Real Estate Primer: Part I

Thank you to Swedbank and Kepler Cheuvreux Swedbank for releasing the material

This text was originally published June 14, 2017 as a thematic piece in Swedbank's quarterly small-and mid-cap product called The Companion. It is, with slight cosmetic alterations, republished by InvestingByTheBooks thanks to Swedbank's and Kepler Cheuvreux Swedbank's kind permission. Note that this altered text is solely the responsibility of the author and not of the above-mentioned firms. This is the first part of two.

Mats Larsson, December 2, 2018

Contents

A lot of ground to cover

8.1 The Basics

Real estate = land + buildings

Real estate is property consisting of land and buildings on it. Real estate companies are firms that engage in the acquisition, management, development and selling of real estate, generally for a commercial purpose. The ownership of a piece of real estate is by definition a very local undertaking and real estate companies are often classified by the regions where their properties are situated and by their type of usage, such as residential housing, offices, shopping malls, warehouses etc.

Increasing value of assets and…

Real estate companies to a larger extent than most listed companies create value through both what could be called internal and external measures. Internal value creation in the exiting property portfolio can be generated by occupancy improvement, property maintenance, rental increases, tenant upgrades, more efficient expense handling etc.

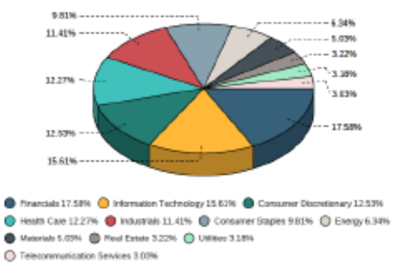
…profitable trading of assets

External value creation is achieved through astute trading with properties. Development projects where either an existing property is redeveloped to increase the value or a new property is constructed falls in-between the two categories.

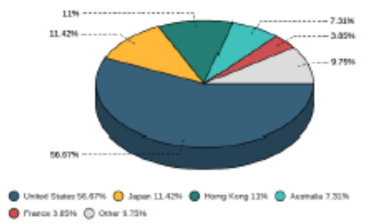
A small sector

Listed real estate used to be the smallest of the global GICS sectors - if broken out in accordance to today's index structure - but has the last few years surpassed utilities and telecom in market capitalization. Still, the real estate weight is only marginally above 3% with 3.2% of MSCI World.

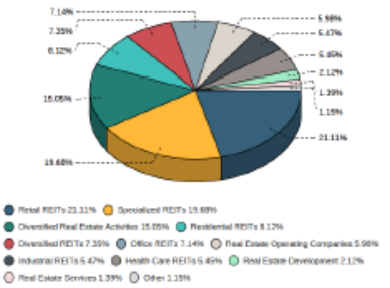
Picture 8.2. Sectors MSCI World Index



Picture 8.3. Countries MSCI World Real Estate



Picture 8.4. Industry Groups MSCI World Real Estate



Picture 8.5. Largest Constituents MSCI World Real Estate

	Country	Float Adj Mkt Cap (USD Billions)
AMERICAN TOWER CORP	US	53.61
SIMON PROPERTY GROUP	US	51.93
CROWN CASTLE INTL CORP	US	34.11
EQUINIX	US	32.02
PUBLIC STORAGE	US	30.87
PROLOGIS	US	28.76
AVALONBAY COMMUNITIES	US	26.07
WELLTOWER INC	US	25.90
WEYERHAEUSER CO	US	25.34
UNIBAIL-RODAMCO	FR	24.39
Total		333.00

Source: MSCI, as of April 28, 2017

If we dissect these 3.2% further and look to the regions within MSCI World Real Estate we notice that the US, Japan, Hong Kong and Australia dominate the index with over 85% of the market capitalization weight.

For the US this is a small underweight (i.e. the weight of real estate is lower than 3.2% within the separate US index) but the other countries mentioned are to various degrees overweighted in real estate in their national indexes.

Tower companies – own infrastructure for communication services

France is the largest European country in the global index; the UK (with for example British Land and Land Securities) is of almost equal size while the listed sector is very small in Germany. French Unibail-Rodamco further qualifies for the top-10 list of constituents, which is otherwise dominated by US companies – including the large tower companies American Tower and Crown Castle.

