

## *Adding Value in a Challenging Return Environment*

June 2003

### Pinehurst

Each spring Prudential Real Estate Investors holds a conference in Pinehurst, NC, to discuss trends in the institutional real estate investment industry. This year's gathering focused on reassessing the institutional investment landscape in light of the current difficult investment environment. The following provides a summary of this year's proceedings.

All in attendance agreed that pension fund returns have been disappointing for three years. Compounding the decrease in value of the funds is that returns for stocks and bonds for the next several years are projected to be significantly below historical averages. If we then overlay the fact that many plans will soon be paying out more benefits because of the aging of the workforce, we come to the conclusion that shrinking returns and higher payout rates mean that many funds will need fresh contributions soon.

As a result of these circumstances, CIOs are under more pressure than ever before to enhance return and to increase current yield. Out of necessity, they are also more open to considering new private or enhanced public strategies. One of these strategies, commercial real estate, has been a beneficiary of this rethinking of asset allocation. CIOs whose funds have a real estate allocation have been pleased with the attractive performance of real estate over the last several years. Many who lost confidence in real estate in the late 1980s and early 1990s are reexamining the asset class because the real estate capital market has gone through a fundamental transformation over the last 10 years. Those who did not invest in real estate during the booming years of the public markets are asking more questions about private assets like real estate. Furthermore, many CIOs are taking actions to diversify their investments beyond stocks and bonds and to seek nontraditional opportunities to enhance current yields, as well as risk-adjusted returns.

#### **Facing the Reality of Return**

The bursting of the stock market bubble, historically low interest rates and a deep corporate recession have forced investment pro-

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professionals to think seriously about where future sources of return will originate. Examining closely the major asset classes of public stocks and bonds reveals that the required levels of return for the plans are most likely not going to be generated from these two asset classes in their most traditional forms.

To illustrate the point, let us look at the potential returns of stocks and bonds using the simplified assumption that expected return is the sum of current yield, expected growth and return attributable to valuation change.

The stock market's current dividend yield is approximately 1.8%. Historically, S&P 500 companies' earnings have grown at a rate slightly below nominal GDP growth. Let's assume, however, that earnings growth will approximate GDP growth over the longer term. Nominal GDP growth of 5% to 6% could be expected from a 1% growth in population, 2% to 2.5% growth in productivity and 2% to 2.5% inflation. Thus, the current dividend yield of about 1.8%, plus earnings growth of 5% to 6%, adds up to roughly between 7% and 8%.

The wild card in projecting stock market returns is determining the return from valuation changes, or forecasting the sustainable P/E ratio. The current P/E ratio is already much higher than the historical average of 15x. Because of the increasing democratization of stock ownership, some might argue for a higher P/E today, but it would be difficult to assume a historically high P/E ratio of 30x, which the market reached just before its collapse in 2000. The expected return of the stock market, therefore, could be 7% to 8% (say 7.5%), assuming no change in P/E ratios. With an exit P/E of 30x 10 years from now, we would expect a return from US stocks of about 12%. P/E ratios must set new records in order for returns to be higher than 12%. The upside potential of equities, therefore, is limited. But the downside risk is great. With an assumed exit P/E of 15x 10 years from now, the expected return would be in the range of 4% to 5%.

The outlook for bonds is similarly tepid. Currently the 10-year Treasury bond has a yield to maturity of about 3.5%. If we add 100-150 basis points to the Treasury yield to arrive at an aggregate yield to maturity for all investment-grade bonds, we would expect a return of 4.75% for the bond market. Unfortunately, an imbedded, unfavorable asymmetry exists between upside potential and downside risk. If interest rates move up, the bond market would return much lower than expected. And with little room for further interest rate declines, higher bond market returns are unlikely.

Stocks and bonds are the mainstays of pension investing. Investors with a portfolio of 60% stocks and 40% bonds would expect a return of 6.4%, given the returns outlined above. Many pension plans, however, need their portfolios to earn 9% or more to achieve their target rates of return. The disparity between expected returns and desired returns means that funding shortfalls are almost inevitable.

