White Paper No. 47A

Investing in Real Property-A Primer

Greycourt

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Until recently, real estate to most people was something you lived in, played on, went to work in, or pulled food out of. It is only in the last 30 years or so that investors began to consider real estate as an investable asset, and only 20 years or so that mass investors could buy commercial real estate as part of their overall portfolio.

What is Real Estate?

The definition of real estate is "land and the improvements associated with it," be it structures (buildings), crops, or even mineral rights. It is part of the class of investment vehicles known as "real assets," which include things like commodities and natural resources. The reason these get lumped together is that they tend to have many of the same characteristics – they are a "real asset" in that we can touch and feel them, they tend to be more long-term in nature, and they guard against inflation (more on that later).

Types of Real Estate

Real estate can be further broken down into the following core groups:

- **Residential Real Estate –** usually refers exclusively to single-family housing.
- **Commercial Real Estate** – almost always involves a landlord and tenant and always has a business purpose, verses personal use. Commercial real estate comes in the following flavors:
    - **Retail** – shopping centers, malls, etc., property that is used by a business which facilitates daily shopping by individuals.
    - **Industrial** – manufacturing plants, warehouses, etc., used by businesses for production and storage of goods.
    - **Multi-family** – apartments, usually refers to a residential property with more than 4 units.
    - **Office** – office buildings, from large urban towers (Empire State Building) to suburban office parks.
    - **Hospitality –** hotels and resorts.

- **Land –** typically includes "raw" land (without any buildings or "improvements") that is either in a continuously undeveloped state (agricultural property) or is pre-development.

These are the core classes of real estate and fairly describe the bulk of real property. Within these groups, however, are smaller, niche areas of real estate: senior and student housing (multi-family), self storage (industrial), youth hostels (hospitality), flex office (office) and agricultural property (land).

With the exception of raw land, real estate can be further categorized by its current state (raw land can also be broken down but that's for another paper). Other than purely raw land, real estate must be "created," and therefore assets will fall along a continuum:

- **Entitlement** – property is in the process of being planned and approved. No construction has yet occurred. Depending on the type of real estate and its location, the entitlement process can take anywhere from a month or two to decades (see box below).

- **Development –** property has been approved and is being prepared for construction. Sometimes called "horizontal development," utilities are installed, building sites are cleared, mitigations are completed (like adding an off-ramp to a freeway or creating a reservoir).

- **Construction –** property "goes vertical," structures (buildings or houses) are built and prepared for occupancy.

- **Lease-up** (for commercial property) – buildings are largely completed but not fully occupied. Final improvements are made, "kinks" are worked out. In the case of residential housing, homes are starting to be completed and sold, buyers are starting to close.

- **Stabilized –** for commercial property, property is fully leased and operational. For residential housing, property is sold out, and responsibility for things like maintenance of the common areas and operating the homeowners' association is transferred from the developer to the homeowners.

Patience is a Virtue

Depending on the location and type of development being considered, getting a project "entitled" or fully approved, can be an exhausting, and in many cases bankrupting process. Approvals can take as little as a few months to decades or more, which can have significant effects on investor returns as timelines can be unexpectedly lengthened.

Santa Barbara Ranch, California

Almost there…

Entitlement risk is something investors are keen to understand when looking at undeveloped properties, as the time frame for approvals can be significant. Santa Barbara Ranch in California (shown at left) is a good example of a difficult entitlement process. The first development plan for residential housing was requested in 1888 (autos were still 20 years away), and the county just issued its approval in February 2009 (the Coastal Commission hasn't yet ruled).

