Clarion Partners

Building for the future

Recently, **Jonathan A. Schein**, managing director of global business development at Institutional Real Estate, Inc., spoke with **Steve Furnary, David Gilbert** and **Hugh Macdonnell** of Clarion Partners. The following is an excerpt of that conversation.

You and Legg Mason have been partners for more than a year now. Have things gone as expected?

Gilbert: Better than we could have expected. For us, Legg represents the best of two worlds. It is a public company that focuses on product distribution, so they are able to help us access sources of global capital that we didn't have before. Meanwhile, their affiliate model allows us to control our investment process and maintain our private culture. This model allowed us to retain a substantial investment in Clarion and acquire a small investment in Legg Mason.

Furnary: Legg Mason has created a portfolio of the best-in-class investment managers in each of their asset classes. We are the only real estate manager. Being part of their family will become even more important as the world moves to defined contribution plans, and employers look to distributors such as Legg Mason — which only distributes its affiliates' products — to provide options for their employees.

Steve, you are stepping up to executive chairman, and Dave is assuming the CEO title. What does that mean for Clarion?

Furnary: It means that succession has been seamless. Dave moved from president and chief investment officer to CEO and chief investment officer, so clearly no change for him on the CIO part, and our clients and I are thrilled to have him also take on the operating part of the business. I'll now be able to focus more on the strategic initiatives of the firm, which is more fun for me. I'll also remain on the investment committee, so this really isn't a drastic change.

Clarion has been around for about 35 years. What makes it different from its competitors?

Macdonnell: One of the key things that makes Clarion special is, although we are partnered with a larger organization, we operate and feel like a private partnership. Second, we are one of the few large, real estate-focused boutiques out there. Our clients appreciate the fact that we come to work every day just focused on creating value in real estate. Third, we have over $250 million of partner and employee money directly invested in the firm and its products. This includes $150 million invested in equity of the firm from 92 partners and employees, and over $100 million invested in our funds by that same group. That level of co-investment unifies us as a team, as distinguished from being just employees of a larger organization. We believe this level of co-investment leads to better investment performance.

What strategy do you use to acquire assets?

Macdonnell: Clarion is both an allocator and an operator, depending on the situation. In every single deal structure, we look for the optimal way to create compelling real estate returns. Sometimes it's with a properly aligned partner at our side, but mostly it's through direct ownership.

Clarion Partners team
L-R: Hugh Macdonnell, Head of Client Capital Management; Steve Furnary; Executive Chairman; David Gilbert, CEO and Chief Investment Officer

Furnary: Roughly 75 percent of our assets are stabilized (core) assets, and we manage all of these directly. For our value-add projects that are in some phase of development or significant renovation, we typically partner with a developer until these assets stabilize. Our multifamily fund is the exception, as Gables, our vertically integrated operating company, develops and manages all assets for that fund.

What makes you a strong real estate investor?

Gilbert: Research, local execution and operational specialization by property type. The trick is to take a classic top-down, somewhat academic approach and marry it to an on-the-ground bottom-up approach. We have a huge proprietary database that contains more than $43 billion and 1,100 properties. Our top-down analysts can learn a tremendous amount from analyzing the information in this database, which is not available publicly. We then take that information and overlay it with information we are getting from our on-the-ground asset and property managers. We are one of the largest asset managers in every one of the four traditional real estate sectors, so we have a scale and specialization that allows us to know what is really happening at a micro level. By listening to your tenants, you get a great sense of where the market is going.

How would you summarize Clarion Partners' mission?

Gilbert: Our mission is simple: To provide real estate investment solutions to our clients. We consistently work to outperform in everything that we do. Now, no one can excel in everything all the time, but Clarion has an excellent long-term track record across our broad portfolio.

What are some of your future growth strategies?

Furnary: We have to constantly look for ways to create scalable solutions and investment products for our clients. The scalability can be a stumbling block. For example, our credit business is principally focused on mezzanine debt investing. Because those loans tend to be small, it's hard to do on a large scale. But we are working to expand that business by introducing additional products to our credit platform, such as net lease and distressed debt investing. Because of where we are in the cycle, we need to provide products that will provide some defense for clients. That could lead to more credit investing with higher income returns. The other fundamental thing that's going on is that baby boomers are retiring and looking for better income from their fixed-income investments. That plays right into real estate's strength.

