

Harrison Street Real Estate Capital

Recently, **Geoffrey Dobrmann**, publisher and editor-in-chief of The Institutional Real Estate Letter – North America, spoke with **Christopher Merrill** and **Dean Egerter** of Harrison Street Real Estate Capital. The following is an excerpt of their conversation.

How did Harrison Street come to be?

Merrill: We had a desire to create a new private equity business that offered investors the ability to participate in differentiated and focused real estate products. We wanted to change the typical model related to culture, innovation and process. Our founders included Chris Galvin and Michael Galvin, who are members of the founding family of Motorola. We named the firm Harrison Street because Motorola started as the Galvin Manufacturing Corp. on Harrison Street in Chicago.

What differentiates the way Harrison Street invests in real estate from how others invest?

Merrill: We invest in real estate that is not necessarily tied to the overall economy. From the start, we determined to seek out asset classes with strong demographic trends that could do well in both good and bad economic times. Our process led us to education, healthcare and storage real estate — specifically student housing, senior housing, medical office and storage properties. Not only do those sectors have excellent long-term demand drivers, but they also possess other attractive characteristics. For instance, ownership within these segments is fragmented and individual property investment size is smaller relative than traditional property types. With this in mind, we chose to design a new platform to take advantage of these characteristics with an evolving strategy refined by our portfolio experience and sector focus.

Why would investors be interested in those particular niches?

Egerter: Unlike traditional sectors, which are driven by job growth or the economy, our property types are driven by strong demographics: for example, the echo boomers going to college or the aging baby boomer population and their healthcare needs. Many of our investors are attracted to our sectors as they offer steady performance in downturns and thus can provide diversification by offsetting the cyclical market has seen in traditional real estate portfolios.

Merrill: Investors were looking to access these sectors but found it difficult because of the size of the properties and the fragmentation of the market. It's true that a lot of investment managers have dabbled in these asset classes, but there was no one firm focused exclusively on them. By creating the right platform and process we could roll up our sleeves and drive real value to our investors. After going through the recent tough economic cycle, we now have strong empirical data that shows that these asset classes have held up very well compared to traditional real estate investments.

Egerter: Another advantage of our sectors, relative to the traditional property sectors, has been that even during a very difficult time of accessing financing, banks and other lenders were always willing to provide debt capital for these segments. The stability of our assets combined with increased performance allowed us to continue to access



Christopher Merrill is the co-founder, president and CEO of Harrison Street Real Estate Capital, as well as a member of the board of directors and chairman of the investment and management committees of the company. During his career, Merrill has led the launch of numerous differentiated and focused real estate funds in both the U.S. and Europe that have raised approximately \$3 billion

in equity capital and that have acquired and/or developed over \$8 billion of real estate in both the U.S. and Europe.



Dean Egerter is a principal of Harrison Street Real Estate and serves on the investment and management committees. In addition to establishing and growing relationships with operators/developers, Egerter has responsibility for overseeing institutional capital, debt capital and investment consultant relationships. Over the course of his 25-year career, Egerter has completed and managed

approximately \$3 billion of real estate and corporate investments, financings and institutional fund raisings.

ABOUT HARRISON STREET REAL ESTATE CAPITAL

Founded in 2005, Harrison Street Real Estate Capital is a real estate private equity firm with over \$3.5 billion in assets under management through private equity funds and public securities products. The private funds focus exclusively on the education, healthcare and storage segments of the U.S. real estate market. Harrison Street Securities currently manages over \$425 million in REIT securities through three long-only product offerings.

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new loans and refinancings when the debt capital markets were very difficult for traditional property types.

How have investors reacted to your approach?

Merrill: Our investor base has grown over the years and it could not have happened without the great support we received at the start and in the early years from a number of current investors and consultants, even groups that chose not to invest in early years offered us great advice and insight. While some investors were not looking to invest with a firm with a focused approach, we found investors that saw the benefits of our sector focus and leverage policies. Today we have about 100 LPs invested across our three opportunistic funds, our recently established core fund as well as in our REIT securities business. Across our business units we have raised about \$1.9 billion.

What are you able to access that somebody with less of a commitment to this asset class can't?

Egerter: Compared to other real estate managers who invest in our sectors, about 90 percent of the investments that we've made and continue to make have been single-asset acquisitions and developments, and even if

we purchase a portfolio, we are still underwriting each individual asset and making sure that property is a good fit with that sector's investment strategy.