No Scandinavian company is large enough to qualify into the Real Estate World Index but real estate is still, compared to other countries, significantly overweighted in the broad all-share index in Sweden.

Vasakronan on top

If ranked by the property values, the largest Swedish real estate company by some margin is the unlisted Vasakronan jointly owned by the First to Forth Swedish National Pension Funds. Out of the top 10 Swedish property owners 3 are institutional investors, 3 are public organizations and 4 are listed companies.

Picture 8.6. Cool buildings: Bosco Verticale, Italy

To make the text more visually enjoyable we will present a number of cool buildings

Source: theurbandeveloper.com

REITs 3/4

Out of the MSCI World Real Estate index close to ¾ of the constituent weights are in companies registered as so-called REITs (Real Estate Investment Trusts). A REIT is a form of association common in Anglo-Saxon countries that has been granted tax advantages similar to those of investment companies in Sweden, i.e. they don't pay corporate income tax and only dividends are taxed, avoiding the normal double taxation of shareholders.

90% payout

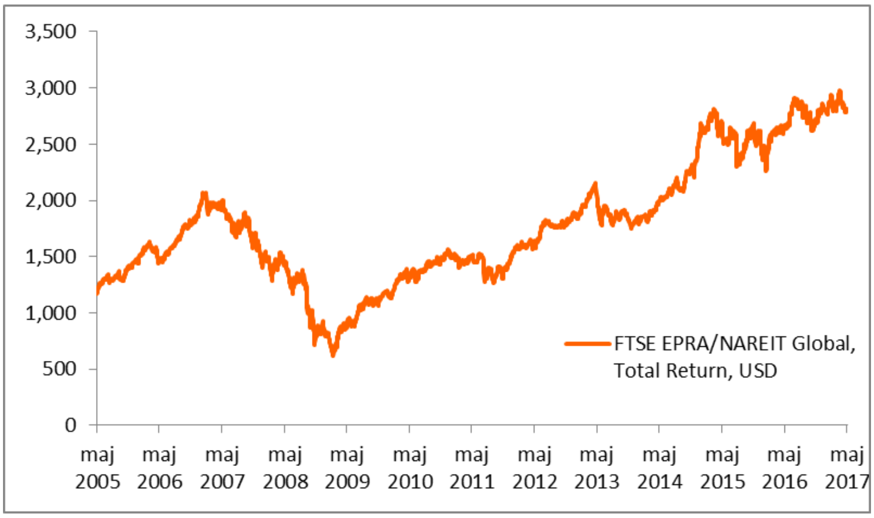
To qualify for this preferential tax treatment the REIT must, amongst other requirements, distribute at least 90% of taxable net income as dividends, buybacks etc., have at least 75% of its assets in real estate, generate at least 75% of gross income from real estate and no more than 50% of the shares can be owned by 5 or fewer individual shareholders. The form of association was developed in the 1960s to provide investors with a liquid way of accessing property ownership.

Also mortgage REITs

Some 80% of REITs are Equity REITs and about 20% are Mortgage REITs. The latter lend money to owners of real estate and don't have any business operations outside that of financing. The first type is today 99 times of 100 a fully integrated operational real estate business similar to those we think of as real estate companies in Scandinavia.

Picture 8.7. Global REIT Index

8% including a real estate crash



Source: FactSet,

Over the last 12 years the Global REIT total return-index has delivered a return CAGR of 8.3% - a very respectable number given the low interest rate environment during the period and a whopping 70% downturn 2007/09.

8.2 An Asset Class

1/3 of assets?

Even if it is hard to pin down an exact number, real estate is a huge part of global capital assets. Some estimate that real estate's share is up to a third of investable assets.

Listed and direct

Only some 5-10% of this relates to real estate in listed companies and for most global pension funds, endowments, insurance companies and the like their exposure to real estate is mostly through direct ownership or real estate vehicles, such as investment funds employing a private equity type of business model.

Generally, real estate accounts for 5-20% of most investment portfolios but for example some US endowments have up to 30% exposure. The long-term investment horizon of many institutional investors fits rather well with the long investment cycles of the real estate market and those investors often have the financial muscles – if not always the gumption - to invest counter cyclically.

