

Featured Article



Expanding Investment Horizons for Real Estate – In Search of Alpha

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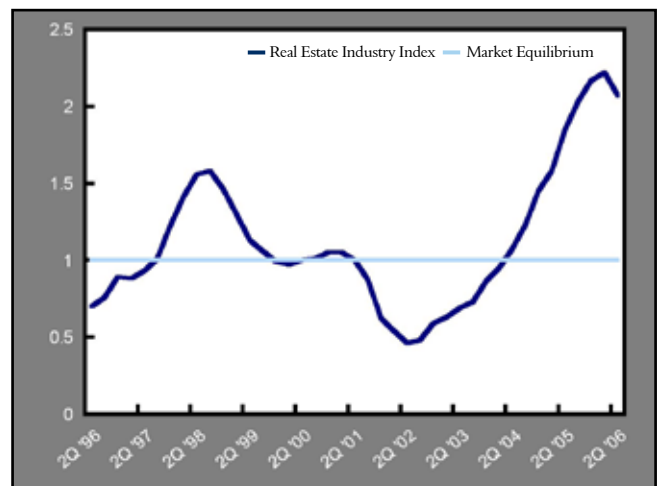
Driven by their need to find innovative ways to generate alpha¹, or superior risk-adjusted returns, many institutional players are broadening and expanding their view of acceptable commercial real estate investments. Read on to see how they are achieving higher returns...

Commercial real estate continues to gain recognition as a very attractive investment relative to stocks and bonds for many reasons. Today, however, the appeal of commercial real estate is in its extremely high “realized” total returns in the absence of very little perceived downside risk. Further, commercial real estate is clearly coming of age as witnessed by the level of capital that continues to flow into the market. This sustained level of capital in both the public and private real estate markets has created a very competitive environment for investment product, thus redefining beta². With this continued influx of both retail and institutional capital, commercial real estate investments will push the envelope for investment strategies and for real estate products that fit or fulfill these strategies.

Commercial real estate performance has easily outpaced and continues today to far exceed investor expectations. This can be measured by a comparison of “realized” versus “expected” returns, which has been a very good barometer of the maturity of the industry. As can be seen in the All Property Types Investment Performance Cycle chart, commercial real estate has been in an overperformance (realized returns exceed expected returns) phase since second quarter 2004. Institutional commercial real estate investors sense

that they have had it too good for too long in the traditional core real estate arena, and they realize that it is an appropriate time to look outside the defined core property types and change their traditional views of real estate investments. (This expanded view is a response to many factors, but our examination is based on the realization that the real estate industry is maturing like the stock and bond markets have done in their respective evolutionary periods.)

RERC All Properties Investment Performance Cycle



¹ Alpha: The excess return, on a risk-adjusted basis, that active managers generate over and above their benchmark.

² Beta: In general terms, the market return or benchmark return. In finance terms, it is a measure of the sensitivity of a portfolio relative to the market (i.e., a portfolio with a beta of 1.0 will mirror the market).

Realized returns refer to what has happened or has a historical perspective and generally helps formulate what the “expected” return will be in the future. The expected return is what you hope, or expect, will happen for the future performance of the investments. What has happened over the past several years? Realized returns have far exceeded expected returns in the face of an anemic stock market.

Commercial real estate recently has seen a trend toward higher yield strategies on the part of institutional investors. Although not the sole impetus for this change, the growth of the public equity markets since the early 1990s has brought transparency and liquidity that has moved commercial real estate into the investment mainstream for both retail and institutional investors, alongside their stock and bond allocations. The addition of real estate investment trust (REIT) stock companies to the Standard & Poor’s 500 has placed real estate into funds indexed to that subset of the New York Stock Exchange. The next stage of real estate investing should witness a maturity phase of the commercial real estate industry that has been spurred by this enhanced credibility and is branching out in response to sustained capital flows that performance-driven investors are searching for.

The Primary Food Groups (a.k.a., Core Property Types)

The initial evolution of institutional investors naturally placed them in a risk-averse posture, and they dutifully minimized risk by placing most of their real estate investments in what the industry termed “core” assets, seldom straying far from the safety of the herd. The definition of core assets was based on two primary criteria: the property type and the risk profile. The character of this investment classification includes five main property types, which all are included in the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NPI): namely office, retail, apartment, industrial, and hotel property sectors. The NPI has tracked real estate returns since 1978, creating a meaningful time series that lends itself to statistical analysis and serving as a reliable anchor or reference point to when institutional investment took hold.