### **The Pressure from Demographics**

As a result of poor investment returns, the number of plans already experiencing shortfalls has increased steadily over the past few years. According to Watson Wyatt's *2002 Survey of Actuarial Assumptions and Funding*, in 1998, only 16% of US plans were underfunded, meaning that the ratio of the market value of plan assets to the current liability for accrued benefits was

less than 100%. In 1999 and 2000, 22% of plans were underfunded; in 2001, 47%, and in 2002, 63% of the 171 plans with data available for the 2002 valuation year were underfunded.

Lowered returns are not the only reason pension funds can expect funding problems. Demographic shifts will also cause difficulties, as the largest age cohort ever enters their 60s. The oldest of the 78 million baby boomers, those born in 1946, turn 62 in 2008 and can then begin taking advantage of Social Security's early retirement pension. The boomer retirement wave will crest in about 2015. Yet the next generation, often called Generation X, contains only about 45 million to 50 million people, depending on how one defines the group. Thus, the ratio of current workers to retired ones will fall sharply.

In 2000, 62% of the US population was between ages 15 and 59, and only 16% of the population was 60 and above. But in 2050, the United Nations Population Division estimates that 57% of the US population will be between 15 and 59, and 26% will be 60 and above. In other words, a ratio of about four to one working to retired people will eventually change to a ratio of about two to one. While the UN definition of the working age versus retirement age may not fit the US, the trend is indisputable. Furthermore, the UN estimates that US life expectancy will increase from about 77 years in 2000-2005 to almost 82 years in 2045-2050.

Demographics also exert pressure on investment markets. As society ages, it becomes more risk-averse and demands more current income to pay for current liabilities. Although this process is both long lasting and slow moving, its impact on the investment landscape has already been felt and will continue well into the future.

### **Real Estate Reexamined**

Real estate is a large asset class. The investable universe of US real estate is approximately \$4.5 trillion to \$5 trillion and compares favorably with the US stock market's size of about \$12 trillion. Over the 10 years ending December 2002, real estate returned 10% per year, as did the US equity market.

Unleveraged real estate currently can be acquired at a cash yield of 5.5% to 6.5%. The expected growth over the longer term is modest, as it has been in the past. Let's assume a growth rate of 2%, which is at the lower end of the assumed inflation rate of 2% to 2.5%. In the absence of a change in cap rates, real estate would have an expected return of 8%, highly competitive with the 7.5% expected return for stocks and 4.75% for bonds. Since real estate has a lower risk profile than equities, real estate is even more competitive on a risk-adjusted basis. While the realized return will likely deviate from the expected return, because real estate has a high current yield and a more stable cap rate than the stock market's P/E ratio, the range of expected returns for real estate is relatively narrow. In other words, the expected return for real estate is relatively safe. For example, if the cap rate goes back to its historical high at exit, which has negative implications for real estate values, we would still expect a 6% return from real estate over the next 10 years.

Private investors own more than 85% of US commercial real estate (public companies own the balance); thus, real estate is primarily a private asset class. Real estate, therefore, has a low correlation with public market instruments, such as stocks and public fixed income. The

NCREIF Property Index in 2001 and 2002 had positive, although single digit, returns compared with the large negative returns of the stock market. Over the longer term, real estate has indeed exhibited low correlations with stocks and bonds and has proven to be an excellent portfolio diversifier.

Approximately 75% of real estate's return is derived from income, and high income lowers volatility. Real estate thus has a low return volatility and has proven so with its historical performance. The high-income feature of real estate is also in great demand as pension funds struggle to find cash flow to pay liabilities. Geoff Dohrmann, one of the panel moderators at Pinehurst, noted that for those funds that invest in real estate, the asset class now provides 21% of portfolio income and covers 17% of payout obligations, with an average allocation to real estate of about 8%.

It probably will take more than these arguments, however, to convince those who have not invested in real estate for some time to return to the asset class. Many of these investors remember the late 1980s and early 1990s, when the oversupply of space was compounded by a wholesale withdrawal of capital from multiple capital sources. The depression of the investment market for real estate, however, triggered fundamental changes that gradually transformed a relatively opaque, monolithic market into a dynamic, efficient and sophisticated investment market.

None of the changes were more significant than the rise of the REIT and CMBS industries in the 1990s. This growth of the public markets brought about a dramatic increase in the amount and depth of information available to industry participants. Analysts and rating agencies gathered detailed data on properties, sectors and markets, and this data brought much-needed transparency and discipline to the industry.