Real Estate Risk

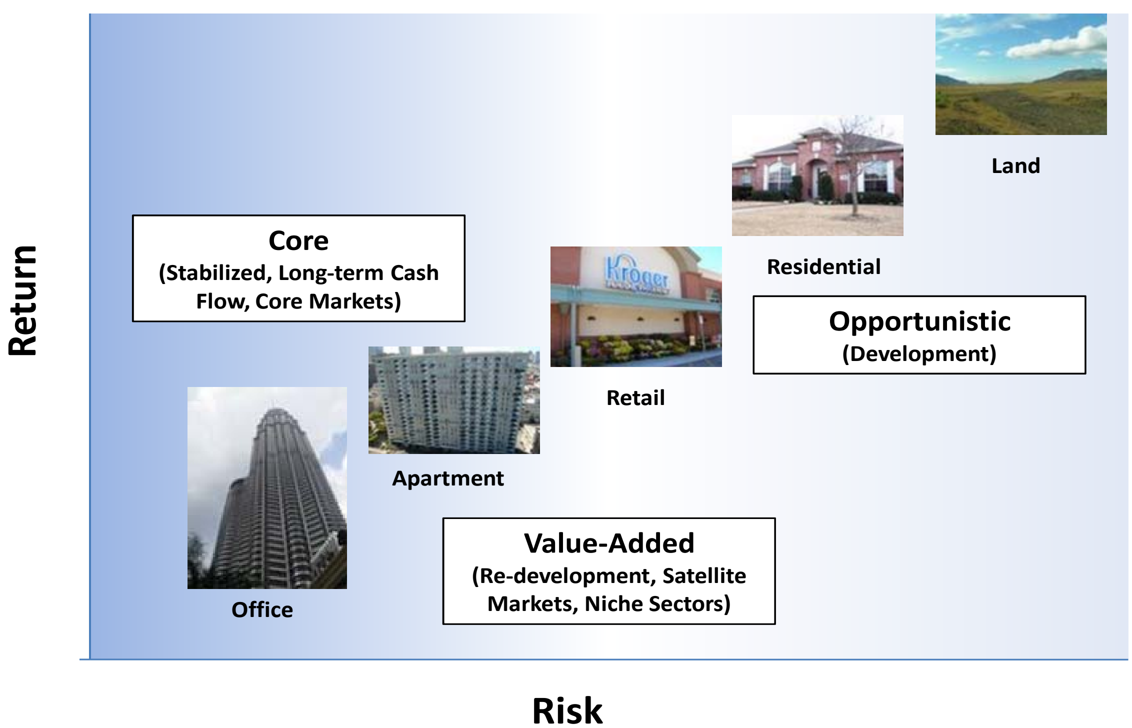
Investors today have the option to invest in virtually any type of real estate and at any point in its development. Properties will have different risk and reward characteristics depending on a) the type of property, b) the location of the property, and c) the status of the property in terms of its development;

- **Low Risk (also called "Core" real estate) –** stabilized property in major metropolitan areas with predictably stable long-term cash flow. Fully leased office buildings in New York are an example. Office properties tend to be less risky as their cash flow tends to be more predictable – tenants are usually signed to multi-year leases.

- **Moderate Risk ("Value-Added") –** properties with less predictable cash flows, either as a result of their location, their type or their status. A shopping center in the process of being leased up; an older mall in need of complete renovations and re-leasing; etc. Hospitality properties usually fall into this category as their cash flow is less predictable – essentially the "tenants" in a hotel are signing very short-term "leases" when reserving a room.

- **High Risk ("Opportunistic")** – properties with limited or no cash flow, either as a result of its status (currently under development) or type (raw land). Opportunistic investments tend to be longer term in nature and to require a greater degree of skill in execution. They also tend to provide the greatest return over the long term.

