Blackstone bosses tackle the broad concept of disruption

Co-heads Ken Caplan and Kathleen McCarthy's first onstage appearance together centered on how service provision is impacting across property types. By Jonathan Brasse

McCarthy: service provision could be more capital intensive

When you are the world's biggest manager and raiser of institutional capital for private real estate, your prognostications on the asset class tend to be heard. And so it proved at *PERE*'s Asia Summit in Hong Kong last month where Blackstone's real estate co-heads Ken Caplan and Kathleen McCarthy joined *PEI*'s Real Estate Group senior editor Jonathan Brasse on stage to discuss exactly that: what the $250 billion landlord, which has sat atop the *PERE* 50 ranking of fundraising managers with $49.83 billion raised in the last five years, is thinking about these days.

Unsurprisingly, Caplan and McCarthy are contemplating how to place Blackstone's customary, high conviction bets in a marketplace in which many cycle peaks have been reached and in which every property type is being disrupted to one extent or another by demographic and technological changes. They took to the stage at the *PERE* Asia Summit, together for the first time in their new capacities, as a *PERE* record attendance looked on. Here is an abridged retelling of the interview:

***PERE*: In the face of peak cycles, where does Blackstone get the confidence to make its customary high conviction bets?**

Ken Caplan: You're hitting on something we discuss in just about every meeting we have. In this current environment, what do we buy? How do we develop convictions? Some might argue that we are in the latter part of the cycle, economic growth is slowing, things are too expensive, there are too many reasons to be cautious, shouldn't we wait? There are indeed reasons to be cautious: we do have a potential rising rate environment in parts of the world and there is declining growth. But we see positives as well. We see good GDP growth overall around the world – GDPs at different speeds, in different regions, and good employment growth almost everywhere.

Overall, we are driving our convictions through our portfolio, with our team and our experience. This is one of the benefits we have from our scale and from over 30 years of being an owner. We also do an intense amount of research and homework when we're making an investment. We have an added benefit of having portfolio companies ranging from traditional offices, logistics and multifamily, life science offices and healthcare across geographies. Our asset managers often attend their board meetings to figure what works and what doesn't. What we see in one part of the world might be relevant in another part, and that allows us to develop our convictions. We're not just index investors who might say 'buy Asia, or logistics in Japan or China,' we're much more targeted.

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> Kathleen McCarthy

***PERE*: Indeed, you're the world's biggest landlord; presumably, your data is the most reliable for you. But do you have the capabilities to understand all the data you have to the degree you can make bets from it?**

Kathleen McCarthy: We're always developing our systems to better understand the data we have. The benefit of scale is we don't have to wait for a

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Betting the bottom $1m

Caplan and McCarthy would place their last hypothetical $1m in…

Caplan: Indian office gets mine. This is another place we've had a different view than the overall market and have become really active in buying buildings. We continue to see incredible fundamentals there.
McCarthy: Infill logistics, because this is where we see strongest demand relative to weakest supply. Infill logistics near urban driving areas gets my last $1 million.

research report to come out to tell us what's going on in leasing in Seattle or Shibuya. This is one of our core competencies. We decided long ago to be very democratic regarding access to our data. For example, we share portfolio company board reports with our team and have weekly performance reports across all the different asset types. This allows our people around the world, focused on different markets, on different asset classes, to look at the information and ask, 'What's going that I can translate into what I'm doing, or move to do something else?' We have some great examples of this: for instance, when we had a strategy session in the US, Chris Tynan, who runs our Australia business, saw the trends in the logistics market there and realized nobody was investing in the same way in Australia. He acted on that and continues to get information about our portfolio performance in Europe and the US to help him build the conviction to keep going in Australia, which was further behind the trend.
KC: Logistics is probably our greatest example. We bought almost 700 million square feet of warehouses since the downturn. Really it started in the US, where we were buying warehouses post-crisis through a series of acquisitions. We just saw everything outperforming as e-commerce was growing, providing a tale-wind that didn't previously exist. I don't think people really appreciated just how transformative the demand was for this asset class. We saw the same elements unfolding in Europe and put together a 150 million square foot portfolio through 50 different transactions. Then, as we mentioned, we saw the same backdrop in Australia. We realized where it was strongest: near densely populated areas, as logistics providers like Amazon wanted to be closer to their customers.