Gilbert: We remain in a world starved for income, where two-thirds of sovereign bonds are trading at nominal or real negative returns. That is fueling an attraction to alternatives and other places where you can get alpha in ways that can't be indexed. That leads substantially to real estate as a solution. Remember, 30 percent to 40 percent of the entire market capitalization of institutional real estate is in the form of debt, so it's a huge opportunity to create interesting credit strategies.

Furnary: We can also see, down the line, expanding our alternative offerings and partnering with other Legg Mason affiliates to provide a package solution for clients.

Are you offering solutions on a global basis?

Macdonnell: Over the past couple of years, a significant amount of our capital has been coming from foreign investors looking to invest in the United States. Although we manage assets in Mexico and Brazil, we aren't currently investing outside the U.S. We have a long-term goal to develop the right offshore investment products — they will likely be in the credit space — but we won't go overseas just for the sake of starting a new business in a different region. We don't need to do that. Our business is robust and successful here, but we see an opportunity emerging.

Gilbert: We do not see any advantage to going global just for the sake of saying we are global. We are already in a perfect spot. We are part of an extraordinarily well-capitalized firm that has global relationships that we can benefit from, but our investing focus for now is on the United States.

Furnary: And there's lots of scope for significantly increased business in the United States. We are spending a lot of time increasing our open-end fund lines, which we have been offering for 17 years. We now have three open-end funds —multifamily, industrial and diversified — they comprise almost 50 percent of our AUM. Separate accounts make up another substantial portion of our business. Both of these structures allow us to hold assets long term, the way real estate was meant to be held, and benefit not only from value creation, but the resulting increasing cash flows of good core assets. Our value add and credit closed-end funds round out our product solutions.

Macdonnell: We spend a lot of time talking about funds, but our separate account clients are a great and important part of our business. Some go back 25 years, but we have also been adding one or two per year for the past five or six years. We're a little bit different in that we are keen to take on new separate accounts.

What is your view on investing at this point in the cycle?

Gilbert: We are feeling good about where we are in the U.S. and global economic cycles. Globally, we are seeing growth in earnings virtually everywhere. The emerging markets are slowing, but their growth rates are still quite impressive. The U.S. economy's most recent data show acceleration toward a 3 percent GDP growth rate. In terms of real estate fundamentals, they've almost never been better at this stage in the cycle, and that's because the industry has remained disciplined about supply. Core returns, which have been double-digit for the past five or six years while the economy recovered, are beginning to revert to more historical norms. This might be frustrating for some investors, but not for us because those higher returns were not sustainable. There is nothing wrong with 7 percent to 9 percent core returns, and 5 percent to 7 percent real rates of return. Real returns, especially relative to other classes, have still been exceptional. A lot of that is in the form of cash flow. Of course, no particular returns are certain and the market could go down.

Do you see problems on the horizon?

Gilbert: We're in a world with enormous uncertainties, whether in a real estate sector, such as retail, or more globally when looking at weather impacts and political upheaval. To deal with things we can't control or even foresee, diversification is paramount. We're spending a lot of time on credit and focusing the construction of our portfolios to withstand stress when it comes, because it is inevitable.

How have you maintained your entrepreneurial culture over 35 years and several ownership transitions?

Furnary: Since the beginning 35 years ago, the partners and employees have benefited from the success of the company through a bonus pool that is, by industry standards, a high percentage of the bottom line. That means that everyone here is driving together to create an ever-more successful business by providing solid performance for our clients. In addition, a third of our employees have an equity ownership interest in the firm and attend the shareholders meetings. The firm truly operates as if it were a partnership. There is joint ownership in the benefits, and there's joint ownership in how we get there.

Gilbert: We're all rowing in the same direction, which is to improve returns for our clients. That's our definition of success.

CORPORATE OVERVIEW

Clarion Partners, LLC, an SEC registered investment adviser with FCA-authorized and FINRA member affiliates, has been a leading U.S. real estate investment manager for more than 35 years. Headquartered in New York, the firm has offices in Atlanta, Boston, Dallas, London, Los Angeles, São Paulo, Seattle and Washington, DC. With more than $42 billion in total assets under management, Clarion Partners offers a broad range of real estate strategies across the risk/return spectrum to its more than 300 domestic and international institutional investors. Clarion Partners is an investment management affiliate of Legg Mason. Clarion Partners Securities, LLC, is the distributor of Clarion Partners' managed funds.

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