❖ *Translating Risk Into Opportunity*

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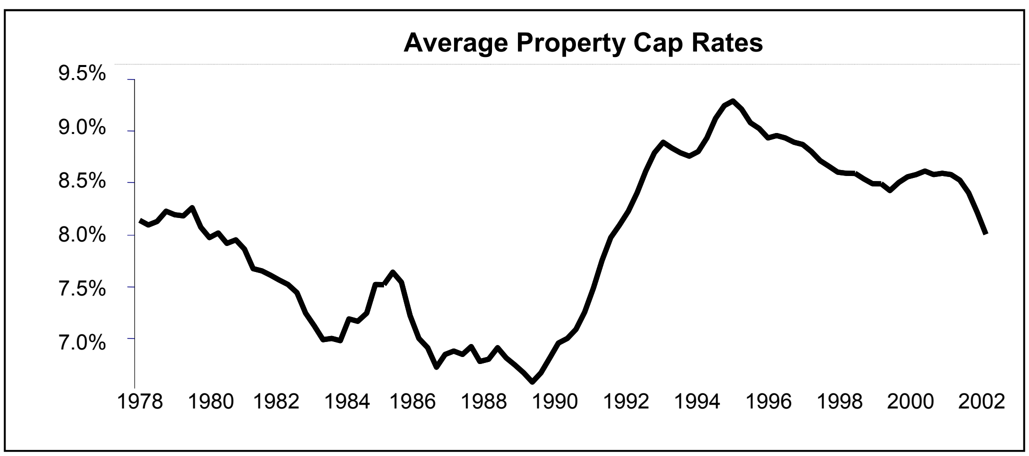
Introduction

It is with great intrigue, a hint of skepticism and yes, a little bit of envy, that veteran real estate investors are witnessing the entrée of new investors and record flows of capital into the industry. These newcomers, as everyone knows, are rewriting the rules of real estate investing and causing the old-timers some heartburn in the process. How, veteran investors ask, can this new crop of investors justify such outrageous prices? Don't they know fundamentals are weak? In an industry where the "correct" answer to almost any question is "9%" (*i.e.*, average cap rates, average stabilized vacancy, average debt constants, etc.), how can they accept 6% yields? Weren't they around in the early 1990s? Don't they know better? Don't they know what will happen to prices when interest rates rise? But, most important: How can we veterans compete?

As always, part of the answer is in the data. First, despite common folklore, 9% is not the "correct" answer to all questions relating to real estate. Over the past 25 years, as seen in Exhibit 1, even with respect to average cap rates for institutional quality property, they have hit 9% only once—in the mid-1990s. Today, the average cap rate for commercial real estate is somewhere between 7.5% and 8.0%, which is about the 20-year average. Does this mean that we are at equilibrium today? It's probably not that simple. However, it is safe to say that cap rates today are not atypical. We have seen times like this before, and we will continue to see them again.

Exhibit 1



Source: NCREIF

Second, while recent headlines make it tempting to believe that a "secular shift" has indeed occurred and that lower cap rates are part of a new world order, there continue to be great differences in cap rates among property types, geographic markets and, most importantly, perceived levels of risk. Anecdotal evidence points to generally lower cap rates today, primarily in a narrow band of properties—namely, core "Class A" assets that are well-leased by credit tenants and located in major metropolitan markets.

For example, by now everyone has read the headlines about One Lincoln Street, a 1.05 million square foot newly built office building located in the financial district of Boston. It sold in February 2004 for $705 million, nearly $700 per square foot, at a rumored going-in yield of 7%.[1] The building was just completed at a cost of $350 per square foot—half the sales price—and was successfully leased to State Street Corp.[2] The buyer of the building was American Financial Realty Trust, a newly formed REIT that had its initial public offering just eight months prior to the purchase.

Nicholas Schorsch, CEO of the buyer, was quoted in December 2003 as stating that the company "had $1 billion to spend on property."[3] In contrast, John Hynes III, the managing partner of the seller, referring to the fact that the purchase contract was signed one hour prior to the kick-off of the Super Bowl, likened himself to the game's winning quarterback, the New England Patriots' Tom Brady, in selling the building for a record price.

Turning Risk into Alpha

So, how do real estate veterans who are interested in not only stability but growth compete with those who have $1 billion to spend and don't mind making sellers feel like Super Bowl MVPs? By recognizing that opportunities exist in every market for sophisticated, experienced investors who are able to recognize and capitalize on the imperfect nature of real estate markets, producing opportunities where "mispricings" in the capital markets are greatest.