***PERE**: Among today's fashionable rhetoric is talk about real estate as a service. Managers are forgoing the landlord tag; tenants are becoming customers. How much does Blackstone buy into this?*
KM: Your question gets to the broad concept of disruption and what people are expecting from their real estate. The perfect place to exemplify the changes we're seeing is in the office sector. In certain of the most dynamic markets, you see offices with hotel-like characteristics. Where you used to look at an office in terms of the space leased, tenants are now looking to landlords to make sure the whole building is dynamic and are complementing that leased space alongside meeting rooms downstairs, or cafés, perhaps exercise facilities. We've been looking at this concept for a long time in our business. In fact, returning to the point about using our own portfolio to hone our convictions, we created something in the UK which we've since taken around the world. It could become more capital intensive and that needs to be anticipated in underwriting. But this is not a scary concept, it's an exciting moment and it's important to tackle this change head on.

PERE: Furthering the concept of 'hotelization,' as has been discussed at ***PERE*** *Asia this year: if every asset becomes hotel-like, surely that will become cap-ex intensive?*

KC: That's one of the reasons we continue to be excited to invest in the current environment. Providing additional services and flexibility is a different capital requirement and I think the economics surrounding this evolution are going to continue to shift. The tenant-landlord relationship needs to shift. Previously, [tenants] would take a space with a lengthy lease for a fixed amount of time, get the keys, then figure out how to design and build the space. Say they'll need that space over two years – more or less – rather than the 10 years of their lease; that's not the most efficient set-up. Now, you have these flexible office businesses where their success is really demonstrating a huge depth of demand for greater flexibility than what the market is currently offering. And tenants are willing to pay a premium for that flexibility, the amenities and such services.

PERE: So that can absorb some of the cap-ex?

KC: Well, yes. We own the Office Group based in London which has been running for over 13 years. They are offering something to tenants that the traditional landlord doesn't. When you see larger scale businesses doing this around the world, continuing to fill up all their buildings, you can see this is deep demand. These groups can build out space faster and cheaper or more efficiently. For instance, [tenants] don't use conference rooms all day so can share them, or they can activate common spaces that make more sense as an amenity. That costs money for the landlord so you do have to factor it into your underwriting. But it's something tenants will pay a premium for; we are seeing that in our buildings when you create those kinds of environments, with such flexibility, it really resonates.

Caplan: tenant-landlord relationship needs to shift

PERE: But what about the growing inherent conflict between providing flexible leases to occupiers while needing to satisfy investors' bent on securing forecastable, recurring income streams?

KC: The economics around these businesses will continue to evolve. Tenants don't want to go from 100 to zero. It's usually just a percentage of a building's space that needs to be flexible; leasing an office building entirely to a short-term occupier would be inconsistent. However, I think the economics and the business model will continue to evolve. It is still all about having the right buildings in the right locations and being in front of demand from tenants. That's how to position long-term appreciating assets. ◻

Gray: transitioned to firm president in February 2018

Filling Jon Gray's shoes

Caplan and McCarthy reflected on succeeding legendary investor Jon Gray as Blackstone's real estate boss last year after he became firm president

McCarthy: This succession was a very smooth transition because we're running the business now the same way we'd really been running it for a long time. For a number of years, Ken was the chief investment officer and I was the chief operating officer. Our focus areas are largely the same. This has always been about continuity. Obviously, Jon is still very much integrated in our business. But we now have an opportunity to push it forward.

Caplan: Obviously, Jon sets a very high bar. He led by example, inspired us to keep growing the business. Succeeding him is to try to continue that. The nice thing is we've both been in the business a long time so there's no drastic change. The transition announced in the beginning of 2018 was in the making for a while. By the time it happened, it was pretty much business as usual – no change in how we do everything.