PERSPECTIVES

VALUE-ADD REAL ESTATE

Income-centric, alpha-driven investing for a late-cycle environment

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CBRE Investment Management

INTRODUCTION

Over the past decade investment advisors have relied on core real estate as a source of strong income and capital returns. As these beta-driven returns moderate, a question among advisors today is how to generate attractive total returns while continuing to benefit from steady income.

We believe value-add real estate can offer investors a powerful combination of income and capital appreciation. Managers generate price gains through active management that grows property net operating income, thereby increasing the value of the asset.

Investor sentiment today can be characterized by both optimism associated with steady economic growth and understandable concern about a late-cycle environment. Value-add strategies take a balanced approach that can allow investors to participate in near-term economic expansion while providing defensive characteristics in the event of a downturn.

Value-add managers seek downside protection by investing in lower volatility property sectors and in quality assets with durable in-place income. Managers also look to further reduce risk by limiting the use of leverage and gaining diversification across property sectors and geographies.

Source: CBRE Investment Management, as of January 2020.

Note: We consider NFI-ODCE returns from 2010 through 2019 as an indication that beta returns in core real estate are moderating.

"In late-cycle markets, it is important to choose a real estate investment platform and manager that combine deep research capabilities, the resources to invest across property sectors and geographies, and in-house operating expertise to execute risk-controlled investment strategies."

BOB PERRY
Head of
Strategic Partners U.S.

VALUE INVESTING IN COMMERCIAL REAL ESTATE

Like value investing in stocks, value-add real estate strategies emphasize intrinsic value and unlocking returns through active management. Managers focus on investing capital and growing cash flows through:

- **SOURCING** – identifying underperforming properties or assets with favorable supply-demand dynamics held by capital-constrained or motivated sellers that can be acquired below replacement cost
- **ACTIVE MANAGEMENT** – renovating, repositioning and leasing vacant space
- **PORTFOLIO AGGREGATION** – building property platforms through portfolio acquisitions or aggregation of single assets with the goal of generating a premium upon disposition
- **FINANCING AND CAPITAL MARKETS EXECUTION** – optimizing the debt-equity capital structure and maximizing price upon property disposition

Value-add strategies employ highly specialized, labor-intensive active management to grow property net operating income (NOI). Investment managers use various techniques to unlock the return potential in real estate assets (FIG. 1).

FIGURE 1: **Value-add strategies involve various active management techniques**

LOWER RISK ⟷ HIGHER RISK

IMPROVEMENTS TO OPERATIONS	RENOVATION STRATEGIES	MAJOR REPOSITIONING	CHANGE-OF-USE STRATEGIES
Reducing operating expenses and effectively executing lease-up strategies to create incremental value with modest risk	Investing capital to increase occupancy and leasing activity, move rents to market, attract higher quality tenants and enhance the asset's appeal to institutional buyers upon exit	Investing a significant amount of capital to improve a property within its competitive set, often resulting in a substantial physical upgrade to the quality of the property	Identifying a higher and better purpose for an existing property, e.g., repurposing a retail asset into office space or other use