Merrill: These are not very transparent segments. There is a lack of research on our property types. We can go into our portfolio and see what works and what doesn't work. For example, we've developed our own internal metrics to determine the overall risk of an investment in these asset classes. While the demographics and supply fundamentals are very strong in our segments, one can still make a mistake if they go into the wrong market or work with the wrong operating partner or build the wrong physical plant. We've created our own proprietary metrics to enhance the way we make investments in our segments. Also due to our reach and our sector focus, we see a lot of investment opportunities that competing investment managers may not see. Finally, our platform now has over 35 local operative partners that are exclusive to Harrison Street. We've met with hundreds of these operating partners across the country, and we've chosen the ones we felt were the best vertically integrated property manager, leasing and development companies in student housing, senior housing, self-storage and medical areas. This creates a barrier to entry for new entrants to these segments.

In June 2011, you closed on your third fund with about \$595.5 million. Why do you think you were successful in raising that much capital in a difficult fund-raising period?

Merrill: We had great support from the LPs, existing and new, and consultants we work with. I'd like to believe these groups focused on the fact that since our founding we have had a very targeted, differentiated investment strategy; we have always had the right leverage policy; we have always right sized our capital raise; and we haven't strayed outside of our sectors of focus.

Egarter: But the most important factor is our property performance and platform, which we've built with the help of the Six Sigma process and what we call Harrison Street University.

What is Six Sigma and Harrison Street University?

Merrill: The Six Sigma process was developed at Motorola by Bob Galvin, Chris and Mike Galvin's father, and made famous by Jack Welch at GE. It's a process that we used to set up the business and build a coherent culture of quality. It is a way to look at and to mitigate risk in a business model. Once we got going, we realized the Six Sigma process wasn't just a good tool for our own organization, but that it would be a great way for our operating partners to improve performance. To that end, we set up Harrison Street University to help our employees and partners learn to implement this process.

Egarter: At its essence, Six Sigma really creates a culture of continuous improvement, which I think is very important from a cultural perspective as we attract and retain employees. We're always trying to improve an investment strategy, improve an investment process and improve the operating partner's ability to deliver better management services to our investment.

Merrill: It's been a great tool for us, and we feel over the long haul it will really benefit the organization. We think it drives overall performance in our real estate portfolio, and we've seen results from it. It's really helped us improve the quality of the partners that we do business with, and it's helped to optimize things such as occupancy levels in our properties.

In 2010 you acquired a public securities team. What were you trying to accomplish with that transaction?

Merrill: We entered this business for a number of reasons, including: we understood that our clients were looking to consolidate managers; a team with a differentiated strategy and strong five-year track record was looking for a new platform to join; and we believe we will see solid growth in the REIT market over the next decade. Consistent with our private funds business, we will right size our capital raise and look to create innovative products and strategies in this business.

In November, you launched an open-end core fund that's focused on the education, healthcare and storage sectors. How can a niche-oriented strategy be core?

Merrill: Core to us is lower risk and lower volatility, and we think there are no better asset classes than these to invest with that kind of strategy. If you look at how medical office does versus office, how storage does versus industrial, how student housing does versus multifamily, what you see is very steady occupancy and NOI and not as much volatility in cap rates. As we just witnessed in a very tough economic downturn, these are asset classes with great capital preservation characteristics. But importantly, they also respond very well in an inflationary or growing environment because they rely on shorter-term leases.

Egarter: From our existing portfolio, we understand what characteristics make a property a core investment in the education, healthcare or storage sectors, and these asset classes have very core characteristics. Investors seem to agree. Within 30 days of launching it, we already had raised \$200 million for the fund and had completed the first investment.

How are your funds structured?

Egarter: The core open-end fund has a portfolio leverage limitation of 40 percent. We seek fully stabilized assets and won't do developments in the core fund. The core fund will be diversified across the education, healthcare and storage sectors. We expect that 70 percent of the return will come from current income. By way of contrast, our opportunistic funds are closed-end vehicles that will utilize up to 70-75 percent leverage, with 30-35 percent development properties, and everything in the opportunistic fund is focused on value creation.

What are the investment prospects for these sectors over the next three to five years?

Merrill: The opportunities in our segments get better each year, and it's really something we don't see changing anytime soon. The demographics in the U.S. are very favorable. With education, we see more high school graduates going on to college, people staying in school longer, and public universities lacking the capital to house their students or build more housing. And you see the same thing when you look at healthcare. People are living longer, which generates health and memory issues that oftentimes can't be taken care of in a home setting. In the medical office space, you're seeing outpatient care moving from the hospital to the medical office building. And the self-storage business is a very sticky business and does well in good or bad times. So we see a very long demand profile for these segments. Couple that with the fact that there has been very little supply because very few operators can access construction financing or equity capital, and we see a continued promising future for our target sectors. ♦