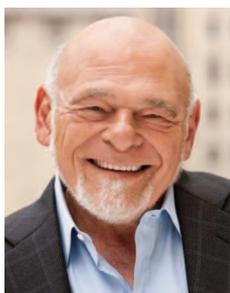


TOP *of* MIND

INTERVIEW WITH SAM ZELL



Sam Zell is the Chairman of Equity Group Investments, the private investment firm he founded in 1969. In addition, he chairs five companies listed on the New York Stock Exchange, including Equity Residential, the largest apartment REIT in the US. He also founded and chaired Equity Office Properties Trust, the largest office REIT until its 2007 sale. While Zell spent much of his career in commercial real estate, the majority of his investment portfolio today is in energy, logistics, transportation, manufacturing, communications, and healthcare. Below, he argues that the current economic expansion may still have room to run, and discusses finding value in relatively “mundane” corners of the market.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: How much longer do you think the current economic expansion can last?

Sam Zell: Frankly, I don't have any idea. If I knew the answer to that, I would be rich. A year and a half ago, I said we were in the eighth or ninth inning of the expansion. But I think the election of Trump has changed that. There is more optimism in the business sector now, which has given us extra innings. So this expansion may last a little longer than everybody thinks.

Allison Nathan: Has your initial optimism post the election waned given the challenges Trump has faced in making progress on his legislative agenda?

Sam Zell: No, just the opposite. Despite all of the public tweeting and noise surrounding our president, the reality is that the steps he's taken on deregulation, reversing executive orders, and so forth are confidence-building and very positive. The possibility of changing Dodd-Frank to increase lending to small businesses, for example, could have a very big impact. And I think that's why the economy is responding in the same positive manner as is the stock market.

Allison Nathan: If tax legislation doesn't pass, would that make you more pessimistic?

Sam Zell: No. Expectations about tax reform have declined over the last eight to ten weeks and are now pretty limited. Originally, there was an assumption that a lot could get done. But that outcome assumed a lot more support both from within the Republican Party and from some lawmakers on the other side of the aisle, which has obviously not come to pass. That said, I think tax legislation will be passed and will definitely feature a reduction in the corporate tax rate, likely some adjustments on the taxation of repatriated income, and maybe some reduction in taxes for middle-to-low-income people.

Beyond that, I don't have much expectation for significant tax reform. And if it fails to pass, I think the opposition will be blamed, not Trump. In my view, Washington continues to be remarkably disconnected from the reality of what's going on in most of the country, and that's reflected in Congress's inability to get things done.

Allison Nathan: You are famous for identifying the peaks and troughs of market cycles throughout your career. What do you look for when you are determining whether we are near an inflection point?

Sam Zell: I tend to see those opportunities when day-to-day activities don't make any sense to me. And there is probably nothing more relevant to seeing around the corner than assessing supply versus demand. For example, when I see people building office space without being able to identify the future tenants, as I do today, that is a warning sign that supply is engulfing demand. In general, we're humans, and we tend to follow the pendulum to extremes. The more I see extreme imbalances between supply and demand, the more I become convinced that the opposite is correct. And when conventional wisdom becomes 100% bullish, I usually close my checkbook.

Allison Nathan: Are there places today where you think we are at or near the top of the cycle and expect a sharp reversal?

Sam Zell: I can't explain the valuation of the big tech companies, and can't believe that we won't see a significant correction there. For example, in order to justify the multiple that Amazon trades at today, the company would have to be worth 25% of the US economy five years from now. This situation is no different from the one in 1997, when I pointed out that Cisco's multiple would only be justifiable if the company represented 25% of the US economy five years later.

Obviously, that didn't happen, and I don't think it's going to happen with today's big tech companies, either. I'm also generally concerned about the size, scale, and influence of these companies, which I think is out of hand and dangerous to our overall society. Absolute power corrupts absolutely, and these companies are being set up to do exactly that.

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Allison Nathan: What about on the fixed income side? Do valuations there concern you at all?

Sam Zell: Yes. Going back to my earlier comments on supply and demand, we've just come through quantitative easing in the US, and the European Central Bank is still buying and adding new money to the system. I look at all that and think there's too much supply, so there's got to be an adjustment.

Allison Nathan: You called the top of the commercial real estate (CRE) cycle in 2007. Many market observers view CRE as a source of risk today. Do you agree that such concern is warranted and, if so, how big of a risk might it pose to the economy?