In actuality, One Lincoln Street itself is a compelling example of mispricing real estate versus fixed income. Although the sales price set a new record for Boston, the building is of the highest quality. Most important, it is 100% leased for 20 years to a AA-rated, publicly-traded institution. And while an unleveraged 7% yield on real estate seems relatively low, it represents a 120 basis point premium to the true yield on State Street's 22-year senior debt and a 200 basis point premium to the current 20-year swap rate.[4] Moreover, American Financial, the buyer, is reportedly financing more than $520 million of the $705 million purchase price at an interest rate of just under 5.8%, resulting in a current return on equity of 10% (assuming no amortization of the mortgage).[5] Not bad *alpha* over bond yields.

What about investors who worry about the residual value of the building and getting capital back at the end of 20 years when the lease ends? Even if the property's equity is cut in half from $200 million to $100 million, the overall internal rate of return on a leveraged basis is still 9% with profits of approximately $300 million. And, even in the "worst-case" scenario that the building is *worthless* at the end of the 20-year lease and assuming that no debt was ever put on the property, the owner still achieves an internal rate of return of 3.6% and profits of nearly $300 million—and has an empty 1.05 million square-foot office building to boot.

1. PR Newswire-First Call, "American Financial Realty Trust Announces Closing of Acquisition Feb. 17, 2004."
2. *Boston Business Journal*, "One Lincoln sold to Pa. REIT for $705M," February 2, 2004.
3. *ibid*.
4. Bloomberg, SST7.35% 06/15/2026, Price 119, True Yield 5.8%, as of February 18, 2004.
5. PR Newswire-First Call, "American Financial Realty Trust Announces Closing of Acquisition Feb. 17, 2004."

All of this analysis, of course, gives no credit to the "upside" potential of One Lincoln Street that fixed-income investments generally do not offer. What happens if the value of the building grows at an assumed 3% per annum rate of inflation over 20 years so that the property is worth about double the purchase price? It is hard to imagine now a building worth $1,300 per square foot even 20 years out, but the resulting leveraged internal rate of return on equity would be nearly 14% with profits of approximately $1 billion. Who feels like the Super Bowl Champion now?

Of course in real estate, like most investment classes, Super Bowl-sized returns are most likely to be found far from the well-trampled fields of Reliant Stadium. Savvy investors know that *alpha* is most often found by choosing the less beaten path. Today, unprecedented amounts of capital are flowing into real estate: Institutional investors publicly announced manager searches for $4.4 billion in new real estate allocations—a 36% increase over 2002.[6] Retail investors also are participating as never before, driving capital raised by private REITs last year to $4.7 billion, up from $600 million in 1999.[7] What is this capital chasing? By and large, what many investors failed to find in the equities market in recent years—stable, income-producing assets with little to no capital risk. So, if "core" is a crowded field, the experienced investor goes where the masses cannot—targeting complex transactions that require an experienced team with the management infrastructure and risk mitigation strategies to intensively work the assets. That same team can then take advantage of today's seemingly insatiable appetite for core investments, once the assets are cleaned-up and converted into stabilized, income-producing properties.

Despite the headlines of record prices for Class A "trophy" buildings, real estate located in secondary markets, those with non-household-name tenants, those that need a little work, and in particular, those held in complex ownership structures or owned by a distressed or otherwise motivated seller have not benefited from material yield compression. In fact, these are the assets in which risk is mispriced and, hence, represent the best prospects for generating *alpha* for investors that have the experience, the resources and the necessary infrastructure to take advantage of the situation.

For example, there is a 300,000 square foot plus "Class B" office building located in the central business district of a major West Coast city that is 100% leased and on the market at a 15% cap rate. The sales price is $25 million or about $80 per square foot. The catch: The building is solely occupied by a telecommunications company with a junk credit rating. As a result, while One Lincoln Street reportedly attracted more than a dozen credible buyers, this building has been sitting on the market for more than 12 months without a single offer.

Here is the opportunity for a savvy investor: While purchasing a single building leased to a non-credit tenant is risky, an experienced real estate manager with the necessary resources could actually purchase 20 such buildings in 20 different markets with 20 different tenants doing business in 20 different industries. Even though the risk of any single tenant going bust is relatively high (like the telecommunications tenant in the West Coast building), the risk that more than three, four or even five of the 20 tenants defaulting on their leases in a diversified portfolio is relatively low. Therefore, using statistical analysis and being careful to measure risk tolerances and correlations among markets, tenants and industries, an experienced real estate manager could assemble a highly diversified $500 million portfolio of 20 buildings that yields $75 million (15%) in current cash flow. Using moderate leverage of 50% at a cost of 8%, the return on equity would be 22% or $55 million (on $250 million in equity).

6. *The Institutional Real Estate Letter*, December 2003.

7. Source: Maximus Advisors.

To test the investor's assumptions and level of risk tolerances, the manager could run sensitivity analyses by asking "what if" type questions. What if two tenants fail immediately and the buildings they lease fall in value by 75%? The answer: 17% internal rate of return and profits of $200 million over five years for the entire portfolio. What if five of 20 tenants go dark and the value of those five buildings is worthless? Even then, the investor achieves a 6% internal rate of return and profits of over $50 million. By asking the right "what if" type questions and getting comfortable that the range of possible outcomes based on a set of assumptions is within an acceptable range of tolerances, the sophisticated investor can translate those same risks into new investment opportunities, generally free from competition.