Real Estate Risk Classifications

The core property types were further segregated by their risk profile. Traditionally, the highest level of capital investment for the market rested in the office and retail categories. It was not until the early 1990s that investors got the notion that apartment and industrial properties added a nice diversification element to their portfolios, and then they struggled to get enough of these assets jammed into their portfolios. Investors then pushed the envelope by heartily breaching into the riskier hotel category. This was done in pursuit of a riskier strategy into a property type that carried more than a hard-asset return. Even then, we observed that the struggle was in finding enough real estate products to round out and satisfy the capital demands of the market.

Commercial real estate has many investment characteristics that differ starkly from the stock and bond markets. One that is not so apparent is the inability of the real estate market to quickly create investment options and opportunities to satisfy demand. Corporate America that underpins the stock and bond markets can create investment options at breakneck speeds; however, the commercial real estate market has a natural governor on the delivery of product – construction. Construction involves securing a site, approvals, and lots of materials and time – ultimately requiring a transparent and watchful eye of the market. Ironically, although real estate is still very much a local business, global pressures affecting construction materials, interest rates, and costs also impact real estate on a local level. The dynamic of construction constraints and costs is in fact a strong contributor to how institutional investors are defining suitable and available real estate investments.

Once we look past core commercial real estate from a risk standpoint, we begin to stack the opportunities in order of increasing risk and thus “expected” return. Investments are generally classified along the risk and return spectrum as core, core-plus, value-add, and opportunistic. The risk profile can be ascribed to both the individual investment or to an investment fund comprised of a number of properties. Although investment funds have defined the risk-based objectives of their investments using various definitions, there are typically prospective equity rate-of-return thresholds presented in the prospectus to define the inherent risk. RERC refers to these as “expected” returns, which are contrasted to “realized” returns. Realized returns refer to what has happened or has a historical perspective and generally helps formulate what the expected return will be in the future. The expected return is what you hope, or expect, will happen for the future performance of the investments.

What has happened over the past several years? Realized returns have far exceeded expected returns in the face of an anemic stock market. Further, we need to think of these expected and realized returns along the lines of unleveraged or a 100-percent equity yield versus a leveraged yield that has some level of borrowed money on it. Not surprising, as you move out on the risk spectrum, the level of borrowed money increases and with the maturity of the commercial real estate capital markets, you can become 95 percent leveraged. This obviously reflects a highly-gearred investment that has traditional debt along with mezzanine capital.

The factors that affect risk are generally not endemic to a given property type. Economic and physical characteristics of a property can affect the risk profile. Economic factors can include the property occupancy, tenant risk, the degree of leverage, market conditions, political risk, and a number of other issues that might impact the reliability of the property's income stream. The physical condition of a property might also affect the risk profile, with a proposed development, a redevelopment, a property conversion, or a property re-adaptation – all influencing risk.

A core investment is typically defined as a stabilized, high-quality asset representing one of the aforementioned five property types, with limited leasing or market risk. When describing the risk profile of an investment fund, a core investment would additionally consider all equity or a lower level of leverage, typically less than 50 percent. For example, one recently announced fund targeting U.S. industrial and office properties is seeking an 8-percent equity return using moderate leverage of 30 percent. Core funds without leverage would likely expect lower equity returns of approximately 75 to 100 basis points.

