

## ***Differentiating Higher Return Strategies In Property Markets***

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### Research

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Investment styles and return objectives in real estate have focused in recent years on higher return strategies. This progressive migration further out along the risk/return curve has led to a proliferation of investment funds and strategies known generically by descriptive names like “enhanced core,” “value added,” or “opportunistic,” depending loosely on the magnitude of the funds’ return targets. All of these funds seek returns in excess of those expected by traditional highly diversified, unleveraged core private equity funds. However, the strategic and tactical approaches individual funds employ to achieve higher returns can vary considerably. That is, within the generally accepted real estate *fund style* nomenclature of enhanced core, core plus, opportunistic, etc. there is another layer of *manager style* which relates to the specific approaches to achieving the stated objectives of the fund.

Investors, therefore, need to examine not only the style of the investment fund, but the style of the manager as well when contemplating investments, particularly those involving higher return or opportunistic strategies. This article introduces some general categories with which to distinguish funds based on the approach to achieving enhanced returns, and suggests some important considerations relevant to each that investors can use to assess a fund manager’s likelihood of success.

#### **Higher Return Strategies and Manager Styles**

In the modern view of investing, excess returns arise in two ways: (1) as a reward for incremental *risk* imbedded in portfolios as a result of investment decisions, and (2) from incremental value added arising from *skills* on the part of the portfolio manager, not related to risk. Capital market theory suggests that this latter variety of excess returns, typically described by terms like “manager value added” and *alpha*, is impossible to achieve consistently in efficient markets. Due to important and persistent inefficiencies in the commercial real estate market, however, it is possible to achieve excess returns consistently in carefully structured

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and managed real estate investment funds. That is, a skilled portfolio manager can deliver superior performance to investors without exposing them to additional risk, creating value for the investor directly and indirectly through careful structuring of investment programs with respect to both financial issues and decision making.

For the purpose of this discussion, higher return strategies are classified into four categories (see Exhibit 1). Three of the categories, defined as wealth creation, value added and income enhancement, involve different approaches to achieving higher returns from the skills or *style* of the portfolio manager. The fourth category, incremental risk, includes all strategies that involve the use of additional conventional risk, i.e., higher expected volatility of returns.

**Exhibit 1: Four Categories of Higher Return Strategies**

<b>Category</b>	<b>Approach</b>
Wealth Creation	Create value by development, redevelopment or repositioning.
Value Added	Exercise superior <i>investing</i> skills – selection and timing – to exploit market inefficiencies.
Income Enhancement	Exploit superior <i>operating</i> skills to enhance revenue and operate more efficiently.
Incremental Risk	Choose investment/leverage combinations higher on return/volatility continuum.

In reality, funds can and often do use various combinations of these approaches to achieve their enhanced return objectives. Because the categories tend to involve contributions from different members of the asset-management/portfolio-management team and can be implemented in concert with one another, the four categories represent a complement of strategic approaches rather than a menu from which investors and managers must choose. Nevertheless, each approach requires different specific skills from the manager/advisor team, exhibits different liquidity characteristics requiring different time commitments from investors, and incurs different costs to implement.

### **Wealth Creation**

For the purpose of this discussion, the term “wealth creation” is used to describe the practice of using contributed capital and retained earnings to increase the market value of the capital base. *Growing* the asset base is the basis of most wealth creation in the equity markets. Wealth creation in real estate arises almost exclusively from development and redevelopment.