The three tenants that constantly come up with regards to the attractiveness of real estate as an asset class are:

Advantages

- Stable cash flow
- Diversification
- Inflation protection

1. attractive and stable cash flows,
2. diversification and
3. inflation hedging

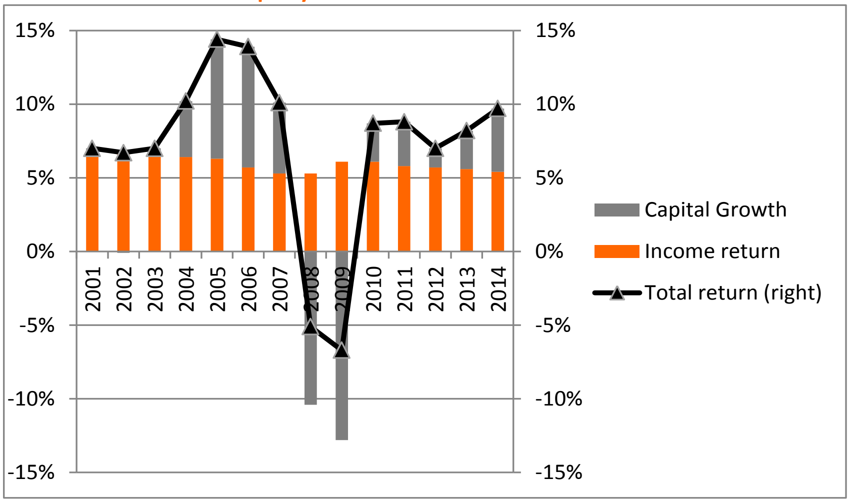
Real estate returns have been strong lately. Over long time horizons the returns have been somewhere between the average equity returns and average fixed income numbers. The base of the real estate returns are stable cash flows through rents set by often relatively long-term contracts.

Income + capital appreciation

Investors look for the combination of income return and capital appreciation. While returns from changes in capital values show cyclical patterns the nominal income yield has been relatively unchanging around 6% during the period 2001 to 2014 pictured below. The capital growth averaged 1.1% during the same period.

One stable and one volatile

Picture 8.8. Global All Property Total Return Index



Source: MSCI, July 2015. The index relates to direct investments

1.9% real appreciation…

Over very long time periods the capital growth of real estate has been somewhat higher than the general inflation. For example, in the US between 1948 and 2004 Robert Shiller of Yale calculated the annual capital appreciation to 5.8% and with an average inflation of about 3.9% during the period the real appreciation was approximately 1.9% per year.

…but we choose 1.0% to be conservative

This relates to properties in one of the more economically successful regions during the period and the time series ends before the downturn in 2007/08. Over time a growing population drives the demand for space, in turn increasing real rents which form the basis for the capital appreciation. The thing is, the population of the developed world is estimated to start shrinking in 2030. Perhaps an expected real long-term appreciation of around 1% annually is a more prudent number?

Private tranquility

Looking at non-listed real estate the monthly price volatility of the returns is relatively low compared to equities. Hence, the risk/reward of real estate is on paper very attractive. Some of this is however due to the lack of mark-to-mark pricing so we are to some extent comparing apples to oranges and the flipside of the low volatility is the limited liquidity of unlisted real estate. In fact, in really bad times with restricted credit access there might not be any price at which an investor can dispose of his physical real estate or his ownership in a private real estate fund.

Heterogenious

Since direct investment in real estate or investments in real estate funds relates to investments in a limited number of properties bought and sold at various times in the cycle in different local markets, the returns generated often differ quite substantially between investors and funds. There are fewer that generate "index returns" in real estate than in equities or fixed interest – it is a more heterogeneous asset class.

2 * leverage

The property market is less efficient, less liquid and offers less transparence than for example the stock market. Hence, the leverage on portfolio management skill is higher – and on top of this the returns are also often financially leveraged. Hence, with differences in skill, luck and leverage the realized real estate return will differ from the unleveraged index.

