REAL ESTATE IN 3-D: SEE IT NOW!

By dividing real estate equity investments into three dimensions—product type, geographic location and life cycle stage—meaningful performance comparisons may be made.

by Joseph L. Pagliari, Jr.

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The increasing institutional commitment to real estate equity investments has been widely heralded. But in a strange derivative of Mark Twain's remark about his rumored death, this commitment has been greatly exaggerated. No, not exaggerated in monetary terms—the flow of investment funds has been huge—but exaggerated in the sense of allocation. The institutional commitment essentially has been an allocation to "core properties"—investment-grade office, retail and industrial properties located in major metropolitan markets.

Necessity Is The Mother Of Allocation

Initially, much of the institutional commitment to real estate equity investments resulted from the disappointing returns realized in institutional stock and bond portfolios. In order to improve the overall portfolio performance, fund managers turned to real estate. This shift seemed to be spurred not by real estate's supposed portfolio-enhancing capabilities, (i.e., high rates of return, low volatility, low to negative correlation with other financial assets and a rate of return indexed to inflation) but by the poor performance of the stock and bond markets. Or had the performance of the stock and bond markets remained strong, the institutional commitment to real estate might have been less.

The importance of this observation is that on a micro basis the process is repeating itself again. This time, the stock and bond markets are being replaced with "investment-grade" office, retail and industrial properties. As prices for these properties continually bid upwards, the realized performance will continue to deteriorate. The answer lies in de-emphasizing these assets and branching into other property types (e.g., apartments) and other classes of property (e.g., Class B and C buildings). However, this redirected portfolio emphasis needs to be done with the specialized market knowledge which enables superior investment performance to be achieved.

Meet The Averages

There are two problems with this heretofore narrow view. First, continued investment in these "trophy" properties (and the exclusion of properties of other types and quality and in other locations) accentuates a two-tiered pricing structure: the trophy properties trade at substantially lower yields, so the premium for these so-called investment-grade properties becomes ever more difficult to justify. Second, this view tends to foster the notion that real estate investment organizations (such as the pension fund advisors, partnership sponsors, etc.) are adept at creating value across all (or, at least, most) strata

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of real properties when, in fact, this is not universally true. For example, a strong sponsor of office buildings located in the Northeast is not necessarily equally skilled at sponsoring shopping centers located in the Southwest.

This narrow view of real estate equity investment creates the impression that real estate is a homogeneous asset class. Accepting this impression as fact is fine if you want your real estate investment performance to mirror the performance averages generated by other institutional real estate investors. (There is precious little solace in knowing that your performance has matched that of your brethren when the achieved yield is substantially lower than expected or is even a negative return.) However, if you want to achieve superior performance (both in a relative and an absolute sense), it is critical to appreciate that real estate is a very heterogeneous asset class.

Real Estate's Heterogeneity

Essentially, income-producing real estate equity investments can be viewed as having three dimensions classified by product type, geographic location and stage in the product life cycle. Product type, or the nature of a property, and geographic location are obvious classifications of real estate equity investments. Although less obvious than the first two parameters, life cycle also is critical in distinguishing the primary attributes of a real estate equity investment. The life cycle dimension is based on the notion that improvements built upon the land have a longevity that is similar to, albeit typically substantially longer than, the longevities of other tangible products. Real estate goes through a start-up phase, which is the construction or development phase. Once a building is constructed and fully leased, the real estate enters the stabilized phase, and, if well designed and located, it will remain in this phase for many years. Like any other tangible product, real estate is subject to obsolescence and deterioration. If the location of a property is still attractive and the structural integrity of the building is still essentially sound, then the property will enter the rehabilitation phase. When rehabilitation overcomes obsolescence and deterioration, the property returns to the stabilization phase. This life cycle process is shown in Figure 1.

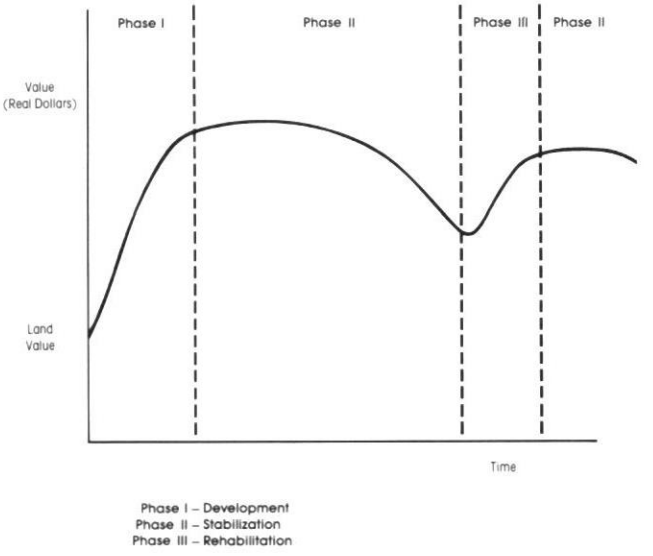
The Three Dimensions Of Real Estate Equity Investments

