCKLEY

It is September 1, and while many of New York City's office workers are somewhere other than New York City, working somewhere other than an office, Brian Kingston sits in a Lower Manhattan conference room. On the table in front of him, a green checkmark says it is OK to sit there. Red Xs by the seats next to and across from him mean they are off limits to promote social distancing. Occasionally, masked colleagues walk past his glass enclosure. These sights, along with infra-red temperature checks, daily health screenings and monthly viral tests, have become fixtures for Brookfield's chief executive of real estate, since the Toronto-based manager reopened its New York outpost in June.

The office is sparse this morning, Kingston tells *PERE* via teleconference, though only slightly more than a typical Tuesday before Labor Day weekend. He hopes the end of summer will bring additional colleagues back to 250 Vesey Street and spark a broader return-to-office movement in the US. But he does not evangelize about it. If other nations are an indication of what is to come, he will not have to.

"If you ask the average person on the street in New York when they're going back to the office, they'll say they don't want to or they're unsure, and that's natural," he says. "We have a unique perspective because we have offices around the world in cities that are at different places on the recovery spectrum and when it turns, it does turn. In China, for example, it's as though it's 2019 again. People are going to restaurants, kids are back to school, workers are back in the office. That part of the world is getting back to some semblance of normalcy."

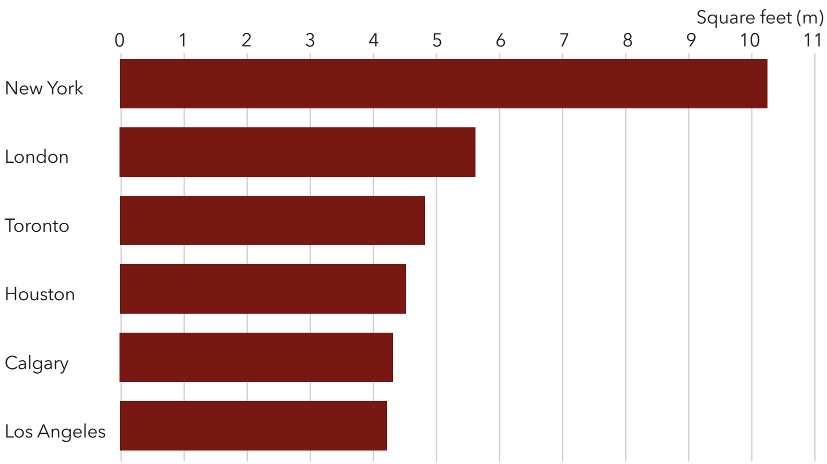
As the head of Brookfield Property Partners and Brookfield Property Group, both of which fall under the $550 billion Brookfield Asset Management umbrella, Kingston oversees the largest office portfolio in the world. It consists of 140 million square feet across 253 properties – 134 of which are core holdings on the Property Partners balance sheet – plus a half dozen more under development.

It is a precarious time for office owners, especially in the gateway markets where Brookfield is most active. After the relative success of the mass work-from-home experiment, many investors and managers are asking if a permanent shift toward this new style of work will hurt office demand. Some also believe the pandemic will accelerate the migration of companies and individuals away from traditional US office hubs to lower cost metros such as Austin, Nashville, Charlotte and Raleigh-Durham.

Prashant Tewari, a partner with the Townsend Group, a Cleveland-based advisory and investment firm, notes that remote work does not have to be widespread to have a material effect on valuations. "Some part of this work from home is here to stay and, in real estate, you don't need 20, 30, 40 percent of people to go a certain way for it to have an impact," he says. "It could be 1 or 2 percent and, all of a sudden, you start to see an impact on rent growth and, consequently, the value of properties."