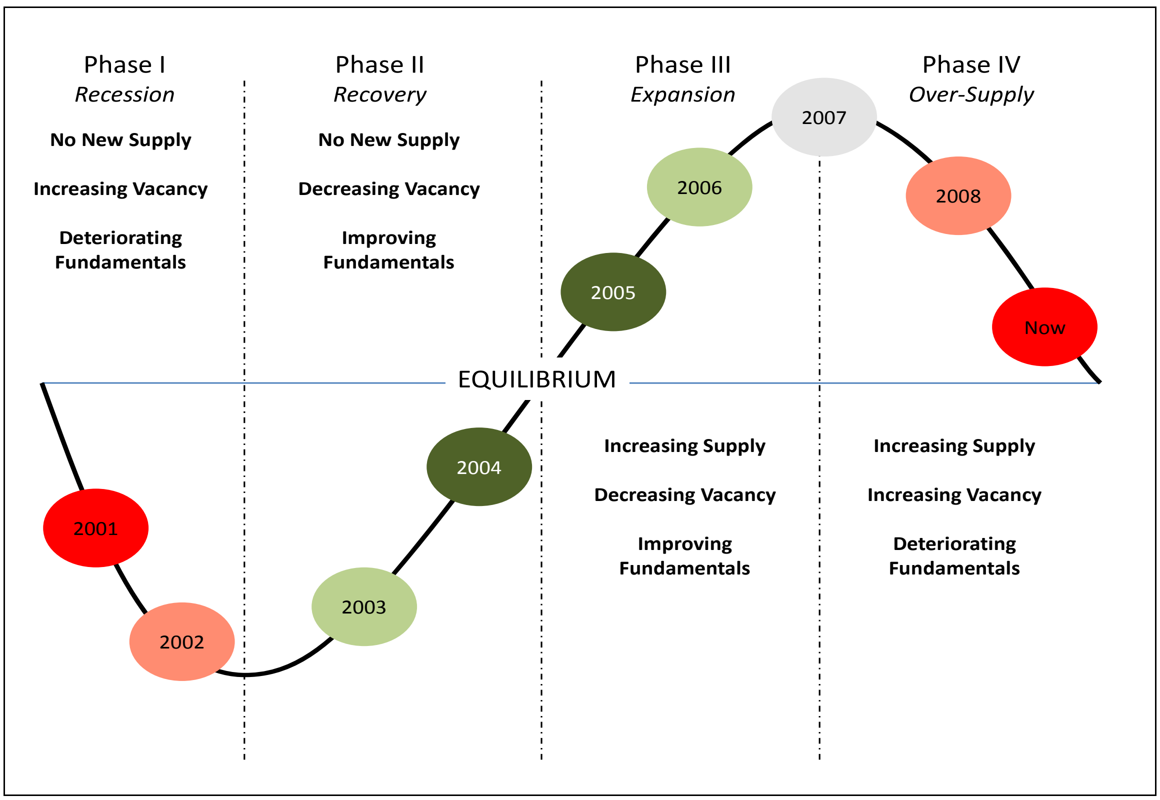
Real Estate Risk & Return



Real Estate Cycles

Like all investments, real estate experiences its own cycle and over the years has become somewhat predictable. The real estate cycle is a direct result of overall economic activity (increased hiring creates greater need for housing and office, more people shop, etc.) and therefore tends to follow a similar cycle to the general economy. However, real estate usually lags behind the broad economic cycle due to the nature of the asset: real estate fundamentals tend to stay strong for some period in the beginning of a general economic downturn, and tend to stay weak for some period even after the economy has recovered. This is due to the fact that decisions made about real estate (building a building, signing leases, etc) are more long-term in nature and therefore decisions are made well in advance of actual construction or move-in.

Real Estate Cycles



- **Phase I: Recession**. Real estate fundamentals are deteriorating as the economy suffers through the recession and job losses and restricted consumer spending work through the system. No new supply is coming on line, but vacancies are increasing.

- **Phase II: Recovery.** Fundamentals begin to improve as job losses are stemmed and spending resumes. Vacancies are reducing at the same time supply is held constant (no new supply) so occupancy begins to rise and prices improve.

- **Phase III: Expansion.** New construction begins to accommodate increased occupancy and lower vacancy rates. Fundamentals continue to improve as the macro-economy reaches its peak.

- **Phase IV: Over-Supply.** New construction continues even as vacancies are increasing and fundamentals start to deteriorate.

Cycles typically last from 7 – 10 years but that can vary depending on the market. And while all real estate goes through this cycle, different types of property will be at different points in the cycle, thereby making it important to remain diversified across property types.