Figure 2, while highlighting key attributes, also oversimplifies the three dimensions of real estate equity investments. Consider the following:

Product Type. The listing of the five major property groups in Figure 2 (office, retail, apartment, industrial, other) could be expanded to include other income-producing real estate types: nursing homes/congregate care facilities, hotels and motels, etc. In addition, each of the major property types could be expanded to reflect the variations within categories. For example, industrial facilities could be further classified in order to delineate incubator space, R&D facilities, ceiling height, square footage, etc.; retail facilities could be further classified in order to delineate regional malls, neighborhood malls, strip centers, etc.

FIGURE 1

Real Estate Life Cycle Phases



Geographic Location. The listing of the four major geographical areas in the figure (East, West, North, South) is an oversimplification. Not only could the number of geographical areas be expanded greatly, but delineations could be made to distinguish urban vs. suburban. For example, urban Detroit and suburban Detroit often exhibit very different suply and demand patterns. Additionally, even these categories could be further delineated by submarket: consider the difference between Manhattan's Wall Street district and its midtown district.

Life Cycle. Figure 2 also oversimplifies the realities of the real estate life cycle. For example, there are different degrees of rehabilitation: light (or "cosmetic") versus heavy (or "gut") rehab.

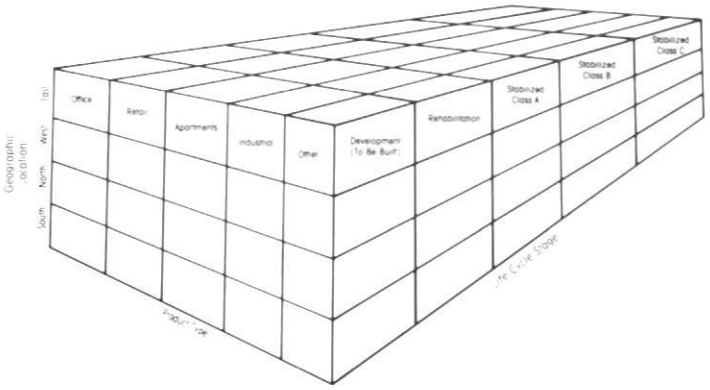
Notwithstanding the refinements that can be made to these axes, the three-dimensional depiction of equity investments in Figure 2 establishes a framework for developing a better appreciation of the heterogeneity of real estate. Each cell, or block, that comprises the three-dimensional depiction represents a unique set of risks, rewards and market knowledge. An appreciation of the differences in the cells will help lead to better investment performance.

Risk, Reward And Market Knowledge

Market knowledge is the key to assessing the risks and rewards of a potential real estate equity investment and achieving superior investment performance. Market knowledge enables the real estate equity investor to more accurately assess the risks and rewards of a particular investment. Market

FIGURE 2

Real Estate in 3-D



knowledge extends beyond the oft-quoted macro vacancy rates; it encompasses an intimate familiarity with the product and the submarket in which the product operates. Less obviously, market knowledge extends to which organization is most skilled at maximizing value for a particular "cell." These factors vary widely by cell.

To illustrate, let's examine some aspects of property type, geographic location and real estate life cycle for an office building of 200,000 square feet and for an apartment building of 400 units, both of which have roughly the same market value.

Property Type. Consider the leasing activity as just one element of a successful property and further consider the different activities involved when comparing and contrasting the leasing activity for office buildings versus that of apartment buildings. Typically, the turnover ratio (i.e., the percentage of square feet, or residents in the case of an apartment building, which is being vacated upon lease expiration in a 12-month period) for stabilized properties might be 15% for the office building and 50% for the apartment building. The leasing staff for each building therefore would have to write six office and 200 apartment leases each year (Table 1).

Obviously, there are tremendous operational differences associated with writing six versus 200 leases per year. And, in fact, the manner of leasing is very different for the two property types. Whereas leasing office space tends to be a prolonged exercise that heavily emphasizes financial and space planning considerations, renting apartment units tends to be an abbreviated exercise that heavily emphasizes ephemeral considerations. Simply put, the former is more of a financial negotiation whereas the latter is more of a selling process. In almost every respect, the skills, techniques and circumstances of leasing are opposed. Consider just a few aspects: the use of outside brokers and print advertising; the sophistication of the clientele, the leasing agents and the lease negotiation process; space planning considerations; tenant buildouts; and the individualization versus standardization of the leasing process.