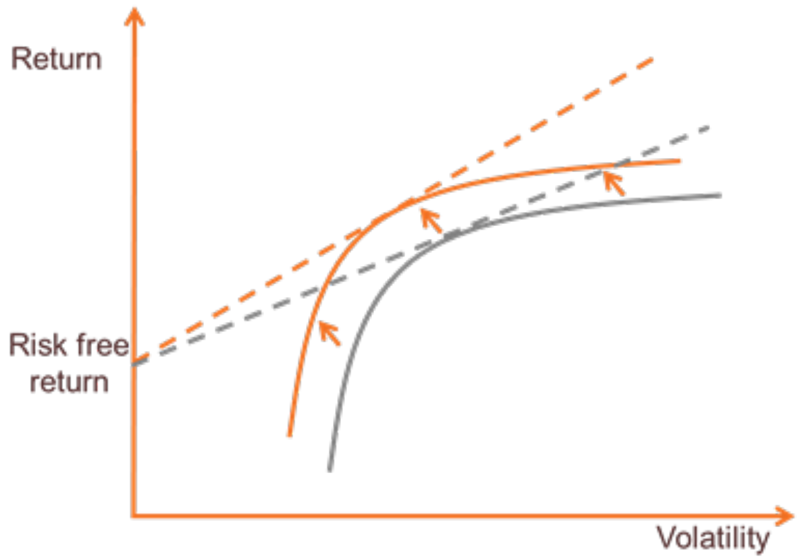
Low correlation -> improving risk adjusted returns

Historically, direct investment real estate returns have shown limited correlations to equity returns (approx. 0.2 to 0.4) and bond returns (-0.1 to -0.2) and subsequently the risk adjusted return of a multi-asset portfolio can be improved by adding real estate – the so-called efficient frontier of the portfolio is moved towards the upper left in the picture below, allowing for higher returns per unit of volatility.

Q: What is the name of the line(s)?

A: The capital market line. Well done!

Picture 8.9. Shifting Efficient Frontier



Source: The author

Smoothed and lagging

Again, some of this low correlation is due to the lack of mark-to-mark pricing and the values of private real estate can be thought of as a smoothed and lagging time series of listed real estate stocks. Historically, at turning points the stock prices of the listed market have led the private pricing levels by 6-9 months.

Own more real estate!

If not including liquidity into the utility function and taking the volatility numbers at face value in a mean-variance optimization, investors should probably shift some additional 30 percentage points of the assets from listed equities to privately held properties. The fact that few institutions do this shift shows that they are factoring in the fact that we are not comparing apples to apples.

Still, even though the low correlation to some extent is artificially created by a lack of liquidity and lagging price appraisals, this illusory benefit could in fact psychologically help investors to not panic and sell assets at the trough of stock market drawdowns.

Established as the third large asset class

Also, it is probably no doubt that with the low expected returns for other asset classes the next decade, real estate continues to be an asset class that will see net investments. Thus, institutional investors' growing presence on the property market the last two decades has meant a tougher competition for property assets on the transaction market.

REITs a bad substitute

If instead, looking at the correlation of listed REITs, the correlation to equities increase to 0.7 to 0.9 (and increasing over time) and to bonds (-0.3 to -0.4). Thus, listed real estate behaves fairly similar to equities in general and if you broke out any equity sector it would have a rather similar correlation to equities as REITs. Hence, we don't think REITs is a suitable substitute to private investments – better to treat them as one of many equity sectors.

Knowledge vs…

Since they know this territory best, most institutional investors have a distinct home market bias in their real estate holdings. In a survey of the largest European pension funds they had about 55% of their real estate exposure in their home country and the remainder about equally split between the rest of Europe and outside Europe. The Nordic respondents with a rather developed home market had about 70% in their home country, 20% in the rest of Europe and 10% outside Europe.

diversification

However, as not all markets move in tandem, different markets have exposures to different property types and tenant segments and the economics, regulations and demographics of different markets also vary the best diversification benefit is naturally achieved by spreading the property exposure over Asia, Europe and the Americas. Due to transparency issues and regulatory obstacles a fully global portfolio is still tough to realize.