The mispricings that create double-digit returns is typically due to imperfect knowledge, lack of real estate value maximization skills on the part of the seller and restricted competition from other potential buyers. All of these factors have played and will continue to play to the advantage of experienced investors, and they demand a seasoned management team that is well-versed in complex transactions that require the successful execution of numerous value-added and creative risk-mitigation strategies.

Management is Key to More Sophisticated Plays

A manager armed with diversification and the ability to measure and manage risks can not only capitalize on opportunities to generate *alpha*, but create them. An experienced manager with a proven track record and a history of investing through the high and low points of economic cycles also can help investors avoid pitfalls and successfully navigate the entire investment period. There are three key aspects of a real estate investment firm's approach that it should be able to clearly articulate: a central investment thesis, an operating philosophy and the firm's core values.

In the value-added and opportunistic arena, the **central investment thesis** generally revolves around "planful opportunism"—the notion that the relationship between the capital markets and the real estate industry is inefficient by nature, creating an erratic but endless flow of high-yield investment opportunities. Erratic because pricing mechanisms are imperfect. Endless because change is the motor of history. Today, the dynamic forces causing change are stronger than ever, with globalization, technology, government and economic cycles all combining to create ample opportunities for experienced investors. Change of this nature typically alters capital flows, causing the market to misprice risk at least for a period of time due to information lags. Change and its market aftershocks are a constant in real estate. Sometimes it occurs by property type. Other times by region; and nearly always in the capital structure itself. Investment strategies are developed around these mispricings, and because market changes can occur swiftly, a clear investment thesis must be in place to guide strategies that are nimble and opportunistic by design.

The **operating philosophy** is essentially a firm's "how-to" manual. Generally, successful firms have a proven track record that reflects their commitment to consistently delivering integrity, attractive returns and opportunities for talented employees. The operating philosophy also serves as the central underpinning of the firm's broad strategy, which typically involves: (1) building strong relationships in each market in which the firm operates; (2) maintaining effective leadership and organization within the firm itself; and, (3) exporting the company's culture, business practices and investment philosophy, so it blends with local law, customs and cultures.

Core values, on the other hand, can vary widely from firm to firm. They form the backbone of each organization's individual corporate culture. A strong culture is a competitive advantage for a firm, which cannot be imitated. It is the sum of values, practices, attitudes and norms. A strong culture should equip employees to make the right decisions without hesitation. As such, the core values that define the culture are the stars by which the firm sets its course. Core values that many successful real estate investing firms have in common include:

Integrity: Irreproachable ethical conduct and commitment to upholding the highest standards.

Commitment to Excellence: Never resting on current performance, no matter how exemplary.

Candor: Being an effective and honest communicator both with employees and investors.

Teamwork: Building a culture of collaboration that values mutually productive relationships.

Speed: An organization that understands windows of opportunity do not remain open very long.

Flexibility: Recognition that change is the ultimate opportunity, and the only thing a firm should not be flexible about is its values.

Core values are key to a firm's sustainability. They help create an environment in which natural leaders emerge, and they help constructively answer a timely question for the real estate investment management business today: how to transition from one generation of leadership to the next. Many private firms that thrived in the 1980s were acquired in the 1990s by large financial institutions. Now, many of the opportunity firms formed in the 1990s are at a similar identity crossroads today. This, of course, makes it all the more important that prospective investors know the investment thesis, operating philosophy and values of the managers with whom they pursue their growth-oriented real estate investing strategies.

Conclusion

So are today's Super Bowl Champs the beginning of a new dynasty or a flash in the pan? Time will tell. Either way, many analysts believe the new real estate investors and their ample pools of capital are here to stay. While they may have changed the investment landscape, the tried and true principles of successful real estate investing remain the same. Looking ahead, it's a safe bet that there will continue to be shocks to the system, whether through spikes in interest rates or less predictable events. It's also safe to say that these shocks will likely continue to do what they have always done: displace capital—creating opportunities for some and disappointments for others.

Sophisticated strategies that move beyond traditional "buy-and-hold" real estate will have the greatest opportunity to produce the most attractive risk-adjusted returns. While the range of acceptable returns may have shifted, particularly at the core end of the spectrum, strong leadership and creative application of risk mitigation strategies, grounded in a central investment thesis, operating philosophy and core set of values, will continue to define successful real estate investing. These principles also will continue to create *alpha* opportunities for experienced investors willing to venture beyond the rising stream of capital chasing traditional core real estate. As such, an investing strategy built on diversified portfolios and the successful execution of creative, proven strategies for managing risk holds perhaps the greatest potential to create value in an investment climate otherwise littered with average market returns.