Another major development in the real estate investment industry over the past decade has been the emergence of diverse investment vehicles that target particular levels of risk and return. Today investors have a choice of whole mortgages, CMBS, core properties, public securities, value-added and opportunistic investments, and even private equity ventures in real estate. Hybrid investments, such as mezzanine debt and convertible securities, are also available. The financial structuring of risk and return levels to appeal to the differing needs of investors signifies the coming of age of the real estate investment market.

### **Adding Value in a Difficult Space Market**

Today's capital sources for real estate are diverse and disciplined. The investment market has become more transparent and sophisticated. The space market, however, remains cyclical. After all, supply still responds to demand with a construction lag. Demand itself, as a reflection of the overall economy, can unexpectedly turn in either direction. The capital markets may dampen real estate cycles but cannot eliminate them altogether.

The stock market meltdown and the severe corporate recession caused collateral damage to the real estate space markets, in that there has been far less demand for space. The challenges caused by a weak economy and a corporate recession will be with us for some time in most real estate sectors, until lost jobs return and tenants absorb enough underutilized and vacant stock.

While the expected return for core, unleveraged real estate is approximately 8%, higher returns in the range of 8% to 15% can be created, even in this challenging environment. One method of driving up returns involves changing the physical attributes of properties, namely development and redevelopment. Although most of the risk during the life of a property occurs in these phases, most of the value creation also takes place in the beginning of a project. At the current point in the real estate cycle, new development opportunities are limited, but pockets of growth still exist. More importantly, the current weak markets provide select opportunities to redevelop failed or subperforming assets to achieve their best and highest use. Development and redevelopment obviously entail additional types of risk. The investor community, however, has become sophisticated in managing and mitigating development risks with instruments such as forward commitments, where investors agree to purchase a property at a predetermined price after the asset has been built and, in some cases, has reached a certain occupancy level.

The second way to increase returns is through financial structuring. Due to low interest rates on fixed-rate mortgages and floaters, this approach has been extremely popular with both institutional and individual investors. Equity investors can use leverage to enhance current yield, as well as total return. Debt investors may participate in mezzanine investments, a type of structured debt financing that can generate returns (and risks) somewhere between those of senior debt and leveraged equity positions, often with a higher expected return than the unleveraged property could offer.

The third way to enhance return is operational. Today's problematic market contains many challenged assets. Operational efficiency may be gained through changes in management or branding, by increasing occupancy, focusing on the tenant mix, intentionally altering lease durations or minimizing cost exposures.

Value can be added at the property level. Value may be created at the entity level as well. Real estate is a large and mature industry; its related activities contribute greatly to the US GDP. Like any mature industry, it expands to meet new demands. We estimate that more than 10% of all real estate activities are of high value creation. Private equity investments in companies with the management know-how and a niche market to grow are excellent ways to finance these activities and to reap the appropriate rewards for investors. While the mantra for property investment is "location, location, location," the focus for private equity ventures should be "management, management, management."

### **Crossing Borders in Search of Risk-Adjusted Returns**

Instead of moving out on the property risk curve, going abroad may be an alternative for pension funds to increase absolute returns and risk-adjusted returns. Foreign investing carries the added risk of foreign exchange movements and may be burdened with relatively complex structures in order to minimize taxation. But the benefits of international investing may amply offset incremental risks and complexities, at least for large plan sponsors who can deploy substantial funds into foreign countries.

What distinguishes international real estate investment, of course, is the possibility of higher returns than are available at home. It is also the ultimate diversifier, far more so than international stocks and bonds, which tend to have a higher correlation with domestic markets.

And because two-thirds of the investable real estate universe is outside the US, international investment presents numerous diverse opportunities that may not be available in the US market.

Three regions may be considered for institutional investment. Europe is the largest and has a real estate market that rivals the US. Asia is about 75% of the US market. Latin America, the smallest region, is less mature and is approximately 15% of the US market.

The prominent story in Europe is the expansion of the European Union (EU). Ten countries will join the European Union next year, bringing important changes with them. The enlargement of the EU from 15 countries with 380 million people to 25 countries with 455 million people means that the fully expanded EU will have 175% of the US population and a GDP larger than that of the US today (assuming the euro maintains its recent gains against the US dollar).