Kingston is not worried about remote work or secondary cities siphoning demand from major markets. If anything, he wants to use Brookfield's $15.6 billion of real estate dry powder to add more exposure to the likes of London, Sydney, Toronto and Los Angeles, not only through offices, but also apartments, condos, hotels and other distress-driven prospects. The most acute opportunities, he predicts, will be

Brookfield's top core office markets are gateway cities and energy hubs



Source: Brookfield Q2 Supplement Disclosure

in New York, a deep and historically resilient market in which a lot of institutional capital has lost faith.

"We have lots of dry powder and our clients have lots of capital they're asking us to put to work in intelligent ways," he says. "New York is a tremendous contrarian opportunity at the moment."

Making office work

Brookfield is not the only large landlord to take a lead-by-example approach to office re-openings. But there are not many others. A July survey of roughly 500, mostly New York-based real estate professionals conducted by the law firm Morrison & Foerster, found that just 9 percent of respondents were regularly going into their offices, up from 7 percent two weeks earlier. The majority, 66 percent, did not expect to return until 2021.

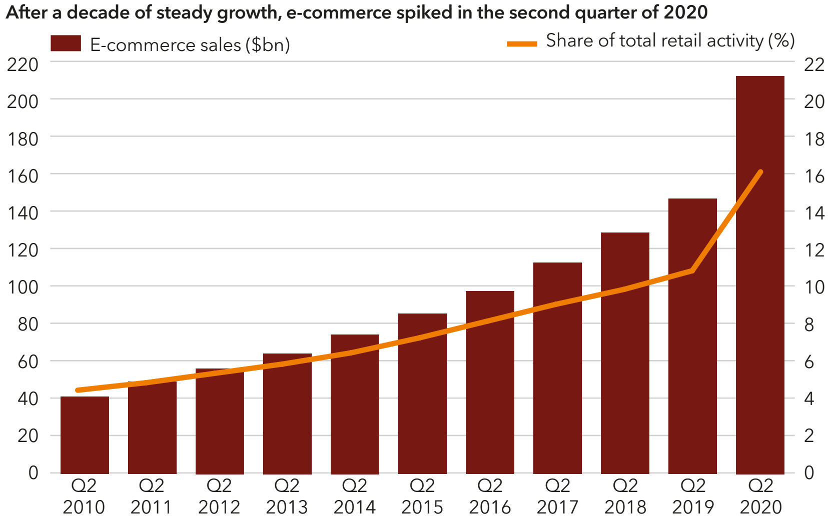
Announcements from prominent office occupiers have fueled concerns. Last month, Bloomberg reported Google walked away from 200,000 square feet in Dublin. In May, Twitter issued a statement saying workers would have unlimited remote privileges and the social media company Pinterest announced it would pay $89.5 million to terminate a pre-lease on a 490,000-square-foot office in San Francisco. Concerns are emanating from the investment banks too, including Barclays, JPMorgan and Morgan Stanley, which said in April and May they are considering smaller New York footprints. Even real estate groups that had planned to be back in the office by early September have delayed returns because of health concerns, Mark Edelstein, head of Morrison & Foerster's real estate group, tells *PERE*.

"Many employees in cities that rely heavily on mass transit, and with high-rise buildings requiring elevator usage for large numbers of tenants, are nervous about health risks in getting to the office, and that is weighing on the minds of employers," Edelstein says. "Companies making it voluntary for their staff to go into the office have found that many are opting to work from home."

New York is Brookfield's largest office market at 27 million square feet, which is 19 percent of its global office space and more than a third of its US exposure to the sector. For the core office holdings on Brookfield Property Partners' balance sheet, Manhattan offices account for 28 percent of net operating income, according to a financial disclosure from the company. It has also spearheaded several large developments in the city in recent years, including the $5 billion Manhattan West complex, which includes four office buildings, a hotel, a luxury apartment high-rise and 200,000 square feet of retail. The final piece of that project, the $2.4 billion Two Manhattan West office tower, is slated for completion in 2023. As of late July, just 25 percent of its 1.9 million square feet have been pre-leased.