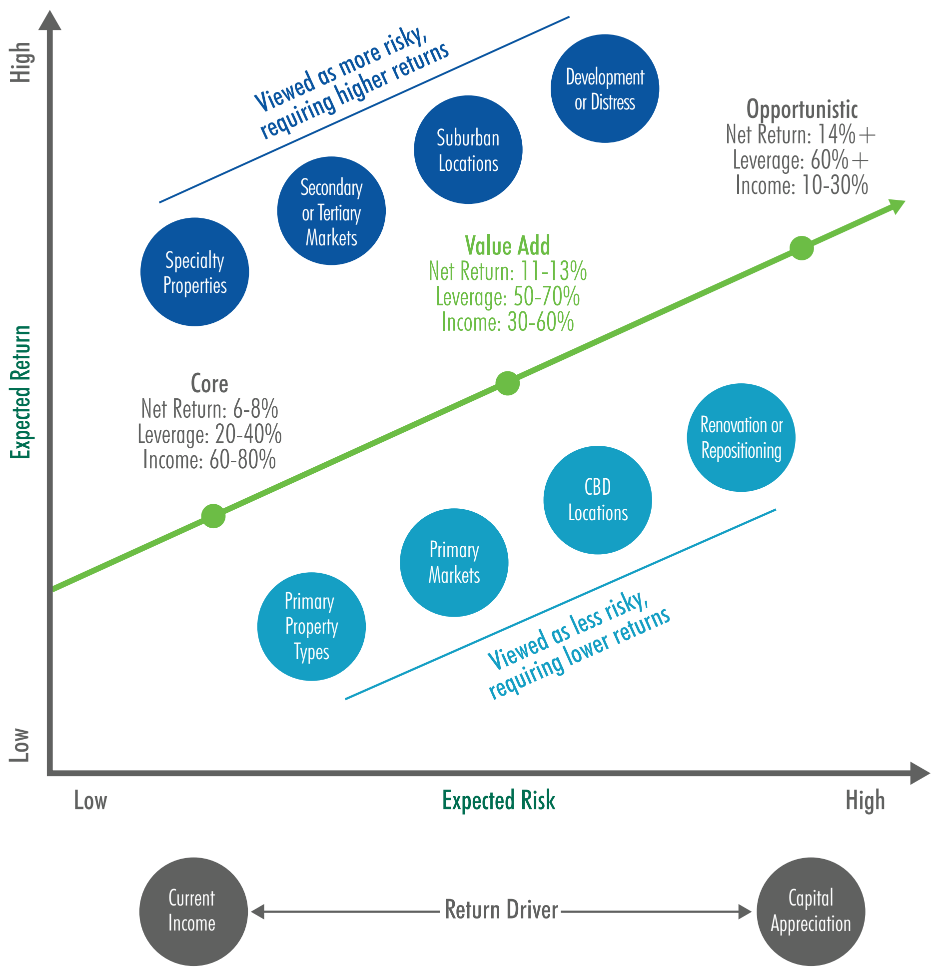
For illustrative purposes only. Categorizations are based on CBRE Investment Management' subjective views. Each investment is subject to its own unique risks.

POSITIONING VALUE-ADD ALONG THE RISK-REWARD SPECTRUM

Private equity real estate (PERE) strategies are often differentiated by the following characteristics: physical condition of the property, building location, occupancy level, credit worthiness of tenants, length/term of leases and amount of debt used to capitalize an investment.

Lower risk value-add strategies employ modest leverage and seek to generate returns through a balance of income and capital gains. Diversified value-add strategies invest across major property types – office, multifamily, logistics and retail – in major U.S. markets. Managers acquire properties with in-place cash flow and make improvements to grow income (FIG. 2).

FIGURE 2: The risk/return spectrum in private equity real estate



Note: Leverage is measured in terms of loan-to-value. Income is measured as a percentage of total returns.
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INVESTMENT ATTRIBUTES