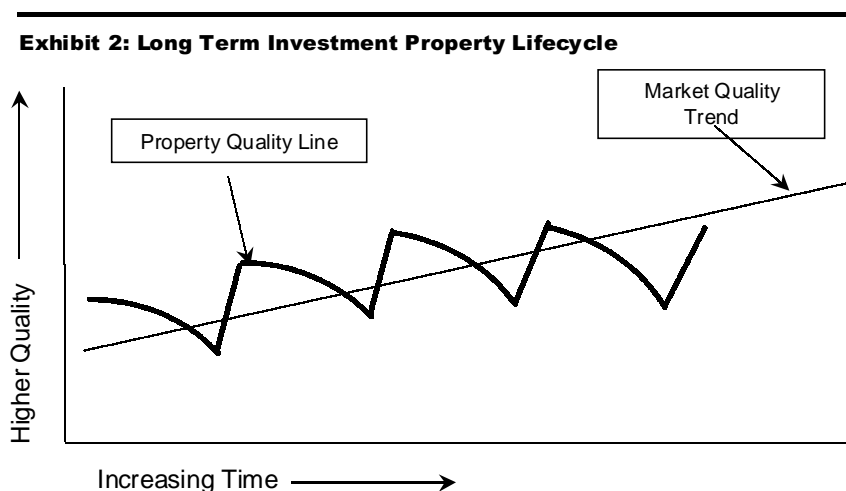
The sources of wealth creation investment opportunities are many, and come from both the supply and demand sides of the property markets. The robust job growth in the office sector of the US economy, for example, has created significant demand for office space, providing opportunities to develop new office properties and redevelop existing space. Likewise, changing demographics and increasing wealth are creating demand for new apartments, just as continual innovation in the

retail sector remains a constant driver of demand for new retail formats. At the same time, technology has significantly accelerated the rate of functional, physical and even external obsolescence which can be cured or exploited through development or redevelopment.

Local market dynamics are an important factor in the execution of wealth creation strategies. Development and redevelopment projects are more likely to succeed when the properties are located in growth markets, like San Jose in the late 1990s, or in turnaround markets, like Boston in the mid-1990s. Absorption of new or refurbished structures in a growth market can occur rapidly. Tenants entering the market for the first time, for example, may select these properties over competitors based on marginal differences in amenities. Slow growth, mature markets pose greater challenges. In mature markets, properties must rely more heavily on current tenants relocating. Potential tenants, therefore, must perceive quality differences sufficiently large to justify a costly relocation decision. This presents a more difficult, though not insurmountable, hurdle to the investment manager.

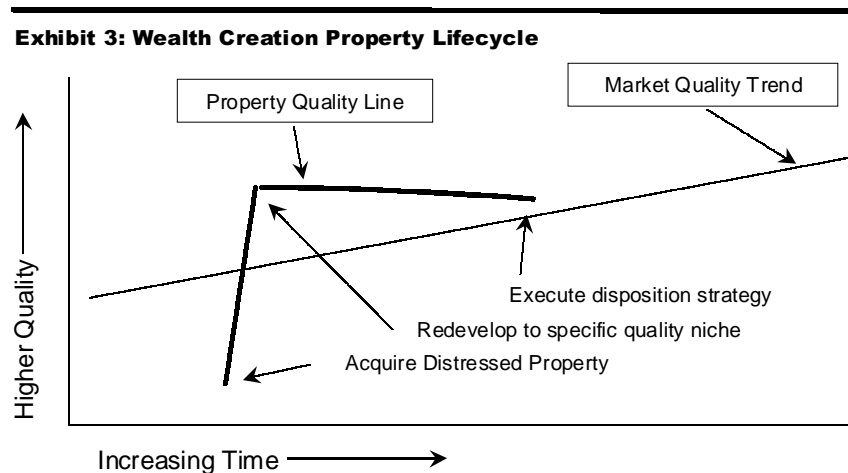
Ultimately, development and redevelopment investment opportunities share the common objective of seeking to exploit a disparity in market perception and the market potential of a property. In the case of redevelopment projects, wealth typically is created through improving cash flow by repositioning a property to market quality or above market quality to realize higher lease rates and/or decrease vacancy. In the case of new development, wealth is created by providing above market quality space (in the form of superior location, amenities, functionality, etc.) to satisfy unmet demand.

We can depict the wealth creation investment approach graphically by way of a property lifecycle diagram. Exhibit 2 shows the typical lifecycle of an investment property, assuming periodic capital expenditures for maintenance and renovations, where “property quality” represents an abstract measure of the services and amenities flowing to tenants from their lease payments. As shown, the average quality of properties in the market as a whole tends to increase over time, a feature arising from the simultaneous pressures of productivity increases and technological advances on the supply



side and rising tenant standards on the demand side, while the quality of existing properties tend to decrease over time. The market value of any property at a given point in time is related to its quality relative to the market average.

