

# Commercial Real Estate: Why Invest? Lessons Learned And A Look Ahead

**Stephen M. Renna, August 2010**

Commercial real estate has been increasingly recognised as an asset class by institutional investors over the past 15 years because of its high current cash flow, diversification benefits and as a hedge against inflation.

The universe of commercial real estate investment opportunities can be divided into four categories based on whether they are held in public or private market vehicles and whether the investment structures are equity or debt.

In each strategy, the fundamental revenue source consists of leases paid by tenants who occupy commercial properties. This income is potentially augmented by the capital appreciation of the asset, realised at the time of sale.

Private equity investment involves the purchase and management of commercial buildings, including office buildings, industrial warehouses, multifamily apartment complexes, hotels and retail shopping centres. This investment may be made through open-end commingled funds and separate accounts.

Public equity investment involves the purchase of shares in real estate investment trusts (REITs) and real estate operating companies (REOCs), providing investors with exposure to real estate via publicly traded securities.

Private debt investment includes the origination and acquisition of senior debt (whole mortgages) and mezzanine debt (equity like subordinate debt) on commercial properties. The public debt market includes the origination and trading of commercial mortgage backed securities (CMBS).

Real estate investment managers manage separate accounts, sponsor funds and other real estate investment programs as well as develop and manage the assets in which they invest. They serve the investment goals of public and corporate pension funds, foundations, sovereign wealth funds, endowments, insurance companies and individuals – domestic and foreign.

## **Overview of US commercial real estate investment universe**

The \$8.2 trillion commercial real estate universe (equity plus debt) represents over 13 percent of the overall investment opportunity universe. Institutional investors hold over half of US real estate, \$4.6 trillion, of which over \$1.1 trillion is equity.

## **Why do investors invest directly in real estate?**

*Favourable risk adjusted returns.* Over the last 15 years, private real estate has provided an annualised return of over 9 percent compared to 9 percent for public REITs and 7.4 percent for US stocks.

*Low volatility.* Over the last 15 years, public REITs have proven to be almost 5 times as volatile as direct real estate investment and US stocks over three times as volatile.

*Attractive current income.* Over the last 15 years, the annualised income return of private real estate is 7.71 percent compared to 6.03 percent for public REITs and US stocks.

## **Lessons learned from market turmoil**

Over the course of 2009, real estate fund managers were reintroduced to the lessons that have been commonly repeated during rapid market contractions throughout history.

First, markets correct. While financial markets build slowly over time, their corrections are often rapid, violent episodes that wreak havoc on the overexposed and unprepared.

Second, leverage is a tool; neither good nor bad. It amplifies the return to equity of market swings in both directions. Leverage can be amazingly

positive during upswings and truly devastating during a downturn.

Third, financing long-term assets with short-term debt is a market timing gamble and not a sustainable strategy.

Fourth, absolute return strategies require greater risk taking during up markets. As capitalisation (cap) rates compress, achieving a fixed target yield will require greater risk of loss due to elevated structural complexity, greater leasing uncertainty, geopolitical complication, construction risk and greater leverage, among others.

Fifth, expectations lead to style drift. Investment success in one phase of a market cycle leads to greater expectations in the next phase of a market cycle, whether rational or not. These expectations, together with natural competition, often lead to 'style drift', where managers expand into new investment arenas or opportunities outside of their original core competency in search of yield. It is often in these new investment arenas that managers are least equipped to handle the rapid shifting of a down market.

Sixth, knowing when to take profits off the table. Unrealised gains do not count for much in the grand scheme of things. Knowing when to take money off the table (realise gains) can be a tremendous differentiator.

Seventh, strong investor relations matter. It may seem like an unnecessary overhead when investors are making 25 percent returns, but when the world turns upside down, strong communication, openness and transparency with investors will pay solid dividends.

Finally, the strongest survive. Only the strong, intelligent and resourceful will overcome these market difficulties and position themselves to profit from the next phase of the market cycle.

### **Important considerations for 2010**

*Maximising the value of legacy portfolios.* With capital still scarce, fund managers must be brutal in prioritising which legacy investments have realistic return potential and which do not. For priority assets, a return to basics and a focus on creating value at the property level through the aggressive re-leasing of space and rationalisation of costs is key.

Nurturing and sustaining investor relations. The significant variance in the performance of fund managers on the basic elements of good investor relations is well-documented by the institutional investment community. Closely managing and cultivating investor relations is an investment in the future.

*Managing retention of key employees.* With fund promote distributions underwater, and perhaps beyond recovery, fund managers need to rethink their strategy for retaining their key employees, or risk losing them to the open market.

Nothing will be more attractive to an ambitious investment professional at the end of 2010 than a new fund with no legacy issues to work out, committed capital to draw and a fresh promote to provide incentive.

*Managing newly raised capital.* Considerable amounts of capital have been raised but are sitting on the sideline. Investors are risk averse and want class A, stabilised properties in gateway cities. Problem is that little product exists. Those products that do come to market attract many bidders and create mini bubbles.

*Mini bubbles.* Most transaction activity is a product of improved capital markets not improved economic fundamentals. This is creating mini bubbles that are dangerously similar in look to transactions made at the peak of the cycle.

### **Outlook for 2010 and beyond**

*Soft fundamentals.* Market fundamentals are expected to be soft as job growth lags behind the broad recovery.

*Capital markets opening.* The capital markets will continue to open slowly and the availability of debt and equity capital will increase throughout the year.

*Valuations continue to slide.* Valuations of private real estate will continue to slide for a time, but pockets of well-positioned, low-risk, prime assets in gateway cities such as London, Washington, DC and New York will rally ahead of the broader market as a result of increased investor demand.

*Extend and pretend continues.* Although the 'extend and pretend' strategy for underwater mortgage maturities will likely continue, banks and other lenders will increasingly feel pressure to finally resolve their troubled loans through sale or foreclosure.

*Bid-ask spreads will start to narrow,* the number of opportunities to acquire real estate at distressed prices will increase and transaction velocity

will start to accelerate by the end of 2010.

*2010, set-up year.* In the US, 2010 appears to be a 'set-up' year for the next chapter of opportunity. The real estate market bottom is still in front of us, but nearing in most geographies and asset classes, and institutional investors are still slowly evolving their focus from principal safety to increased yield.

*Brighter 2011 expected.* The sentiment for opportunistic investing in 2011 is brighter but plenty of caution still prevails.

In 2009, there were no companies that reported over 10 transactions; almost a quarter of respondents expect at least 10 transactions in 2010, according to a National Association of Real Estate Investment Managers (NAREIM) CEO Pulse survey. On average, the respondents are expecting to complete about eight transactions in 2010, up from the average of two in 2009.

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