Arthur J. Gallagher & Co.

Market Conditions

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Real Estate

By Caley LaRue

The strong real-estate cycle continued to march forward and even the much discussed concern over the Federal Reserve's increase in interest rates in 4Q2015 did not seem to have an effect on slowing it down. Investors, especially foreign capital, continued to want exposure to U.S. real estate in all of its forms, and this has driven values higher. Many economists attribute this is in part to the combination of a strong U.S. dollar and the devaluation of currency in other countries. The key drivers in real estate continue to be GDP growth and confidence, and they are still relatively high at the moment, in spite of the volatility in the stock market. Rising rents and occupancies boosted values across virtually every commercial property sector in 2015, fueling speculation that we have reached the top in the cycle. Investors with this concern have become net sellers, but there continues to be many willing buyers on the other side looking for deeper exposure in the strongest markets.

These strong underlying fundamentals in commercial real estate continue to assist us in driving successful insurance negotiations for our clients. The commercial real estate space continues to be seen as a superior class of business by underwriters and there is ample capacity in the market to secure any limit needed.

Additionally, it seems that landlords and management companies are paying even more attention to operating expenses as they utilize smarter technology to drive down costs. Just like clients, underwriters try to gauge where we are in the real estate cycle, but continue to believe the underlying fundamentals are strong. Many underwriters are relieved that debt-to-equity levels are not as high as they have been in the recent past and view this as a sign of discipline learned by clients.

While historically, commercial restate risks have frequently traded assets, we have seen a significant increase in the outright sale of real estate operating companies (REOCs). This trend for mergers and acquisitions (M&A) activity does cause underwriting concern, as 97% of transactions over $100 million experienced litigation. When the seller is named, allegations frequently include inadequate price, unfair process and failure to explore alternatives. In situations where the buyer is named, it is alleged that the buyer 'aided and abetted' in the fraud of the seller. The result is usually a settlement (amend terms, additional disclosure) and payment of defense costs. Underwriters view this as a cost of the transaction—and have implemented higher M&A retentions on their policies to avoid paying for the seemingly frivolous suits that they paid in the past. M&A retentions usually scale up depending on the total market cap or assets under management and range from $500,000 to $1,500,000.

In addition to M&A claims, underwriters are attentive to joint venture (JV)/limited partner litigation especially as JV's unwind. Tender offer or roll-up of minority interests will always be a concern; expect questions from underwriters as this has also been a highly litigated area.

The insurance market for commercial real estate is divided into a few subcategories that are experiencing different trends as reviewed below:

- **Publicly traded equity REITs** – This market continues to become more competitive. ARCH (the NAREIT-endorsed carrier) strives to offer the broadest coverage available for this class of business. ARCH tends to compete most aggressively on primary but will consider excess as well. ARCH's form has the option to add non-securities claims entity coverage—and this is rarely matched by others. While market capitalization (primary rating mechanism) has been growing, rates have been declining on primary polices. The excess market for REITS has become even more aggressive and double digit decreases in premium have been achievable. Many new carriers entering the market and London carriers have become especially strong competitors.
- **Public, non-traded REITS** – continue to be a difficult class of business due to underwriters' perceived concerns around valuations and roll-up exit strategies as well as internalization of the managers. This market is harder as capacity for primary is limited. Rates are trending flat to upward depending on AUM growth.
- **Privately held companies and private REITS** are deemed to be favorable and capacity is generally readily available for this class.

Finally, the excess market is softening faster than the primary market and as a result, clients are seeing rate reductions ranging between 10% and 25% depending upon the pricing of the expiring program. The reductions in the excess premiums coupled with the relatively flat to slight decreases on primary renewal pricing equates to client's experiencing an overall reduction in premiums on renewals.

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