Despite New York's status as the epicenter of the US covid-19 outbreak and the concerns about its future appeal, Kingston is undaunted by the prospect of finding office tenants in the years ahead. He views the current environment as a temporary disruption to a long-running influx of companies into

After a decade of steady growth, e-commerce spiked in the second quarter of 2020



Source: US Commerce Department

> *"There is clearly disruption happening in the market. But, ultimately we take a long-term view that high-quality real estate assets will hold their value and recover when the economy recovers"*

the city, such as Amazon, which signed a 360,000-square-foot lease at Brookfield's Five Manhattan West property in 2017. He acknowledges more workers will likely split time between home and office, but believes physical locations will remain essential for attracting young talent.

"The beauty of New York City is the critical mass here, the talent pool to draw from. This is where workers want to live, so if you want to attract 24- and 25-year-olds that are coming out of college on a fast track, you have to come here. Other places just don't have the infrastructure or the energy of a place like New York. Over the past 20 years, things have become more and more concentrated here, and I don't see that getting disrupted on a long-term basis."

Indeed, just as there is evidence contradicting this assertion, there is evidence supporting it too. Facebook and Amazon both renewed vows to New York during the pandemic. Facebook finalized a long-rumored 730,000-square-foot lease at the newly-renovated Farley Building, while Amazon said it would bring 2,000 more workers to the city and turn the former Lord & Taylor department store on Fifth Avenue into 660,000 square feet of office space. For its part, Brookfield's core New York office holdings are well positioned for the years ahead, with 96 percent occupancy and an average remaining lease duration of 10 years. By comparison, the firm's overall core

office portfolio is 92 percent leased, while the growth-oriented offices in its funds are just 81 percent leased.

Lenders remain confident in Brookfield's ability to execute in the office sector. In late August, the firm refinanced the construction debt on One Manhattan West – a 2.1 million-square-foot office tower opened last year – with a $1.8 billion permanent facility underwritten by Deutsche Bank, Wells Fargo, Barclays, Citi and JPMorgan. The bulk of the financing came from a $1.5 billion commercial mortgage-backed security conduit, which Kingston says was oversubscribed: "At a time when people are worried about New York office, the debt markets are clearly there for it."

At one point, as covid-19 spread across the US and triggered a wave of forced closures in March and April, all 170 of Brookfield's malls were dark at the same time. Unprecedented as it was, Kingston says the company was able to draw from one-off closures during natural disasters across all its properties as the shutdown orders rolled in. "One of the benefits of having such a large presence is that we're able to invest in systems and processes that make us more efficient," he says. "We may have been closing a mall in Idaho for the first time, but we're applying all the learnings from what happens when we prepare for hurricanes to go through Florida, for example."

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The real challenge came weeks later, when it was time to get tenants up, running and paying rent again. Between forgiveness granted to smaller tenants and lost revenue from retailers that have gone out of business, Kingston anticipates roughly 20 percent of outstanding rents from the covid closures will go uncollected. Roughly 85 percent of Brookfield's mall tenants have now re-opened. But footfall is still only about half of what it was pre-pandemic – though Kingston says that mall visitors are now more likely to buy instead of just browse.

Kingston says the current discourse around retail mirrors that of 2010, when it brought General Growth Partners out of bankruptcy before later acquiring the mall REIT outright eight years later. "People were saying the same things they're saying today: nobody's ever going to go to a mall again, every retailer is going to go bankrupt, etcetera, and that allowed us to make that investment in a very opportunistic way at a very attractive basis," he says. "We're looking at this period of time the same way. There is clearly disruption happening in the market. But, ultimately we take a long-term view that high-quality real estate assets will hold their value and recover when the economy recovers."