Picture 8.10. Cool buildings: CapitaGreen, Singapore

The climate of Singapore lends itself well to growing plants

Source: theurbandeveloper.com

Inflation protection

Real estate is together with inflation-linked bonds and commodities often categorized as a real asset that offers at least partial protection from rising inflation. This is because rental agreements are generally linked to the consumer price index or some other inflation measurement, depending on country and tenant type. In some countries and segments the adjustments are done annually while sometimes there could be up to a 5-year lag.

Institutional investors' private investments in real estate can, as mentioned above, be direct investments of they can be made through some sort of investment vehicle. To be able to invest directly the investor must have access to the range of on-the-ground skills and competences required to implement a real estate strategy in practice in regional markets.

Internal direct investments vs…

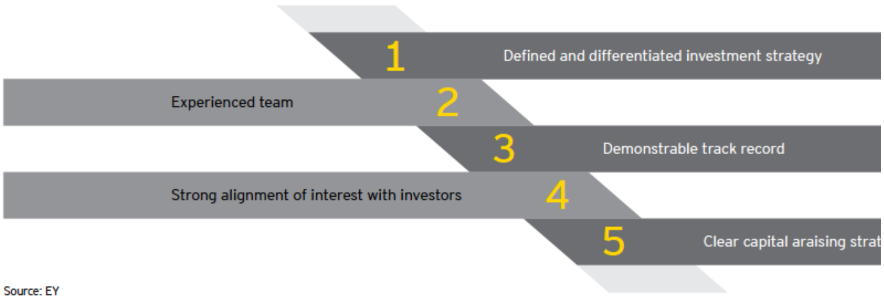
If this access exists and the real estate operations is of sufficient scale it is obviously a clear positive to not have to pay fees to any external managers. A direct investment strategy gives management control and a fully internal strategy is also easier to tailor to the targeted risk/reward requirements of the individual investor.

…investment vehicles

If these conditions aren't fulfilled or a broader diversification than what direct investments provide is required, it is better to seek outside help from external managers. The ways to structure these external setups can range from so-called investment mandates where one investor fully participates in the process of acquiring, developing and disposing of properties, to club structures where several investors join force and are collectively involved in the process plus share the risks and finally to the more common solution of private real estate funds (or even funds-of-funds for those who love paying fees…).

Picture 8.11. Top 5 Qualities Investors Look For in Real Estate Funds

Differentiated strategy executed by good managers



GP's + LP's

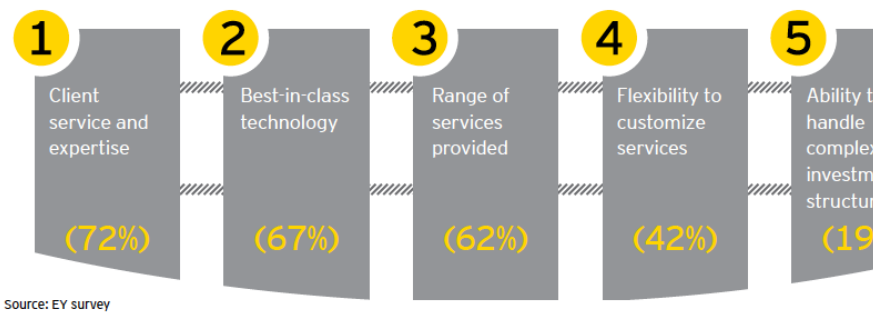
These, often closed-ended fund structures with 7 to 10 year terms, are only available to institutional investors and others who can put in large sums of money and the incentive schemes of the asset managers are often structured quite similarly to those of private equity. The funds invest in properties and the investors participate as limited partners. However, there are also funds that invest in real estate debt.

Fees + fees

Similar to private equity practices the funds charge a fixed annual fee and an incentive fee ("carried interest") with a profit sharing above certain thresholds. Since the limited partners always will have less visibility into the funds' operations, investors sometimes have concerns about the alignment of interests in the setup.

Picture 8.12. Top 5 Items Investors Look For in Operations

Sounds good for any service



Value creation, reasonable fees and good service

In addition to having a team with proven ability to create value in real estate investments and reasonable cost outtakes from the fund, investors also demand state of the art client services and an IT-structure that can handle the reporting required to the limited partners. US based Blackstone, Lone Star and Starwood, Canadian Brookfield Asset Management and Global Logistic Partners in Singapore manage some of the largest funds globally.

