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Real estate alchemy

Transforming non-core assets into prime property requires skill and resources

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Core real estate is attractive to many long-term investors. It provides solid (if unspectacular) yields, adds diversification to portfolios, it holds up well when times are tough and offers the potential for some capital appreciation.

Key takeaways:

- Value-add strategies transform non-core assets into core using expertise to reposition assets
- Not dependent on growth markets – the strategy is primarily alpha-seeking, relying on manager skill
- Appeals to investors who are positioned for illiquidity premium and are averse to drawdown

The trouble is, these attributes are well recognised in the market and current prices of prime property reflect the attractiveness of the asset class. The resulting low yields on offer don't match the longer-term liabilities of many investors, who are looking for higher returns.

What then if we could create more core real estate? And what if investors could buy it at a big discount to current prices? That may sound like an alchemist's pipedream, but actually fairly accurately describes "value-add" real estate investment strategies.

Applying active management to real estate

The differential between core and non-core real estate pricing creates the opportunity for value-add strategies to effectively turn non-core assets into core. These strategies are rooted in skill and the ability to reposition non-core real estate assets.

It takes time to reposition an asset (although timeframes are less than for private equity), but the expected net return of 12%-14% is the reward for patience. Just as important to investors, the return is not dependent on the vagaries of real estate markets and the potential for rising capital values. While the strategy – like all real estate strategies – receives a boost when markets trend upwards, it is not dependent on growth markets. In this sense, it is predominantly an alpha-driven strategy, predicated on the skill and experience of the investment manager rather than on beta from the market.

It is of particular use to investors who are in a position to benefit from the illiquidity premium. That is, investors whose liabilities are not all short-term and who don't require liquidity across their portfolio.

At the same time, it will suit investors who have a low tolerance for losses in their portfolio and for whom therefore opportunistic strategies would not be suitable. There are risks in value-add strategies – as we outline later – but these risks can be offset by a thorough understanding of the asset class and timely execution of the strategy.

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The value-add opportunity explained

Value-add real estate investing derives the majority of its returns from repositioning assets through active asset management. What does this mean in practice? At its simplest, it is sourcing and buying a building which has the potential to be "prime", but isn't because it has vacant space, or because its tenants are tied in only with short leases, or because the building is in poor condition and requires refurbishment. Sometimes it is a combination of all three.

The task is to significantly improve the asset and produce a Grade A building from a non-core asset.

Few real estate owners are willing or able to do this. They may not have the skills or the resources and thus are willing to sell the asset to value-add managers, who use their experience and expertise to reposition the asset. AEW believes a combination of skills and resources are required: the value-add manager must be able to integrate origination, deal execution, financing, asset management and fund operations. Equally important is to develop and maintain relationships with proven operating partners to oversee refurbishment projects. These partners complement in house active management teams. And to access the broadest spectrum of opportunities, it is best to have wide geographical coverage: AEW has over 300 employees in 10 offices across Europe, responsible for €18.5bn of real estate assets.

Where to find the most attractive value-add opportunities

In terms of specific assets, the best returns are likely to come from real estate in the cities and sectors best positioned to benefit from economic recovery - especially neighbourhood retail, non-core office buildings and industrial real estate.

These cities can be almost anywhere in Europe, but the better opportunities for this strategy are likely to be found in Germany, France and the UK, which are the largest and most liquid markets. This is not a buy-and-hold strategy like core real estate, so liquidity is absolutely key for both buying and selling assets. While potential growth in the relevant economy is helpful, liquidity is paramount.

Outside of the three main countries, some Italian and Spanish cities offer potential and other countries selectively provide opportunities depending on the prevailing economic conditions and specific asset. Volatile markets such as Ireland, where real estate prices have fluctuated hugely, are less attractive. Some countries are not currently investible at all: these include Russia and the Baltic states, Turkey and Greece, which all suffer from high levels of systemic risk.

Why allocate now?

The signs are that this is a good moment to consider a value-add strategy. Europe's economy is slowly recovering and systemic risk (despite the UK's recent vote for Brexit) has largely retreated. The euro bloc has posted nine consecutive quarters of expansion.

Amid this slow recovery, the banking sector is throwing up buying opportunities. Most banks are still dealing with the legacy of the financial crisis. Although large portfolios of non-performing loans have largely been purged from their balance sheets, they are still left with a large number of non-core assets, which they wish to dispose of. This provides abundant opportunities for value-add strategies.

In addition, value-add strategies can benefit from financing rates, which are at all-time lows. So good returns are attainable without taking excessive debt risk. In particular, banks are willing to provide debt at compelling interest rates to high-quality borrowers with experience and a good track record in real estate markets.

What are the risks?

To obtain returns of 12%-14%, the strategy inevitably needs to take some risk. Investors should be aware that value-add funds are normally closed ended structures and pay dividends infrequently as most of the income generated by the assets is reinvested in the execution of the business plan. There are also risks around insufficient liquidity in the relevant markets, capital losses if the local economy shrinks, and poor selection of assets.

Risk can however be constrained by maintaining a disciplined approach to leverage. By keeping borrowing to moderate levels (commonly below 65% LTV), debt covenants can be negotiated which should allow the manager flexibility in executing the business plan and in coping with any unexpected economic or asset-specific challenges which might emerge.

It is also important to not only research and monitor non-core markets, but keep abreast of developments in core markets, which is where the asset will eventually be sold into.
At a strategic level, there is little to be gained by taking planning risk. Investors should only take on the risks they can control – such as refurbishing buildings and regearing leases. It is sensible, for example, to directly engage leaseholders before buying a property and find out what kind of refurbishment would suit them.

Lastly, it pays to be cynical about forecasts of market growth. The forecasts may turn out to be correct, but possibly much later than expected. It is preferable to model very conservative estimates of growth.

Conclusion: diversification and discipline

Overall, what are the success factors for this strategy?

For AEW as a real estate investor with 30 years of experience, these boil down to the size of the platform across Europe and the in-house investment and asset management teams spread across 10 offices in Europe. These attributes allow for a diversified and granular strategy that can both unearth and crystallise value.

Keeping the strategy at a manageable size – probably no more than €500m – is another key success factor, allowing capital to be invested within a reasonable time period, maintaining geographic discipline, and therefore avoiding style drift or aggressive underwriting assumptions.

Written on 26 July 2016

Additional Notes

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