Still, e-commerce is a far bigger threat to traditional retail now than a decade ago. While brick-and-mortar

$15.6bn

Brookfield's real estate dry powder

€725m

Closed for Brookfield Europe Real Estate Partnership in Q2 2020

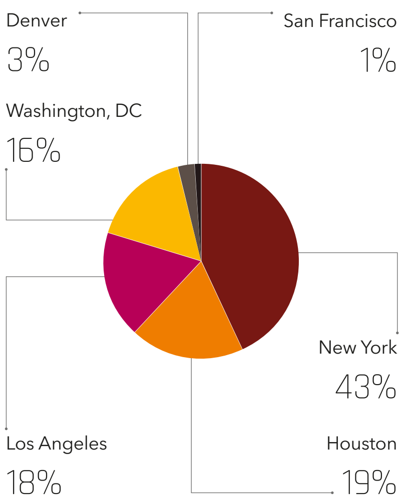
centers were closed, online sales hit a record $211 billion during the second quarter, accounting for 16 percent of all retail activity, the US Commerce Department estimates. But Kingston sees a need for both online and in-person shopping channels, even for digitally native brands. In addition to providing rescue capital, a $5 billion retail revitalization program introduced by Brookfield Asset Management in May will also help traditionally successful brands that have been slow to modernize.

Landlords purchasing their retail tenants has become evident during the pandemic. Simon Property Group, the largest mall owner in the US, has formed a joint venture with the brand management company Authentic Brands Group to buy troubled retailers like Brooks Brothers and Lucky Brands. Brookfield has partnered with those two groups on similar acquisitions in the past, including Aeropostale in 2016 and Forever 21 this past February. The three companies also reportedly made a bid to buy the bankrupt department store chain JC Penney, though an acquisition has yet to take place.

There are several reasons why a landlord would want to acquire a retailer, Eric Rapkin, chair of the real estate practice group at the law firm Akerman, explains, especially an anchor tenant such as JC Penney. Not only would this allow them to keep the lights on and continue drawing in shoppers, but it would also avoid triggering co-tenancy agreements that would allow smaller, in-line tenants to dissolve their leases if the anchor leaves. Owning an anchor tenant could also allow a landlord to make changes to a property that would otherwise be vetoed by an anchor. "Ultimately, controlling your real estate has value," Rapkin says. "I don't think the mall owners are looking at this as an opportunity to get into the fast fashion business or the department store business. This is a real estate owner saying there's real value to us controlling our own real estate."

However, Kingston says Brookfield's retail revitalization is more opportunistic. "This is not playing defense where we're trying to prop up co-tenancy, this is playing offense," he says. "There are some brands that are worth saving. Take Aeropostale as an example. That was a hugely successful investment because you had a very valuable brand that had just gotten itself overextended, needed to have its capital structure reset and then get relaunched. We think there are numerous opportunities to do that."

The bulk of Brookfield's core office holdings are in Manhattan



Source: Brookfield Q2 Supplement Disclosure

The way forward

Like other prominent managers, Brookfield has, in a way, benefited from pandemic-imposed travel restrictions. With investors eager to capitalize on dislocated pricing, but unable to meet with new managers, many have focused on increasing positions with existing partners. Across all its strategies, Brookfield Asset Management raised $23 billion during the second quarter, its best fundraising period ever. More than half of that went to Oaktree's latest distressed debt fund.

Since March 15, Brookfield has raised $1.8 billion across its various real estate funds, primarily from existing partners, including €725 million closed during the second quarter for its first European core-plus fund, Brookfield European Real Estate Partnership. Kingston says record low interest rates have been the driving force behind real estate commitments as investors look for secure ways to replace diminished yields in their fixed-income portfolios. And, historically speaking, Brookfield's convictions have served it and its investors well. Its flagship opportunity fund series, Brookfield Strategic Real Estate Partners, has delivered a gross internal rate of return of 18 percent across three vehicles, the latest of which still has roughly $4.5 billion to deploy.

"There's a lot of capital that's on the sidelines in cash or cash-like investments that wants to get invested," he says. "Investors are looking at the world and seeing a good buying opportunity. Prices have clearly come off from where they were in recent years and this window may not last forever." ■