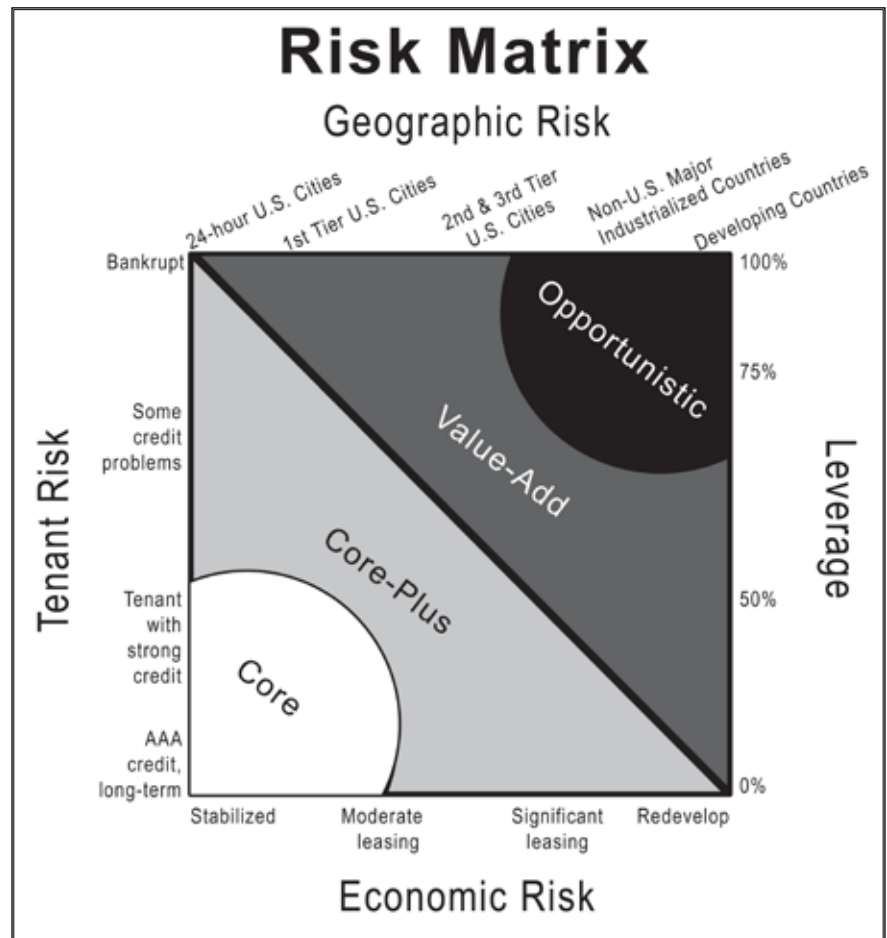
A core-plus investment would add a slightly higher level of risk to the core category of property types, which could include a modest level of leasing risk or slightly higher leverage.

A value-add investment implies that an investor adds to the value of the property by pursuing an upgrading strategy. This could include a modest level of physical property upgrading (i.e., a Class B property upgraded to Class A), taking moderate lease-up risk on an unstabilized property, or buying a property with contract rents below market. Higher leverage can also be found in this investment category, with loan ratios often approaching 70 percent. A recent \$2 billion-plus fund that classified itself in this category was seeking a 13-percent to 15-percent equity return through the purchase of office and mixed-use property that was underperforming, had capital needs, or redevelopment potential.

Opportunistic investments represent the highest risk category and the highest returns. Many offshore investments fall into this category, although globalization and maturing foreign markets have made this classification less clear cut. Domestically, properties requiring major redevelopment or repositioning of a higher risk nature are included in this category. Higher leverage, often exceeding 70 percent, also often accompanies this investment strategy. Some investors consider a higher return threshold than the range noted in the table below,

considering a return closer to 20 percent as the minimum for an opportunistic investment. A \$400 million hotel opportunity fund seeking 18-percent equity returns will use over 70-percent leverage to acquire underperforming hotels in the U.S. that are targeted for renovation or reflagging.

The characteristics of the aforementioned risk categories are not absolute, as some characteristics typical in one category can be found in other categories. For example, a leverage of 70 percent may be more typical of a value-add asset, but when mixed with a number of core attributes, the asset may be classified as core-plus. Essentially, the risk categories are based on a weighting of the risk.



Based on RERC's extensive work in the industry, our conclusions, and the general consensus noted in the forecasts for recent investment funds, the range of total equity return parameters expected by investors give an indication of the risk profile of the noted risk classifications.

Risk Category	Leverage	Equity Yield
Core (no or low leverage)	0%-25%	7%-8%
Core (moderate leverage)	25%-50%	8%-10%
Core-Plus	50%-70%	10%-13%
Value-Add	65%-75%	13%-16%
Opportunistic	70%+	16%+

The foregoing yield parameters have changed over the years, with steady declines over the past several years. Most new investment funds that target institutional capital, such as commingled funds sponsored by pension fund advisors, market themselves with monikers expressing their risk profile using the aforementioned labels.