Wealth creation investment opportunities (shown in Exhibit 3) can involve redevelopment and repositioning of existing properties that have fallen below the average market quality trend line, or new development projects where demand is sufficiently strong relative to supply to support new construction.



In either case, wealth creation investments require a number of specialized skills not involved in the execution of other strategies, and embody distinct event and relationship risks. In particular, timing can play a critical role in investment success because of the relatively fixed time structure of these investments (i.e., negative cash flow and illiquidity during the development or redevelopment phase) and the sensitivity of the final market value of the property to market conditions when the project is complete. The portfolio manager, therefore, must articulate a disposition strategy that provides for sale while the property still commands a quality premium in its market. In addition, the acquisition team must be skilled in locating and successfully bidding on properties at prices discounted to the market average, and the asset management team must be able to identify and execute improvements that quickly bring the property to or above market standards.

Many of the risks associated with development and redevelopment are addressable with carefully structured contractual agreements between the advisor, the developer, and any venture partners. Forward commitments and pre-leasing conditions, for example, help to mitigate the risks associated with cost overruns, construction delays, and unforeseen market demand shifts. Investors need to understand the unique risks and skills associated with wealth creation investing, and should evaluate the advisor's financial strength and experience with these ventures, as well as the merits of the individual investment opportunities. Further, because much of the total return can be imbedded in a project's market value at completion and often can be recognized only at sale, the conventional intermediate measures of performance – total return and internal rates of return – often provide

little insight about final project performance. They may even give wildly differing estimates of performance to date relative to each other, particularly in the early stages of the fund life.<sup>1</sup> Investors need to be aware of the inadequacies of these performance measures for these investments, and pay proportionally greater attention to progress reports, project milestones, and actual cash flow relative to plan.

### **Value Added Investing**

While there is some risk in using a term as fuzzy as “value added” to describe the second category of higher return strategies, we have done so in the context of this paper to emphasize the source of higher returns for investments that fall into this category. Specifically, as defined here value added investing refers to strategies which seek to achieve higher returns primarily from value appreciation, rather than from income, by exploiting properties whose prices are discounted due to non-market risks such as event risk, liquidity risk and information inefficiencies. Although improving income can boost market value, this strategy focuses primarily on steps that improve market value directly.

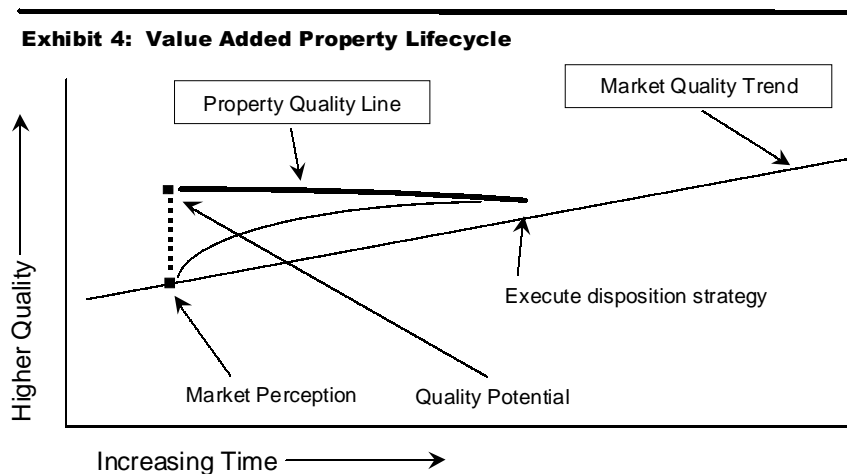
The private real estate markets provide many such opportunities for a portfolio manager to influence, even control to some extent, the true risk exposure while at the same time capturing return benefits for the investor. The critical steps in value added investing involve finding and executing transactions that the advisor believes are mispriced by the market, then structuring the deals to mitigate risk as effectively as possible. As such, value added investing involves actively managing investments to neutralize, at least in part, these imbedded risks so that the realized risk *ex post* is actually lower than the theoretical risk *ex ante* as a result of the professional value added contributions made at the time of acquisition, while invested, and at disposition. The contributions to risk control can take many forms involving many specialties: legal skills, asset management skills, relationship advantages, or market advantages such as preferential access to profitable buy/sell opportunities. Since manager experience, networks of professional relationships and manager negotiating power can play an important role in these contexts, individual managers may assess the risk of a given investment differently, leading to divergent views of fair market price.