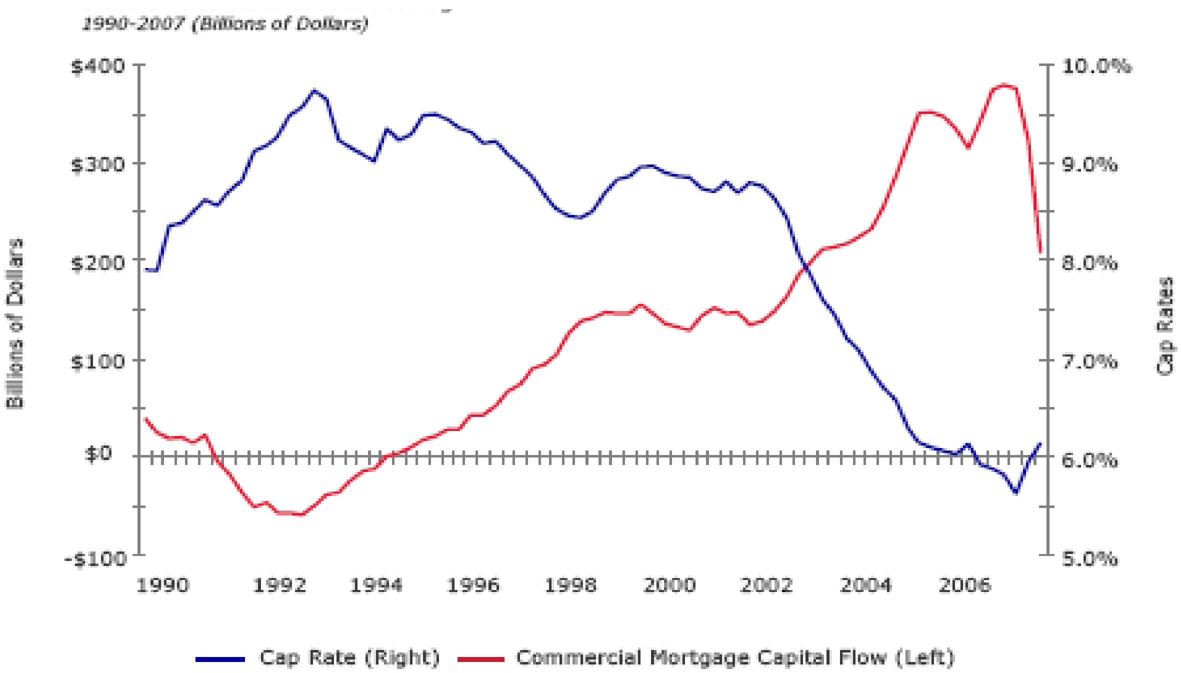
Real Estate Capitalization

Real estate requires large amounts of capital due to the fact that it's, well, large. Be it buildings or land, houses or factories, purchasing and operating real estate takes significant amounts of capital, including a substantial use of debt.

The Importance of Debt

The use of debt (or "leverage") is prevalent in many asset classes, but few rely on it as much as real estate. From the purchase of a home (getting a mortgage) to buying an office building, nearly all real estate trades with some level of borrowing. Up until recently, only mega-sized investors (institutions) could buy and sell real estate. It's the same as an individual buying a house – home ownership would be a fraction of its current rate if people were required to pay cash for their houses. So investors' desire for real estate will ebb and flow with the availability and cost of debt. When capital markets restrict the availability of leverage to buy real estate, prices tend to drop as purchases require larger amounts of equity from a buyer, and the cost of equity is almost always higher than debt. Conversely, having an abundant supply of debt in the market allows buyers to use less of their own equity, which tends to raise prices.

Debt Supply vs. Real Estate Prices



Source: The Federal Reserve, NCREIF, & AEW Capital Management, L.P. As of 9.30.08.

Types of Leverage

The addition of leverage also increases the volatility of the asset class, and Wall Street has done an excellent job of over-complicating real estate lending, with loans being parsed out, sold in tranches, rated, derivatives of loans created, etc. In the end, however, it all starts with a bank (or some financial institution) lending money to someone who wants to buy a property. The bank provides the borrower money, the amount of which depends on the asset and the borrower, and in return the bank secures an interest in the property, either in the form of a mortgage or trust deed (depending on the state). The borrower then promises to pay an agreed-upon rate of interest to the bank, and if the borrower fails to repay the loan, then the bank has the legal right (through the mortgage) to “foreclose” on the property – the bank takes ownership. In the old days (1970s and prior), nearly all real estate lending occurred in this fashion.