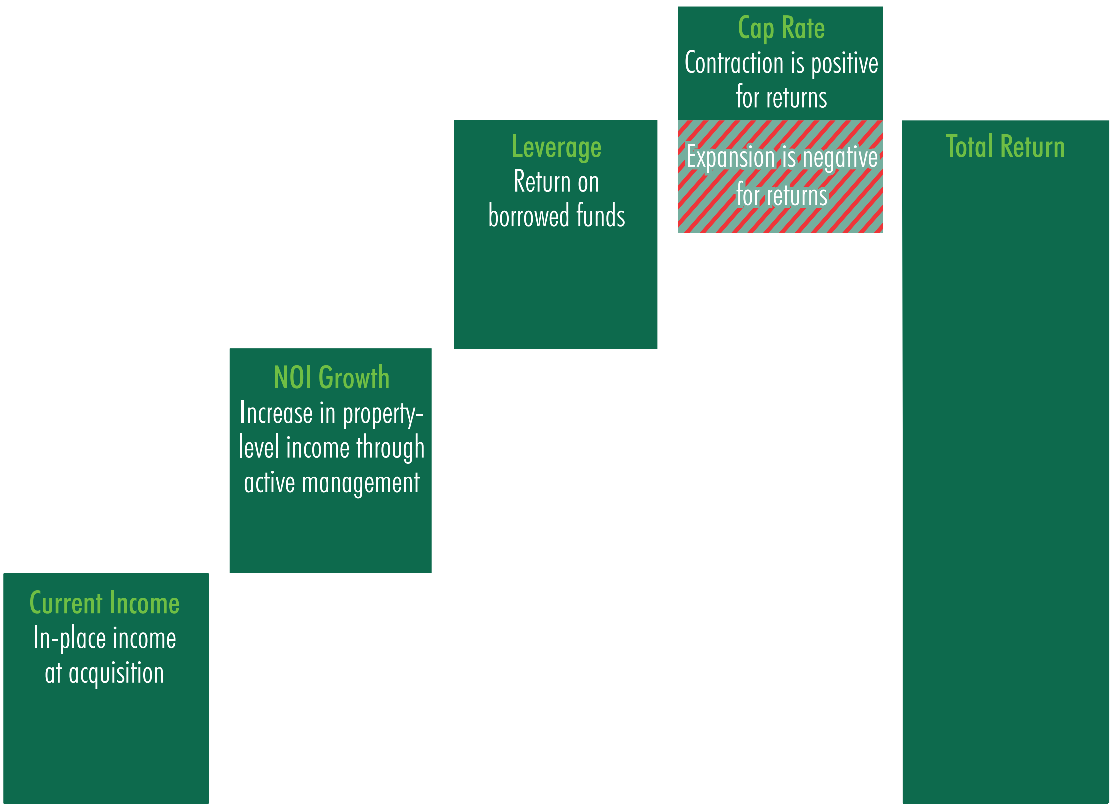
1. BALANCED DRIVERS OF RETURNS

A value-add investment strategy includes multiple drivers of returns, thereby seeking to reduce the risk of poor performance arising from any single source.

Alpha is a key driver of return in value-add investing. A manager's ability to increase NOI across a portfolio of properties can represent a material component of total return. NOI growth involves property-specific business plans and represents idiosyncratic risk-return in a portfolio context.

Movement in cap rates (income divided by property value) can affect total returns. Contracting cap rates contribute to returns; expanding cap rates detract from returns. To be prudent, managers should underwrite stable cap rates or cap rate expansion, even in a continued low interest rate environment (FIG. 3).

FIGURE 3: The building blocks of return in value-add investing



For illustrative purposes only. Categorizations are based on CBRE Investment Management' subjective views as of January 2020. There can be no assurance any particular investment will experience the return attributes shown above.

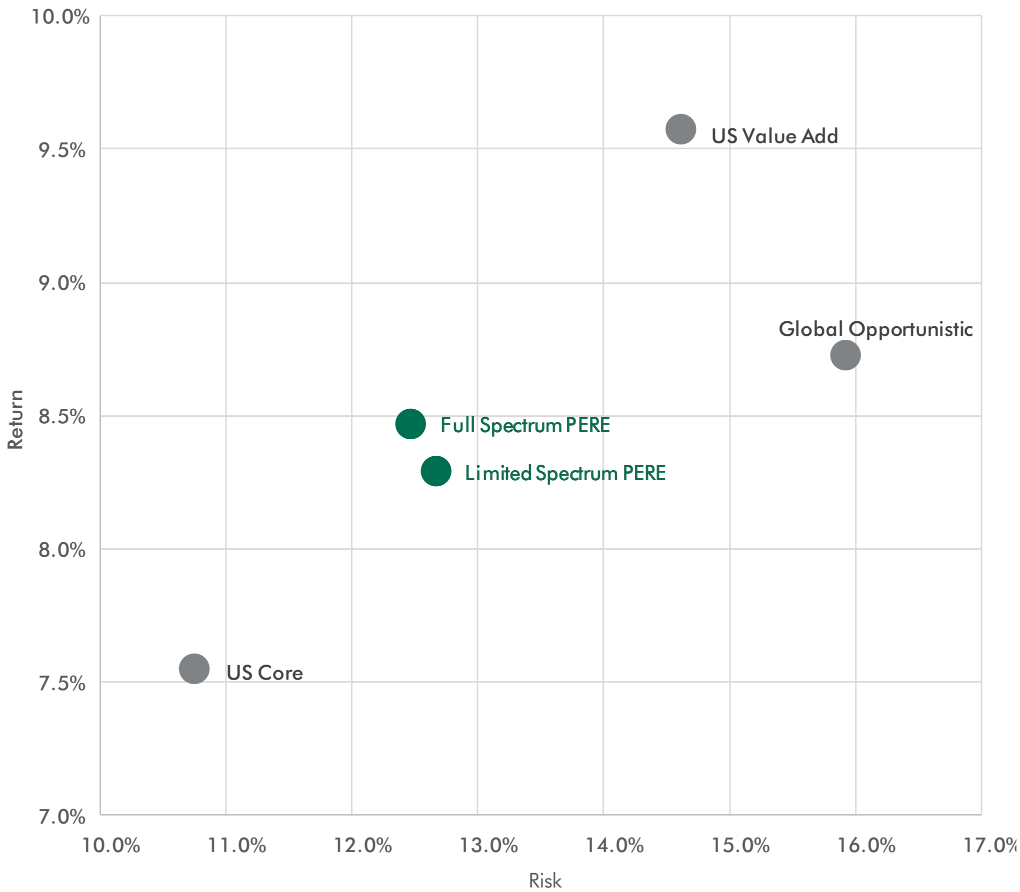
INVESTMENT ATTRIBUTES (CONTINUED)

