Commercial Investment Real Estate

March/April 2003

Building a Powerful Portfolio

Learn Which Commercial Real Estate Vehicle Provides a Strong Foundation for Your Clients' Investments.

edited by Gretchen Pienta

A client inherits $100,000 and asks you for advice on an investment strategy. With stock returns uncertain in today's market, what is the best response?

Invest in commercial real estate.

Adding commercial real estate to a portfolio in the form of direct investment or real estate funds offers private investors a good hedge against inflation, as historically commercial real estate has equaled or exceeded the inflation rate. It also allows investors to diversify risk and create balance, since commercial real estate doesn't experience drastic fluctuations like the stock market.

Direct investment is even more beneficial for investors willing to undertake property management. Real estate assets offer positive leverage; therefore, the cost to borrow funds to buy another investment is lower, says Steven R. Price, CCIM, a principal and managing broker at Benson-Price Commercial in Colorado Springs, Colo. They also provide disposition control and tax advantages, such as cost recovery deductions. Also, "the dilution of yield to taxation is less than non-real-estate investments," he says.

However, knowing that commercial real estate is a good investment is only half the equation. How do you determine which type of real estate investment is best for your client?

The first step is examining your client’s current portfolio to determine his risk tolerance, says Robert L. Ward, CCIM, GRI, president of the Robert L. Ward Co. in Oviedo, Fla. Also, outline his investment objectives. Does your client need the income from a multitenant property or want the future growth potential of vacant land? Is he willing and experienced to take on property management?

“The thing about real estate is that you have the whole risk spectrum,” Ward says. A more experienced investor may be comfortable purchasing a multitenant office property, but most first-time real estate investors fall into the low-risk category, such as a retail property net leased to a national credit tenant.

The amount of capital your client has to invest also is a determining factor. “Investors don’t need huge amounts of capital anymore,” Ward says. Syndications and real estate funds have opened their doors to investors with less than $50,000. “I have seen a rise in syndications, typically two to five well-heeled investors backing local developers,” says Andrew Merin, executive vice president of Cushman & Wakefield’s Financial Services Group in East Rutherford, N.J. Public vehicles such as the Wells Real Estate Funds also are gaining popularity with investors in the $15,000 to $20,000 range, Merin says.

You also must determine how much of a client’s portfolio should be allocated to real estate. “Real estate is a very integral and important part [of a portfolio] but not necessarily the first part,” Price cautions. Real estate is a long-term investment in most cases and “investors need to be prepared by having other liquid assets,” he says.

Once you’ve determined the real estate investment type and amount, you must persuade your client to take the plunge. “Investors used to steer clear of real estate,” Ward says. “But now the public is educated and more familiar with what real estate can and can’t do.” Real estate investment trusts have allowed investors to “get the flavor” of real estate, he says. “It’s not a specialty investment any more."

The most effective way to convince your clients is to inform them of real estate's positive aspects and compare its returns to those of stocks. "With stocks you may not get your initial investment back, but the after-tax yields [of real estate] can be 40 percent higher than non-real-estate assets," Price says. Real estate also offers a safe haven for the "flight money from the stock market," Merin adds.

Understanding the pros and cons of the various real estate investment vehicles can help you make the best choices for your clients. In the following essays, industry experts discuss the benefits of investing in commercial real estate through direct property investment, syndication, and REITs.

Direct Investment: Bargain Shopping in America
If you were a stockbroker and discovered that Microsoft stock was selling for $120 a share in San Francisco compared to only $60 a share in Chicago, you probably would figure out a way to buy it in Chicago. As a commercial real estate investor today, you also must find ways to take advantage of the tremendous inefficiencies that exist across the country.

Unlike stock, no two real estate investments are exactly alike, so the challenges and opportunities are significant. For example, today you can sell your Northern California office building for $210 per square foot at an 8.2 percent capitalization rate and buy one in Chicago for half that price psf with a 22 percent higher cap rate. When you consider the falling rents and job losses occurring in Northern California and the fact that it is the highest priced market in the country, it would be prudent to diversify into other regions with less downside risk.

Investors commonly object to this strategy of capitalizing on inefficiencies of the market because they want their investments to be closer to home so they can keep an eye on them. This makes sense for a small investor with only one or two investments; however, being able to monitor your investment is a small consolation when you are watching it decrease in value due to regional economic factors outside your control.

Some of the reasons investors diversify their risk by investing in multiple regions and property types include the following:

- to insure against regional economic downturns and disasters such as earthquakes, floods, and hurricanes;
- to increase returns by investing in higher-yielding products or regions;
- to balance portfolios with low-risk/ low-return property and higher-risk/ higher-return property; and
- to reduce or eliminate management intensity by investing in net-leased property anywhere in the United States.

For private investors, many factors should be considered, including age, risk tolerance, experience, and management interest and ability, as well as cash flow needs and expectations.