In the late 1980s and early 1990s, the country headed into a downturn and the capital markets were no longer available to real estate investors – borrowing in the traditional sense became unavailable. As a response, Wall Street invented the concept of a mortgage backed security (MBS). The basic premise is that a bank would lend money to a borrower to buy a building, and the bank would then sell the loan to investors. But the bank went further, prioritizing the loan such that investors could buy higher or lower in the capital structure depending on their risk appetite. For example, a bank that originated a loan against a building at 65% loan-to-value (meaning the bank appraised the property and loaned 65% of that value to the borrower) would turn around and sell the loan to investors.

Too Much of a Good Thing

Harry Macklowe in NY

What…me worry?

Harry Macklowe, CEO & Founder of Macklowe Properties, bought $7 billion worth of prime Manhattan real estate in 2007 from the Blackstone Group, a private equity firm. He financed the purchase by borrowing $6.95 billion and putting only $50 million of equity into the transaction, thereby achieving a Loan-to-Value of 99.3%. Ultimately nearly all of the property was foreclosed upon by the lenders as he couldn't service the debt, and he lost much of the rest of his holdings as well. Many point to this transaction as the exact height of the real estate market.

However, the bank would prioritize it such that investors who wanted the lowest amount of risk would take the most senior piece of the loan (meaning the property would have to lose 100% of its value for an investor to lose their money) and investors willing to take more risk for a greater return would take the most junior piece (meaning the property would have to lose only 36% of its value for investors to lose money). The investment vehicle that investors then held was called a mortgage-backed security because the repayment of the investment was backed by a mortgage originally issued by the bank. This created a new source of capital for real estate buyers – banks no longer had to hold the mortgage on a property, they could sell it out in the open market. Unfortunately, it also created a moral hazard, as banks, by selling the loan off to others, no longer bore the risk of the real estate loan.

Finally, MBS offered a new way for financial investors to acquire real estate, along with the previously completed formation of the publicly traded Real Estate Investment Trust or REIT (discussed below).

Why Invest in Real Estate?

Real estate generally provides a somewhat slow and steady return to investors, and in many instances it will under-perform other asset classes. We say generally because, just like other asset classes, real estate is susceptible to the occasional bubble-and-burst phenomenon (1985-1993, 2003-2008, etc). This usually occurs as a result of two factors:

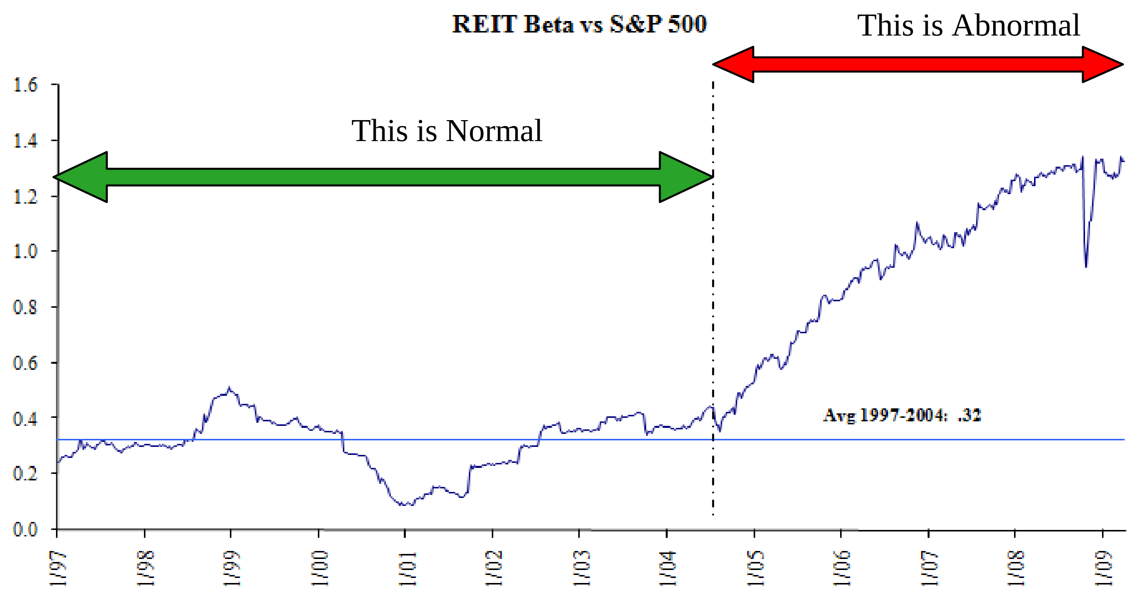
- Other asset classes are out of favor.
- Access to capital is cheap and easy.