Investment styles

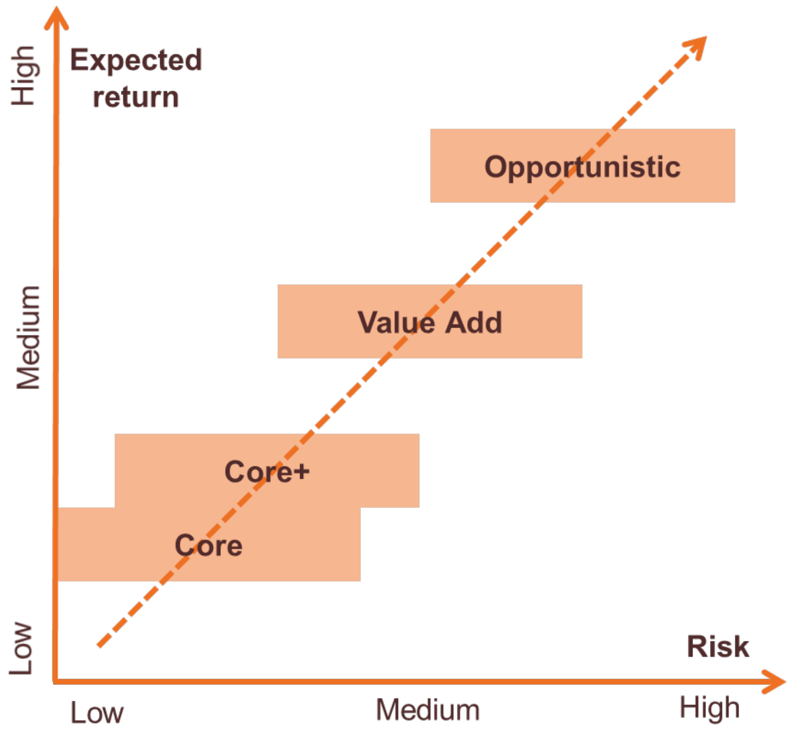
- Core
- Value add
- Opportunistic

Apart from diversifying over regions, real estate segments and types of tenants institutional investors have a choice of the preferred investment style. Depending on their investment style, the risk/reward-profile of the investment vehicles can be categorized into so-called core, value add and opportunistic strategies.

The different strategies will show varying relative success in different parts of the market cycle. In theory investors can try to exploit this and invest in different strategies in different vintage years (i.e. fund startup year in private equity speak), but with long lead times and an uncertain future it isn't easily done.

Picture 8.13. Investment Styles

Risk/reward



Source: The author

Core

In a core strategy the fund invests in properties of high quality in good central locations in primary markets with long-term leases using a moderate amount of leverage. When funds invest in somewhat more speculative objects using slightly more leverage this is sometimes called a core+ strategy. Still, both are lower risk/lower return styles with Loan-to-Value (LTV) not above 50%.

Value add

The value added strategy tries to add to the returns by repositioning the properties through renovations, new leases, re-developments and non-speculative (meaning tenants are largely secured in advance) project development. The debt proportion is higher with LTV up to 60%.

Opportunistic

In the opportunistic segment the risk and potential reward is upped even more with LTV up to 70% and development projects of more risky character as they can be in secondary locations and be built on speculation. Furthest out on the risk scale investments can be made in distressed situations and non-performing real estate loans.

Picture 8.14. Cool buildings: Statoil Headquarters, Norway

Source: businessinsider.com

Oil has earned Norway a few bucks the last decades

If the core strategy is bond-like with a focus on purchasing a long-term stable income stream, the value added more resembles long-term equity investing with its focus on building and increasing corporate income streams over time. To some extent the opportunistic segment could be linked with shorter-term equity investing with a focus on exploiting cyclical market dislocations and temporary mispricing's.

Core-satellite

The standard institutional investment approach is with regards to strategies called "Core-Satellite", meaning that the majority of the investments will be in core and core+ strategies, but a certain portion of the investments is dedicated to generating higher returns in value added and opportunistic funds.

8.3 The Market

Many macroeconomic factors affect the real estate sector overall, while each property type also is affected by specific factors. Job growth increases the need for office and industrial space and with employment comes more consumer spending in shops and an increased demand for a place to live.