European markets are highly diverse. In countries like the United Kingdom, Germany and the Netherlands, investments in core properties, value-added deals and private equity ventures are common. Emerging markets, such as Poland, Hungary and the Czech Republic, carry developing country risks, but convergence offers enormous potential. Some mature economies, such as Italy, have immature property markets.

The unified capital market created by the euro is facilitating the gradual formation of pan-European property companies and the securitization of mortgage debt in the form of commercial mortgage-backed securities. Pressured by a large and more harmonized market, enterprises are refocusing on their core competencies. Large-scale divestitures by corporations and governments are creating portfolio-buying opportunities. Financial institutions are also divesting real estate holdings in the form of carve-outs, spin-offs and property-for-stock swaps.

The driving force in Asia is the explosive growth of China, which has become a growth engine for the rest of Asia. China's entry into the World Trade Organization has helped further stimulate its economic development. The pent-up demand in mass housing, for example, is one of the major factors that the government counts on to drive future GDP growth. While China has amassed a huge quantity of institutional-grade real estate from offices to retail malls to residential complexes, its investment market is still in its infancy. The Chinese yuan is not fully convertible, but it is under pressure to appreciate due to the large inflow of foreign direct investments as well as the back-flow of Chinese capital that has found better opportunities at home. To investors, however, China remains an emerging market and carries with it all the emerging market risks.

The rest of the Asia story is one of anticipatory recovery. Excluding China, which had an unprecedented boom in the 1990s, and Japan, which experienced the longest stagnation and deflation in history, the rest of Asia continues in the recession and stagnation triggered by the 1997 Asian financial crisis. The recession in the US, the global fight against terror and, most recently, SARS all contributed to this long retrenchment – the worst since WWII. Asset values in the more developed markets, such as Hong Kong, Singapore and Tokyo, have deflated to levels that make yields highly attractive to global investors. And prices per square foot are now comparable to those in other major business centers in Europe and North America. Premium yields are available in South Korea, Malaysia and Thailand.

Three Latin American countries hold the most promise for real estate investing. Mexico and Brazil dominate the region with a more than 70% share of Latin American GDP. These two countries also have the largest population shares in the region – Brazil with 40% and Mexico with 24%. Chile, a country of 15 million people, has had a stable government, a well-run economy and the highest credit rating in the region for more than two decades. Aside from its size, it deserves the attention of international investors.

Thematic or programmatic investing that satisfies local pent-up demand is probably the best approach for emerging market countries in Latin America and elsewhere. The housing sector is a prime example. First, huge housing deficits exist in countries like Brazil and Mexico. Second, these countries are developing their primary and secondary mortgage markets to ensure that more people can purchase homes on credit, rather than with cash. Third, demographic trends favor household formation. And lastly, the economies have developed to a stage that the mass-affluent class – the middle- to upper-middle-class families that have the income to afford quality housing – has emerged en masse. Opportunities in industrial and retail are also abundant in many developing countries.

### **Closing Thoughts**

One of the most important ideas attendees at Pinehurst learned this year is that although a gap still exists between those who are “sold” on real estate and those who have never considered it (or who have distant but unpleasant memories of it), that gap may slowly be closing. CIOs are starting to ask the right questions about what investments in alternative asset classes, including real estate, can do for their funds. Consultants are responding that although real estate returns are moderating, real estate still has highly competitive risk-return characteristics. In a world of declining return expectations for stocks and bonds, many of these CIOs like that answer; some are even making commitments to real estate for the first time or after a long hiatus. And those who have already seen the light are, in some cases, increasing their allocations or are aiming for the upper end of their target ranges.

With new capital flowing to the market as fundamentals remain weak and cap rates on desirable properties are declining, managers are finding creative ways to take advantage of today’s economic realities. Returns may be ratcheted up through physical, financial and operational changes, as well as private investments in real estate companies. Given where interest rates are, investors have also taken advantage of creative ways to structure investments by using different ways of leveraging property. Finally, in search of higher risk-adjusted returns, more pension funds are becoming receptive to overseas opportunities. Some large pension funds either have already made, or are pondering, investments in regions such as Europe and Asia. Even Latin America is gradually showing up on the radar screens of some US investors.

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