Historically, real estate tended to produce slow and steady (read boring) returns to investors, notwithstanding the occasional bubble-and-burst phenomenon mentioned above. Although the REIT market has created a liquid version of real estate, most property investments are illiquid and long-term (multi-year) in nature, providing little flexibility to investors seeking to exit an investment at any particular time. So why invest in real estate? Two reasons: 1) real estate tends to move in a different direction than the rest of the market (see the correlation chart above), and 2) real estate acts can be a natural hedge against unanticipated inflation.

Relative Non-Correlation to Other Asset Classes

Historically, real estate has been relatively un-correlated to the broader stock and bond market. Said differently, investments in real estate typically didn't fluctuate based on the broader market, and therefore real estate provided a dampening or diversifying effect on a portfolio. There are several reasons for this, the most important of which is the stock and bond markets' high level of liquidity, which allows them to react faster to short-term fluctuations in the economy or investor emotion. (In other words, people can buy and sell stocks and bonds any time they like, and usually do based on something going on at that particular time.) Because of the generally illiquid nature of real estate, investors cannot make knee-jerk buy and sell transactions when they want, which provides a greater stability to the asset class and therefore makes it less correlated to the rest of the portfolio.

Real Estate Correlation vs. the Market



Source: Oak Hill REIT Management & Standard & Poors, through 3/31/09.

The recent real estate bubble has increased the correlation (or "beta") of real estate to the broader market, but we expect correlations to return closer to their historical average of less than 50% of the broader market.

Inflation Protection

Real estate also acts as an inflation hedge, much like other real assets (natural resources in particular). When inflation is rising or is expected to rise, investors tend to seek out investments that they can "touch and feel" – investments whose shape and fundamental characteristics change far less than other asset classes. Stocks are somewhat of an inflation hedge but that's only if companies can pass along increased production prices to consumers. Bonds aren't an inflation hedge at all as they are conversely linked to interest rates – rising inflation produces higher interest rates, which drives down the value of most fixed income investments. Inflation has the opposite effect on real estate, and so it is sought after by investors in times of current or anticipated inflation. Having real estate in a portfolio will help offset the effects of inflation over time, thereby preserving an investor's purchasing power.

Beauty is Only Skin Deep

One of the reasons many investors get into real estate is the appeal of the physical asset – high-end resorts, oceanfront property, etc. Unfortunately, there tends to be a negative correlation between the physical attractiveness of an asset and its investment performance. Such “trophy” assets garner a lot of press attention and usually attract a number of well-known bidders at a sale, but they rarely live up financially to expectations.

Bacara Resort, California Coast

Beautiful Property, Ugly Investment

Holiday Inn, Baltimore Airport

Beautiful Investment, Ugly Property

How to Invest in Real Estate

As mentioned above, historically there were very few ways individual investors could participate in the broader real estate market, outside the purchase of their own homes. The sheer amount of capital required to buy real estate made it prohibitive for all but the largest investors and institutions. Today, real estate is widely available to investors in the form of publicly traded instruments and private partnerships.

Public Markets

Investors buy real estate through the public markets by purchasing securities in a real estate company, either a REIT or a REOC (real estate operating company). REITS were developed in the United States in the early 1960s as a way for individual investors to invest in real estate. Recall that prior to this stage, only large institutions with significant amounts of capital were able to buy property. The REIT structure allowed investors to buy shares in the REIT, which owned real estate. REIT shares are similar to stock in a corporation and can be traded on virtually any major exchange. Today, REITs are commonplace in the United States but are only beginning to take hold in other countries: both the United Kingdom and Japan have a REIT market, and Germany is in the process of creating one.