Typically, the value added variety of excess returns arises from investment selection and timing skills – investing in better opportunities over the right interval relative to similarly risky alternatives. In this sense, this approach is not unlike that pursued by traditional equity portfolio managers. The opportunities to achieve higher returns from superior selection and timing are created by market inefficiencies – the cyclical behavior of different regions and property types – which typically are reflected in lower prices and/or higher potential returns to compensate investors for the additional risks they incur. Real estate investment managers can actively address these risks with combinations of properly structured management and JV contracts and active asset management.

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<sup>1</sup>From a technical standpoint, the IRR and total return can diverge significantly in a number of circumstances, particularly when the investment cash flows are large and variable relative to the current market value. This often happens in the case of development projects.

This approach can also be shown graphically by way of the property lifecycle. As shown in Exhibit 4, value added investments focus on the disparity between the perceived market value of a given property and the potential market value (“Quality Potential”) not recognized by the market. This disparity allows the manager to acquire the property at a price reflecting the market’s perception, then operate it in such a way that provides cash flows representative of a higher quality property. Eventually, the market and manager assessments of the property’s quality and value should converge, after which the property should earn market, often core, returns.



As is true with most higher return strategies, time works to the investor’s disadvantage over the course of holding value added investments. Often, investment performance is strongest in a relatively short time interval after the acquisition, and then gradually converges toward market average performance as the perceived market value rises to a level consistent with the investment’s actual (lower) riskiness. Because value added investments by their nature will not achieve superior returns indefinitely, the manager should have a clearly defined, carefully timed exit strategy for each investment property. Timely disposition, therefore, is an important element of the value added investment strategy.

Investors considering funds employing value added strategies should examine the advisor’s track record with executing value added investments, giving specific consideration to the ability of the advisor’s transactions team, legal team, the engineering and inspection process, the structure and partners of any joint ventures, and the disposition plan. Investors should also look for effective portfolio management skills, and proven ability to provide strong leadership to orchestrate the separate contributions from the asset management and the portfolio management team members.

### Income Enhancement

A manager/advisor can also create value by concentrating on the income component of real estate investments. Income enhancement strategies typically derive excess returns from the asset and

property management skills of the manager/advisor. This approach to achieving higher returns takes advantage of one characteristic that distinguishes private real estate investing from equity investing, namely the ability of the portfolio manager to participate actively in the value creation process taking place at the asset level.

In fact, operational control and oversight involving specific investments marks a major difference between private real estate portfolio management and conventional public equity portfolio management. In a sense, these contributions represent something more akin to *production* value added than *investment* value added, where the flow of value from services provided by a portfolio manager/asset management team accrues to the investor.

By contrast, stock equity investors can influence their investments at best only at the entity level, and then often only indirectly through share proxy voting.

The most common means by which managers can directly influence the income producing potential of an investment property are through leasing activities and providing services to tenants. A manager may, for example, be able to take advantage of special relationships with tenants to improve the overall credit quality profile of investment properties, thereby reducing the risk of the expected cash flows, or may be able to achieve higher occupancy through superior leasing skills.

Similarly, managers can realize higher returns through services to tenants by providing either the same level of services as others at a lower cost or better service for the same cost. Both lead to higher occupancy rates and more stable tenant bases. Market success in this context has been identified historically with the management concept of “cost leadership” coined by Michael Porter, and resembles the economic concept of “producer surplus” commanded by more-efficient-than-average producers of a commodity.