Drivers

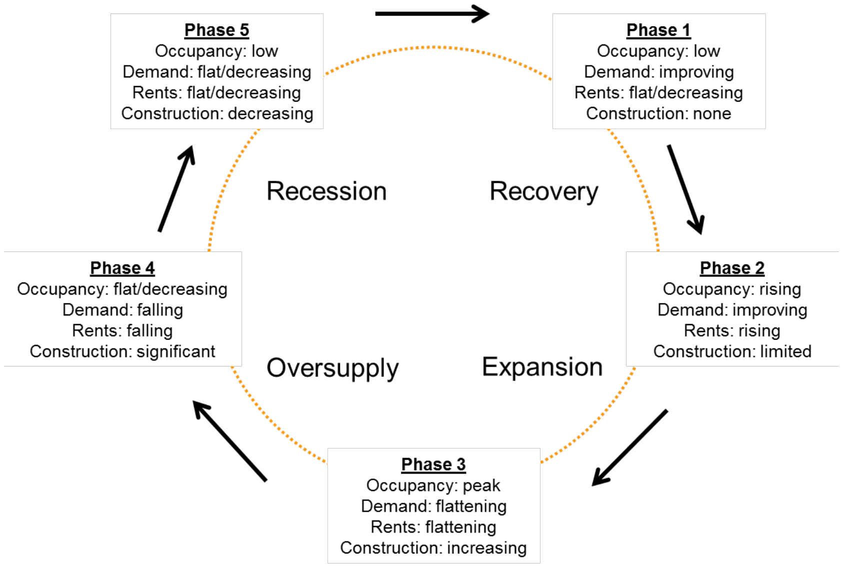
Interest rates directly affect the sector's cost of borrowing, influence the pricing of assets, make mortgages more or less expensive and indirectly influence the health of the economy. Demographics like population growth, average age and average income affect both retail properties and residential.

Cyclical patterns

Historically the real estate market has experienced a clear cyclical pattern and although no cycle is ever the same they are often quite long, averaging a decade or so. Some of the factors affecting these cycles are the accessibility to capital and the pricing of this borrowed capital, the economic cycle but also government regulations, policies and taxes.

Picture 8.15. The Real Estate Cycle

The merry go round



Source: The author

As economic fundamentals improve, for example in an economic recovery, occupancy increases and this will lead to an increase in rents. When rents have increased sufficiently property developers want to take advantage of the strong market and initiate construction projects that increase supply and potentially lead to oversupply, causing vacancies to increase which in turn lowers rents.

Added supply can break the upturn

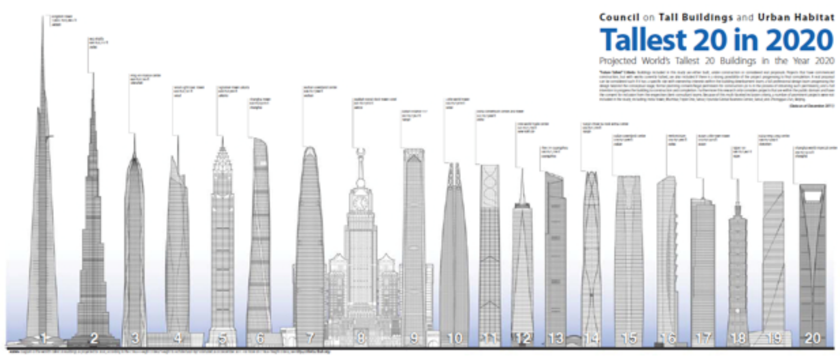
Real estate companies' revenues drop and property prices decline until the cycle starts anew. Somewhere between phase 5 and phase 1 in the illustration central banks often try to stimulate growth through monetary policy and somewhere around phase 3 the monetary policy instead tries to cool the economic climate.

Two markets

Although they are highly interrelated, real estate companies could be said to operate on two markets. The first is the rental market that relates to the operational part of the business letting facilities to tenants and the second is the transaction market that relates to the buying and selling properties. We discuss them both briefly below.