For example, an older investor may choose to exchange his management-intensive apartment building for a net-leased retail center. Using actual median prices from 2002, he would sell his Seattle apartment building at a 7.5 percent cap rate and trade into a 9.13 percent cap rate Seattle shopping center for a 22 percent increase in an all-cash return. On a 70 percent leveraged basis, the cash flow is about 71 percent higher.

An investor who was willing to venture outside her city could take this same investment to Philadelphia and achieve a 10.1 percent cap rate for a whopping $485,000 cash flow per year — more than double her Seattle apartment's return.

The challenge in advising clients to capitalize on these opportunities is not an economic one: It is an emotional one. There is a high level of fear when venturing into unknown territory, whether it is an unknown investment type in the same city or an unfamiliar region of the country.

Before introducing the concept to clients, learn about where the client is from, where he has family living, and where he likes to vacation. He is likely to be familiar with these areas and have reason to visit them. (He even may be able to make part of his trips tax deductible by investing there.)

Do not expect most of your clients to overcome their fears of the unfamiliar no matter how significant the returns. However, the rewards for you and your clients who capitalize on the higher returns being offered in other products and regions are well worth the extra effort.

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Syndication: Pooling Resources
In general, syndication is simply the process of a group of investors pooling their resources to achieve a financial goal that cannot be accomplished by an individual investor acting alone.

A partial list of the benefits that an investor might get from being part of a real estate syndication is buying part of a property when he is not able to buy the property himself, being part of a larger real estate investment than he could purchase by himself, obtaining financing that he couldn't obtain on his own, investing in a property that is large enough to afford professional management, diversifying and investing in a number of properties rather than one property, and investing in a property in a different geographic location than he lives. Investors generally are sophisticated in their comprehension of real estate investing but are unwilling or unable to invest in a single piece of real estate by themselves.

Real estate syndications' popularity has been cyclical during the past 30 years. Financing is one of the primary factors affecting their popularity. When lenders require larger equity investments in real estate, investors pool their resources to come up with the down payments to finance their projects. As interest rates increase, the cost of financing places too large a burden on the property's cash flow and a larger down payment is required, forcing investors to combine their resources.

The fluctuating capitalization rates found in various property types are another cycle affecting real estate syndications' popularity. As a property type's cap rates decrease, the prices of the properties in that category increase in relation to the net operating income. Thus, larger down payments are needed to generate the more profitable cash flows that investors desire from their real estate investment properties.

In the early 1980s, the tax code offered terrific advantages to real estate investors, and syndications were extremely popular. When the tax advantages were taken away from investment real estate, the syndication industry practically disappeared.

Today, syndication activity is increasing primarily due to the rising investment real estate costs resulting from decreases in all property types' cap rates. As investors pull their money from the stock market and turn to the perceived safety of investment real estate, the increasing amount of dollars chasing the limited inventory of available properties allows sellers to raise their prices. When negative leverage is present, a rule of thumb is to decrease the amount of financing required by increasing the down payment. The need for real estate investors to pool resources to fund larger equity positions is resulting in an increase in the amount of real estate being purchased through syndications.

The returns investors are looking for in real estate syndications are similar to the returns that an individual investor looks for when he owns a property by himself. An acceptable range of before-tax yields in a non-development real estate investment is 10 percent to 14 percent. First-year cash-on-cash returns may be as low as 4 percent to 5 percent. Investors should know that a syndication property not only should provide adequate returns, but also must have sufficient cash flow to pay for the additional layer of management.

Consultants should consider syndications for their investors who have small amounts of money to invest in real estate but cannot own a property by themselves. Investors with large amounts of money should invest in private syndications to diversify their real estate holdings and take advantage of the professional management available through these real estate investments.

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REITs: Less Risk, Stable Growth

The growth of REITs during the past decade has been impressive. With a market value less than $20 billion in 1992, the market capitalization of REITs today is approximately $140 billion. In fact, REITs have infiltrated the private commercial real estate market and have emerged as major players in the real estate industry. As a result of this growth, REITs represent an increasing percentage of institutional investors' portfolios. Thus, it is important to measure the incremental benefits of REITs in the context of a mixed-asset portfolio.

Over the long term, REIT stocks should perform much like their underlying real estate, with changes in price closely related to changes in the value of real estate owned. In the short run, the performance of the underlying real estate may be obscured by the stock market effects of daily investor buying and selling. Additionally, there are times when REIT stock valuations incorporate a discount or premium to the underlying real estate value to reflect investor sentiment about the future.

During the past 20 years, the diversification benefits of REITs have become evident in the context of mixed-asset portfolios. The table Annual Risk-Adjusted Return Summary Statistics summarizes risk-adjusted returns on REITs in comparison to large-cap stocks, small-cap stocks, and corporate bonds. Over a 20-year time horizon, REITs compared favorably to all other asset classes studied.

A review of the table shows the following.

- REITs have the highest risk-adjusted returns of all major asset classes as measured by the Sharpe Ratio, a risk-adjusted performance measure equal to the risk premium earned on the portfolio divided by its standard deviation.