In real estate, the producer surplus represents the margin between the property rents set by market conditions and the costs of operating the property. Investment managers who can operate properties more efficiently, because of economies of scale available to large firms, above average management skills, or attractively priced contracts with suppliers and servicers, for example, enjoy wider margins. Hence, management operational skills and tactical execution are important sources of enhanced returns in the form of enhanced cash flow. Investors, therefore, need to focus on the asset management skills of the advisor, and to evaluate the sources of net income enhancement.

Superior returns are achieved not from a particular pattern of market value changes, but rather from higher-than-average income returns generated from tenant services, for example, from investments priced at the market average. Effective design and execution of property asset management strategies play a key role in extending the market life of properties. Managers, therefore, must maintain skilled staff to properly execute these strategies.

Of the four categories of higher return strategies described here, the income enhancement approach generally falls at the lower end of the return (and risk) spectrum. Importantly, the types of assets which fit the income enhancement “profile” often involve investments which are held for a longer term relative to other higher return strategies. Funds that seek excess return through income enhancement typically do not try to benefit from market timing transactions, and instead rely more often on rolling investment strategies structured to stabilize cash flows and neutralize business cycle effects. Under these circumstances, the advisor/manager purchases and sells properties more or less continuously, but at a slow pace relative to fund size, disposing of aging properties and purchasing new ones to refresh the portfolio.

Investors should recognize that excess return through income enhancement comes not from appreciation, but rather from income. Although some of the increased income should become capitalized into property price, to the extent that the market views the enhanced income as transferable to new owners, this aspect is fundamentally different from the value added category which derives excess return from increases in asset value.

### **Incremental Risk Strategies**

Finally, excess returns can arise from investing in more volatile investments and being rewarded accordingly. In other words, the funds can be structured to have a high portfolio *beta*. The two approaches used most frequently involve choosing properties with more uncertain cash flows and leveraging property investments. For example, hotel investments, with highly variable daily and seasonal cash flows, typically provide higher returns than industrial properties which often come with more stable tenant bases and long term leases. Similarly, leverage can increase both return and volatility as a percent of net asset value even if the individual assets exhibit normal cash flow characteristics. Generally, the degree of return enhancement depends largely on the leverage ratio and the cost of debt relative to the return on equity investments. The degree of risk increase depends largely on the leverage ratio.

While these approaches can produce returns that exceed core fund returns, they do so primarily by exposing the investor to incremental risk. Investors should recognize that there should be a clear relationship between expected return and return volatility from funds using incremental risk strategies. From the investor perspective, these funds have the advantage of requiring only that managers be able to select investments for which market prices match the imbedded market risks. The intrinsic nature of the investments and/or the fund leverage provide the mechanisms for achieving excess returns rather than some special skills on the part of the manager. In principal, these funds should achieve their objectives without higher-than-average transaction volumes.

Performance measurement for these investments must allow for the deliberate use of increased risk to achieve enhanced return. Risk-adjusted return, therefore, can be a useful construct for the investor when monitoring manager and fund performance.

## Summary

The increased pressure on private real estate advisors/managers to deliver returns in excess of core investing strategies has led to a proliferation of higher return strategies. The broad categories identifying these more aggressive funds – core plus, higher return, opportunistic – can mask strikingly different styles and skills that managers can bring to the marketplace to achieve their objectives. It is important, therefore, that plan sponsors differentiate advisors/managers and investment funds by means of the specific investment style they employ to achieve higher returns.

In this paper, we have identified four broad categories of investment strategies with which to further subdivide the universe of funds pursuing greater-than-core return objectives. These categories, defined as wealth creation, value added, income enhancement, and incremental risk, represent four distinct approaches to generating excess returns. In addition, we have highlighted several skills that advisors/managers must cultivate to successfully execute the four strategic classes, and have added some comments about the measurement of investment success in the context of each approach.

Clearly, fund managers in the real world can and often do employ more than one of these approaches to achieve higher returns, depending on circumstances and manager skills. However, these perspectives should help institutional investors assess the tradeoffs among risks, cash flows, and returns offered by funds with differing strategies, and ultimately may help them to select the private real estate funds best suited to meet their own investment needs.

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