REOCs are different from REITs in that investors are buying into more than just the property; they are buying into a company's business model that uses real estate for its core business. Examples of REOCs would be hotel chains, large-scale homebuilders, and major commercial developers. REITs also operate their real estate holdings but it's usually more in the form of property management, and the bulk of a REITs' value will come from the real estate, where a significantly higher amount of a REOC's value comes from the business itself. Another major difference between the two is their tax treatment – REITs receive special non-tax status; in exchange for distributing at least 90% of their income to shareholders they are able to pass through the income free of corporate income tax. This limits their reinvestment opportunities; REITs therefore tend to trade mainly on their yield (somewhat analogous to a bond). The higher REIT yield makes them very attractive to investors looking for an annual yield or cash flow, verses longer-term appreciation.

Mortgage-Backed Securities

As mentioned above, mortgage-backed securities are another way for investors to participate in real estate investing. However, many MBS investors consider this type of investing to be a fixed income investment, rather than a real estate investment. The reason is that while the underlying collateral is real estate, the investment acts much more like a bond (and in fact it is a bond) and has similar risk-return characteristics as corporate bonds and other fixed income assets.

Private Investments

Private investments in real estate usually require a greater amount of capital and are therefore limited to investors with greater capacity to invest beyond a REIT security. These investments come in many forms and investors can choose their type of investment based on their risk and return appetite:

- **Direct Ownership** – investors directly own a property outright. An example would be an investor who is the sole owner of a single property, say a hotel or parking garage. This kind of ownership affords the greatest level of control but also the highest amount of risk. Successful direct ownership requires a deep level of understanding of property investments and the associated business (i.e., running a hotel or managing a parking operation). It is usually accomplished by very experienced operators who have had their fair share of failures. It also tends to be counter-intuitive, with the "curb appeal"' of an asset having an inverse relationship to its success as an investment, as mentioned above. The investment is also highly concentrated – the success or failure of the single property will determine an investor's success. Investors in this situation do not pay any fees or share any profits as there are no other participants. This type of investment is not recommended for most investors.

- **Joint Venture –** here an investor will partner with someone who has experience in direct ownership. The investor relinquishes day-to-day control of the asset to the operating partner but retains authority over major decisions (i.e., refinancing, disposition, etc.). The risk is somewhat lower than direct ownership but the success of the investment still relies heavily on the outcome of a single investment, which in turn relies on the capabilities of the operating partner. Investors in this instance will usually have a structured investment with the partner that pays an operating or asset management fee to the partner, in addition to some level of profit sharing. This type of investing is also typically reserved for larger, more experience real estate investors.

- **Private Partnership (or Fund)** - here multiple investors invest in a pool which is managed by a General Partner who has extensive experience in direct ownership. Investments tend to be passive, meaning even major decisions are delegated to the General Partner. In addition, private partnerships will hold numerous assets, thereby spreading the risk among multiple properties. Investors usually share profits disproportionately with the General Partner – in many cases investors (also called Limited Partners or LPs) will put up nearly all of the capital but receive only 50% - 80% of the profits. Investors will normally get their money back first, and in many cases an additional amount (usually called a "Preference"). This strategy is designed to compensate the General Partner for the "sweat equity" it invests in the Fund and to compensate the LP for putting up most of the money. In this case, the investor's role is limited to being a capital supplier, and so extensive real estate knowledge is unnecessary. This is the recommended investment type for investors large enough to make long-term commitments to real estate (these funds tend to be 10+ years in term) but who do not have in-house real estate expertise.