- REITs are less risky than both small-cap and large-cap stocks. Despite having slightly lower average returns than small-cap stocks over this time horizon, REITs significantly outperformed small-cap stocks on a risk-adjusted basis.

- REITs are superior return generators compared to corporate bonds. Although REITs have higher volatility than corporate bonds, the differential in total returns is significant enough to yield a nominally higher risk-adjusted return.

The correlation of REITs to corporate bonds, large-cap stocks, and small-cap stocks is low, as illustrated in the table Correlation of Returns."

The table Optimal Portfolio Allocations illustrates the role of REITs in a mixed-asset portfolio, taking historical annual returns, volatilities, and correlations of all the assets into account. REITs offer portfolio diversification at all levels of risk and return. The allocation to REITs reaches a high of 35 percent but averages 23.8 percent across the risk-return spectrum.

In addition to offering investors diversification benefits, REITs also offer superior dividend yields. The current yield for the sector is 6.7 percent versus 1.7 percent for the Standard & Poor's 500 and 4.2 percent for 10-year Treasury bonds. Payout ratios of 72 percent illustrate the security of REIT dividends.

During the past 18 months, many of the blue-chip REITs in the hotel, apartment, and office sectors have underperformed and now appear significantly undervalued versus their private real estate values and, more broadly, the REITs in the property sectors that have been less affected by the economic downturn. Additionally, smaller, higher-yielding REITs have continued to outperform many of the larger, higher-quality REITs with lower dividend payout ratios. While these performance trends appear unsustainable in the long term, they showed no signs of abating as of third-quarter 2002, and they may continue in the short term if the economic recovery fails to gain traction or reverses.

Recovery will be felt unevenly across property types and regions. Property types that have early cycle attributes (hotels, apartments, and manufactured homes) should benefit from an economic recovery more quickly given the short-term nature of their leases. In contrast, later cycle property sectors with longer leases, such as office, are not likely to benefit until the economic recovery matures in late 2003 or into 2004.

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Chart
Top 10 Buyers' Markets

	Office	*Industrial*	*Retail*	*Multifamily*
1	Atlanta	Columbus, Ohio	Austin, Texas	Philadelphia
2	Tampa, Fla.	Philadelphia	Tucson, Ariz.	Cleveland
3	Cincinnati	Houston	Dallas	Houston
4	Dallas	Atlanta	Denver	Atlanta
5	Philadelphia	Baltimore	Houston	Phoenix
6	Orlando, Fla.	Dallas	Baltimore	Dallas
7	Denver	Boston	Philadelphia	Las Vegas
8	Chicago	New Jersey	Miami	Fresno, Calif.
9	Baltimore	Washington, D.C.	West Palm Beach, Fla.	New Jersey
10	Miami	Miami	Atlanta	Miami

Table
REIT Equity Total Return

	Dividend yield	*3Q02*	*2002*	*2001*
Apartments	7.7%	-11.6%	-5.0%	8.7%
Diversified	7.2%	-10.0%	3.1%	12.5%
Free-standing retail	6.8%	-6.2%	19.3%	24.0%
Health care	8.0%	-5.2%	12.5%	51.9%
Hospitality	3.9%	-20.0%	-1.9%	-8.6%
Industrial/office	7.1%	-9.7%	1.4%	7.1%
Manufactured homes	6.9%	-9.5%	1.4%	13.7%
Regional malls	6.2%	-0.8%	24.0%	31.9%

Self-storage	6.0%	-11.5%	-1.2%	43.2%
Shopping centers	7.0%	-2.1%	13.4%	29.9%
Specialty	9.1%	-19.4%	-8.4%	7.6%
Weighted average	7.0%	-9.1%	3.4%	13.9%

Source: National Association of Real Estate Investment Trusts

Table
Annual Risk-Adjusted Return Summary Statistics, 1983-2002

	Geometric mean	*Standard deviation*	*Sharpe Ratio*
S&P 500	14.9%	19.2%	0.47
Small-cap stocks	14.3%	23.0%	0.36
Corporate bonds	12.1%	12.6%	0.49
NAREIT Equity Index	13.8%	15.8%	0.50

Source: LaSalle Investment Management Securities

Table
Optimal Portfolio Allocations, 1983-2002

Portfolio annual returns	12.3%	15.0%	15.6%
Portfolio annual risk	9.1%	11.8%	13.8%
Allocation levels			
REITs	15.0%	35.1%	10.4%
Small-cap stocks	3.6%	0%	0%
S&P 500	14.0%	61.9%	89.6%
Corporate bonds	67.4%	3.0%	0%

Source: LaSalle Investment Management Securities

Table
Correlation of Returns, 1983-2002

	NAREIT Equity Index
S&P 500 stocks	0.44
Russell 2002 small-cap stocks	0.49
Lehman Bros. capital bonds	0.21

Source: National Association of Real Estate Investment Trusts

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