Comparing the expected returns noted above with the realized returns show a market that is under-promising but over-delivering, a contrast to the relationship observed in the past. Observation of the NPI annual total property returns of nearly 19 percent for the 4 quarters ending second quarter 2006, and nearly 16 percent over a 3-year period for largely core-type investments, exemplifies this phenomenon. Investors have lowered their expectations as the languid stock market shows flat capital growth year-to-date, and low interest rates have permitted a high degree of positive leverage. For much of the 1990s and earlier this decade, strong returns for alternative investments, including stocks, led to the promise of overly aggressive acquisition returns. NPI returns were negative to approximately 8 percent from 1990 through 1995, and did not exceed 9.5 percent from 2001 through 2003. The improvement in recent performance suggests that real estate has earned its broader level of acceptance, with high-yield players finding that venturing outside the core is less daunting than in the past.

In Search of Alpha

As expected yields have been compressed in recent years and perceived risk has been lowered, institutional investors have incrementally shifted some of their capital focus from core real estate to value-add and opportunistic strategies in search of alpha, or ways to find higher risk-adjusted returns. The opportunistic targets often include offshore investments. The movement to “higher risk and return” products signified a departure from safety as investors began to explore the frontier of the unknown (or at least, the lesser known). Commingled funds touting opportunistic strategies have included real estate in India, Europe, Japan, and a number of other areas in the world, accelerating the globalization of the investment universe.

There is a broad spectrum of other candidates that illustrate the expanding universe for real estate that augments the core property type investments. The NPI, which many institutional funds use as a benchmark index for judging return performance, has emphasized this effort by establishing a subcommittee to expand the index to include properties other than the five core property types currently included. Investor capital often has been reluctant to stray toward investments outside those represented by the established NPI benchmarks. Although not in the NPI total index, NCREIF has a history of over 10 years of returns for timberland and farmland that are illustrative of the trend that will eventually include indices for other property types. NCREIF has collected property level returns on approximately \$4 billion in market value of these specialty properties, which

will provide a running start in developing return indices that will establish return benchmarks that will further stimulate investment in these areas.

Data for healthcare properties, land, and self-storage buildings are already reported to NCREIF, but are not analyzed independently. In addition to potentially establishing indices for these property types, the list of future index candidates includes medical office, senior housing, entertainment (theatres, golf courses, et al.), manufactured housing, parking facilities, and student housing. Indeed, investment funds are journeying into uncharted territory for a wide number of institutional investors.

The Future

The momentum for a changing investment landscape is already underway. The inevitable establishment of a broader property type spectrum of indices will induce a greater flow of capital into real estate. The larger variety of asset pools will allow investors to have broader diversification with the newer fund types largely filling in the high-risk, high-yield portion of the portfolio.

On the opposite side of the fence from the investor, these heretofore “step-child” property types will benefit from the advantages offered by critical mass. Improved operational management, research, geographic diversification, and access to capital will all result from this larger pool of assets.

For investing managers and consultants that serve the institutional market, the challenge will be educating themselves on the property-specific nuances of the various non-core property types. Valuation and supply/demand analysis will follow established methodologies, but the inputs will deviate by property type. Researchers will have to identify and analyze a new set of demand drivers, and then determine a way to gather and process the relevant data. Fund advisors and consultants will have a number of new arrows they will have to fit into their quiver of investment choices. Ultimately, more rigorous analytical tools will be used to solve for alpha.

Commercial real estate coming of age in a global environment is creating new investment frontiers and strategies. As the industry matures, it continues to take on elements of investment style and attitude like the stock and bond markets. In today’s extremely capital competitive world, investors are willing to take on unexplored risk arenas in search of alpha. The challenge for the entire industry is to develop more rigorous models to approach risk classification and quantification relative to expected return. Commercial real estate is in a very solid position to get it right this time and to continue to play a more significant role in the investment portfolios of both retail and institutional investors. Given the still local nature of commercial real estate, there is the opportunity for investment managers to add value and thus find true alpha strategies.