TABLE 1

Total Number of Yearly Leases Required for An Office vs. An Apartment Building

	Office	Apartment
Size of building	200,000 sq ft.	400 units
Turnover ratio	× 15 %	× 50 %
Vacated space	30,000 sq.ft.	200 units
Average tenant size	÷ 5,000 sq.ft./tenant	÷ 1 unit/tenant
Leases to Write	6 leases	200 Leases

Geographic Location. If we explore the dimension of geographic location as it relates to, for example, apartment buildings, we will see there is wide dispersion in the turnover ratio among locations. Our hypothetical example uses a turnover ratio of 50%, which is a very rough benchmark of the national average. However, in rent-controlled New York City, the ratio is typically 5% to 10%. In a soft market such as Phoenix with high turnover, short-term leases and a somewhat transient market, the ratio can approach or even exceed 100%. The magnitude of turnover ratio and, in turn, the number of new leases (20 for New York City, 400 for Phoenix) written each year has a dramatic effect on how the property is operated. Consider the possible differences in: advertising budgets, "lost rent," turnover costs, the amount and quality of leasing personnel, financial record keeping, etc.

Life Cycle. Examining the dimension of the property's life cycle for our hypothetical apartment building, the turnover ratio (or, more accurately, the lease-up ratio) would be 100% when the building is newly developed. The ratio would range from 50% to 100% after rehabilitation, depending on the degree and process of the renovation. Obviously, in terms of the leasing function, these properties more closely resemble those in soft markets.

As this example demonstrates, without market knowledge, it is extremely difficult to prepare a thorough acquisition underwriting, and it is equally difficult to overcome the inevitable, but unforeseen, obstacles that materialize after a property has been acquired and is being operated.

Size And Performance

For organizations that do not have in-house management capabilities or, that do not have in-house capabilities for a particular cell, another important ingredient is the selection of a joint venture partner/investment manager. In fact, as institutional investors diversify away from core properties and into intensive real estate assets (i.e., defined to exclude an entire building leased to a major credit tenant with a triple net ten-year lease), selection of a joint venture partner will become increasingly important.

Ironically, there is a tendency to use the size of a potential partner's organization as a proxy for future performance. Now, surely, there is some minimum critical size beneath which a real estate operator cannot efficiently perform; however, the corollary—

that, as an organization continues to grow from this critical mass, its performance (at enhancing the value of the real estate assets) continues to grow—is not necessarily true. A review of no-load mutual funds clearly displays this tendency, with the smaller funds, on balance, outperforming the larger funds. Intuitively, this might appear to be true also for real estate investment companies: the more successful firms are more likely to concentrate on a particular set of cells along either the geographic or the property type dimensions. By limiting themselves to a particular set of cells along one of these two axes, successful firms are better able to build and utilize a knowledge base (specific to a geographic location or a property type) from which they will be able to outperform the competition.

It is important to note that firms concentrating in a particular geographic location are capable of building and utilizing a knowledge base on all product types within their locale. Similarly, firms that specialize in a product type are able to amass market knowledge about that property type regardless of locale. However, firms that specialize in property at a particular life cycle stage are not always able to develop market knowledge of properties in other stages. The skills necessary to develop or rehabilitate a property are compatible with the skills needed to operate stabilized properties. However, the converse is not true: the skills necessary to operate stabilized properties are not sufficient to either develop or rehabilitate properties. Therefore, Figure 3 shows that rays in either the geographic or property type axes are bilateral, but the ray along the life cycle axis is unilateral.

Conclusion

Several premises have been presented here: (1) real estate as an investment class is very heterogeneous and includes the dimensions of property type, location and life cycle; (2) a concentrated allocation of investment to the three major institutional real estate investment categories (investment-grade office, retail and industrial properties), at best, is likely to "meet the averages"; (3) in order to prudently overcome the present herd mentality, a diversification within real estate's various market sectors must be done with specific market knowledge in hand; and (4) the size of an advisor's/manager's firm is not necessarily a proxy for this specific market knowledge or future performance.

Although the real estate community has made great strides in providing standardized performance measurement, as compared to the stock and bond sectors, it has a long way to go with regard to standardized measurement techniques, breadth of market coverage and segmenting real estate asset classes. The three-dimensional depiction of real estate is intended to be a basis for segmenting real estate equity investments into meaningful groups which will enable a more satisfactory comparison of performances.

FIGURE 3

Comparison of Venture Partners' Real Estate Performance Skills