- **Fund of Funds –** A fund of funds is simply a fund that invests in underlying funds or partnerships. This type of investment gives investors with limited amounts of capital the ability to gain exposure to real estate without tying up too much capital. Here, investors play an even more passive role, deferring the decision as to what funds to invest in to the General Partner of the fund of funds. Funds of funds will charge a management fee and may even charge an incentive fee, and that's on top of the fees being paid to the underlying managers. But the fees can be worth it for investors who wish to gain access to high-quality underlying funds but do not have the necessary capital to invest in direct funds individually or the skill required to select top managers.

Summary

Real estate investments, properly structured, have the long-term ability to generate attractive risk-adjusted returns for portfolios of all types. Recent history suggests that a lot of money can be made (and lost) in very short time periods of time by investing in real estate; we prefer to look at the asset class long-term and not use it as a vehicle to generate outsized short-term returns.

- **Return assumptions should reflect long-term historical averages, not recent performance**. As with any asset class that experiences a bubble, real estate returns should be measured against long-term historical averages, not recent performance. The bulk of real estate's return comes from the ability of an asset to generate cash flow, verses appreciation (this depends on the asset class, but most real estate consists of income-producing commercial property). Long-term real estate performance, combined with the current market environment and where we are in the cycle, would suggest far more modest target returns (these are unleveraged returns):
    - Core Real Estate: 6% - 8%
    - Value-Add Investments: 10% - 12%
    - Opportunistic Investments: 15% - 18%
- **In general, portfolios should maintain an ongoing exposure to real estate**. The types of managers we use or the size of the allocation may change depending on current market conditions, but we believe a long-term role for real estate exists in a portfolio. Therefore, real estate should generally be a part of the core asset allocation, rather than merely an opportunistic investment. The size of the allocation depends on an investor's risk/return appetite as well as the rest of the portfolio, but can generally be in the range of 5% - 15%.
- **Investors should generally stick to passive investment options verses direct ownership**. Unless investors have the experience and knowledge to actively manage real property assets, they will be better served investing with managers who do the heavy lifting. Direct real estate ownership and operation requires a high level of skill and knowledge about that particular asset class, and while the fees tend to be higher in real estate than other asset classes, the cost can be offset by the benefit of the manager's ability to produce above-average returns.
- **Strategy-specific funds are preferred compared to global 'all-asset" managers**. Real estate has numerous subcategories of property types and investment vehicle options. It is also a local investment; unlike other asset classes, a high level of geographical expertise is required. We tend to look for managers who are narrower in their focus – experts at one or two things verses familiarity with many.

- **<u>Holding a diversified property portfolio is important</u>**. Similar to private equity, it's important to be diversified across asset types and vintage years (thereby diversifying the economic cycle risk). In addition, it's important to diversify geographic risk, as different parts of the country (and by extension the world) can provide different entry points along the cycle.

- **<u>Private investments tend to work better than public vehicles</u>**. REITs and other publicly traded real estate companies are good options for retail investors who do not have the capital to access private partnerships, but as we saw earlier the correlation between public vehicles and the broader market is much higher. This means that one of the main reasons for real estate investing – low correlation to the rest of the market – is negated. We do believe those correlations will reverse themselves and eventually come back to historical averages, but for the time being we tend to see publicly traded vehicles as being more closely correlated with broader equity markets and less with private real estate.

- **<u>Funds of Funds make sense – for smaller investors.</u>** For clients whose real estate allocations are too small to build a high-quality diversified portfolio of private real estate investment managers, real estate fund of funds are a good option, provided the additional layer of fees is justified by the fund of fund manager's ability to invest in the best underlying funds. Real estate generally does not have the same problem of access into quality funds that private equity does, so investors need to be diligent in avoiding "aggregators" (funds that simply push money out to other funds) and focus on fund of funds managers who can build a complementary and high-quality portfolio of investment funds.

- **<u>Manager skill is key.</u>** As mentioned above, real estate is a management-intensive business that requires very specific skill in identifying, acquiring, financing and operating properties. Because of the nature of real estate investments, many quantitative measures used to screen managers may not apply, and there are many cases where managers need to be evaluated even though their track record is still in progress (due to the significant duration of most real estate funds). It is therefore critical when evaluating investment opportunities that the bulk of the effort be spent on evaluating the manager's skill in selecting assets and executing on operating plans.

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October 2009

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