Sam Zell: I don't think substantial concern is warranted just yet. The level of activity in CRE is nothing like previous periods of massive expansion, like the one that took down the economy in the 1980s, for example. In fact, the Great Recession of the late 2000s was the first recession since World War II in which we didn't have massive oversupply of CRE built or under construction heading into the downturn. And there was a period of three or four years after the start of the recovery with almost no new construction; we didn't begin to see a significant amount of new supply until 2013. That said, as I mentioned earlier, I see some signs that CRE supply is overwhelming demand. If it keeps going at the current rate, I would become alarmed about the potential for another CRE crash. But I am not quite there yet.

Allison Nathan: There has been a lot of focus on retail property coming under pressure with the rise in online shopping. How concerned are you?

Sam Zell: Well, let's start with a very simple fact: The US has five square feet of retail space for every one square foot that anybody else has around the world. So we are starting with a significant over-allocation of space to retail. Then we bring in the internet. It makes up only about 8.5% of retail sales at this point, so we're just talking about early stages. But those early stages are creating dramatic changes. Why would anybody go to the store to buy something that they can order online and have delivered the same day or the next day? The result is that the very best retailers and the small, corner strip mall centers are immune, but everything else is either obsolete or in grave danger. And the definition of "everything else" is a lot. So I think that the retail format and platform is going to change radically. And the net result is going to be the US needing a lot less retail space across the country than we currently have and previously felt was necessary.

Allison Nathan: You have substantial exposure to residential real estate, which, of course, was a key source of the Great Recession. What notable residential trends are you seeing today?

Sam Zell: For over 20 years prior to the Great Recession, the US built over a million single-family homes per year, leading to a massive oversupply. But that did not apply to multi-family units, or what I'd call rental property. Post the recession, the number

of new single-family homes per year dropped as low as 500,000, and new mobile homes, which at the peak reached 350,000 per year, fell to 25,000. With the collapse in supply of new single-family homes, there was significant growth in the demand for multi-family units. That growth has continued, particularly as the definition of demand has changed. When we went public with Equity Residential in 1993, it was made up of garden apartments in the suburbs. And the definition of quality was expressway frontage. Today, we own no garden apartments in the suburbs. All of them are high-rise apartments in central business districts. And the measure of quality is walking score (i.e., how far to the subway, to Starbucks, to the gym, etc.).

These are pretty dramatic changes, many of which are driven by perhaps the greatest demographic change in the last 100 years: the deferral of marriage. I graduated college in 1963 and was married ten days later. So was everybody else. Today, the average male is getting married with a three in front of his age. And the average female is almost as old. That has enormous implications for demand and for society more generally.

Allison Nathan: If you take a step back, how do you rate the investment environment today?

Sam Zell: I rate the investment environment as certainly not good... and certainly not bad. The real issue is that the supply of capital is at a level that I've never seen before in my career. And that oversupply of capital is dramatically reducing the rewards that you get for investment. So whereas there are always opportunities, dislocations, and inefficiencies, the number of those opportunities is significantly lower than normal relative to the amounts of capital available today.

Allison Nathan: What do you make of the apparently large amount of "dry powder" in private equity today?

Sam Zell: To me, dry powder reflects the amount of fear in the market. I'd say there's insufficient fear today, so there's too much capital available—and thus too much dry powder to allocate towards a limited set of opportunities given generally high asset prices. If you change the fear factor, you could go from too much dry powder to no capital available in a relatively short period of time.

Allison Nathan: What would instill fear in the market?

Sam Zell: How about North Korea? How about Venezuela? How about Russia? How about the South China Sea? Want me to keep going?

Allison Nathan: But will markets ever respond in a significant way to these geopolitical risks?

Sam Zell: I don't know the answer, but if North Korea fires an inter-continental ballistic missile at Guam, I think everybody's perception of investment will change.

Allison Nathan: You mentioned that there are always investing opportunities. Where do you see the most compelling ones today?

Sam Zell: The most crowded areas are in technology, applications, "disruptions," and all of the magic words that are driving people today. But the excitement over them doesn't make them compelling. In many cases, I don't think you're getting paid for the risk involved—and the risk, by the way, may be unbridled competition.

By contrast, I see opportunities in much more mundane areas. For example, we made a big investment this year in a trash-hauling business. We're building waste-to-energy facilities. We've been buying refineries. We're looking at agricultural investments. These are all assets that people value inappropriately, in my view. And, while perhaps less flashy than tech, that's the kind of stuff that I'm always looking for.

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