2. ATTRACTIVE RISK-ADJUSTED RETURNS

Value-add strategies play an important role in the PERE opportunity set. The addition of a value-add investment strategy to a portfolio with core and opportunistic real estate exposure would have produced higher nominal returns and improved risk-reward characteristics.

For example, broadening a PERE portfolio from a mix of 50% core and 50% opportunistic (Limited Spectrum PERE) to a mix of 50% core, 25% value add and 25% opportunistic (Full Spectrum PERE) would have lowered portfolio volatility and increased returns over the past 20 years (FIG. 4).

FIGURE 4: PERE strategies and combinations of strategies (trailing 20 years)



Limited Spectrum PERE: 50% U.S. Core, 50% Global Opportunistic

Full Spectrum PERE: 50% U.S. Core, 25% U.S. Value Add, 25% Global Opportunistic

Sources: U.S. Core: NCREIF Fund Index-Open End Diversified Core Equity; U.S. Value Add: NCREIF Fund Index – Closed End Value Add; Global Opportunistic: Cambridge Associates Global Opportunistic as of December 31, 2018. Index performance reflects total return, net of advisory fees.

For illustrative purposes only.

INVESTMENT ATTRIBUTES (CONTINUED)

3. FOCUS ON DOWNSIDE PROTECTION

Value-add investors seek downside protection by acquiring properties with strong in-place income in lower volatility property sectors, limiting leverage and gaining portfolio diversification (FIG. 5).

FIGURE 5: **Strategies aimed at creating downside protection in value-add portfolios**

INCOME

- Properties that provide steady streams of income can help offset the volatility associated with real estate price movements

SECTOR FOCUS

- Certain property types display less elasticity in demand as compared to more cyclical property types; the multifamily sector, for example, has exhibited lower volatility in rent and occupancy levels

LEVERAGE

- With low interest rates, employing leverage on properties with strong debt service coverage ratios can be accretive to investment returns
- Prudent investing in a late-cycle environment, however, suggests using modest leverage

DIVERSIFICATION

- Value-add strategies not only gain diversification by investing in different property types and geographies but also by employing diverse active management techniques aimed at growing net operating income

"The addition of well-executed, lower-risk, value-add real estate to a portfolio can increase risk-adjusted return potential as a diversifying complement to investors' allocations."

LIZ TRONI
Global Portfolio Strategist

CONCLUSION

Overall market conditions in commercial real estate are in relative equilibrium, supported by an extended stretch of economic growth that has boosted tenant demand. This equilibrium has been aided by generally cautious and disciplined underwriting and a delayed supply response due to restrictive credit conditions in the post-financial crisis recovery period. As a result, excessive risk-taking generally has been curbed, allowing for improving fundamentals without significant imbalances in supply-demand, pricing or debt.

Economic expansion and low interest rates have supported rising real estate prices, which have compressed yields across property types. With unemployment levels at near-historic lows, vacancy levels are approaching cyclical lows. Given this backdrop, investors can expect price returns to be modest in the coming years, although income levels in stabilized real estate will remain attractive relative to other asset classes.

We believe value-add investing can be a compelling strategy at this stage in the cycle given its continued ability to deliver both income and capital gains. Additionally, differences in regional growth dynamics have metros at different points in their cycle of supply-demand balance. This provides astute managers with an opportunity to exploit asynchronous growth cycles to identify mispriced assets.

Source: CBRE Investment Management, as of January 2020.

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