Picture 8.16. The Tallest 20 Buildings by 2020

19 in Asia



Source: zdnet.com. The tallest building will be the yet to be completed Kingdom Tower in Jeddah. Apart from One World Trade Center in New York in number 12 all other buildings are situated in Asia.

8.3.1 The Rental Market

1 square meters = 10.7 square feet

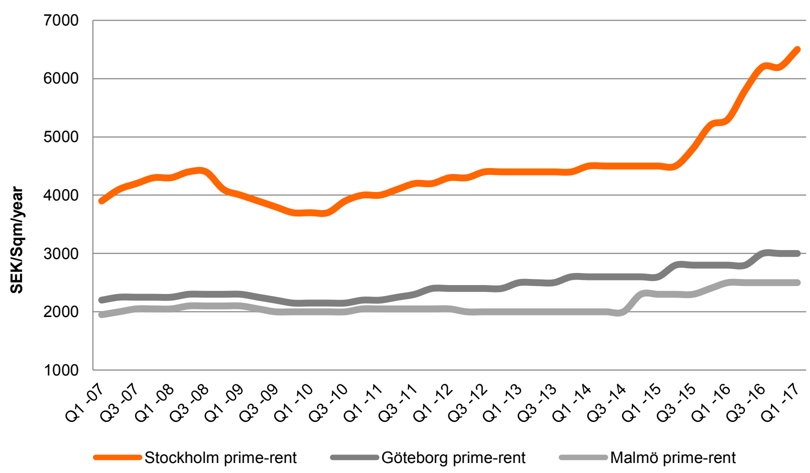
The real estate rental market can be thought of as the supply and demand of access to cubic meters of buildings. Landlords supply space and tenants demand space while in everyday life we rather discuss square meters than cubic meters.

Strong office market

The rental market has been strong the last few years and especially so for office properties in the larger cities that benefit from low interest rates, decent economic development and the urbanization trend. Below we show the rental development for Stockholm, Gothenburg and Malmö.

A price push since 2015

Picture 8.17. Office Rents CBD, Sweden



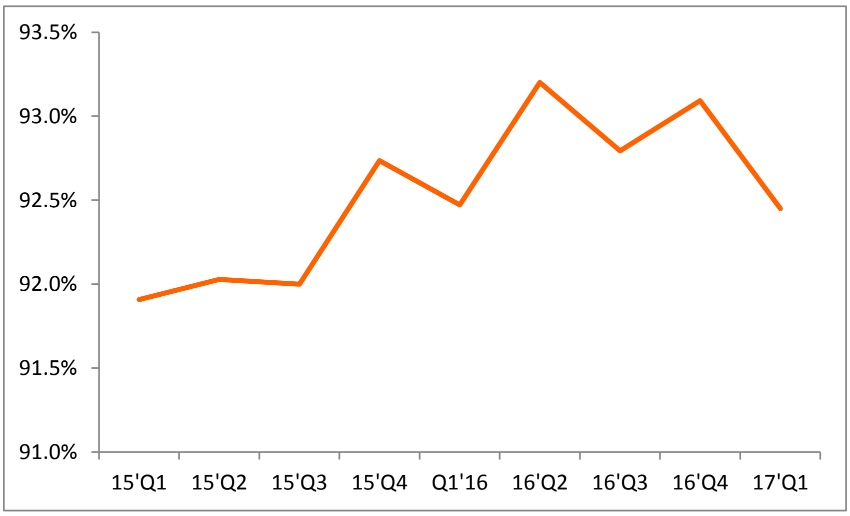
Source: Jones Lang LaSalle, The author

Vacancy & occupancy

The vacancy rate (% of available space vacant) and the inverse, the occupancy (% of available space let), are useful indicators of the health of the rental market. The vacancy rate and occupancy rate measures the current utilization of the owned properties. The occupancy varies between segments and geographies but can be said to have an interval of 85% and 95% over time. Right now the occupancy rate of listed Swedish real estate companies is about 92.5%.

Getting a bit crammed

Picture 8.18. Occupancy Ratios, Listed Swedish Companies



Source: The author, Company reports

A double whammy

Note that when occupancy rates increase/vacancy rates decrease this not only leads to a volume effect as more of the available space is let but often also to a lagging price effect as less vacancies drives up rents, creating a double whammy. Unfortunately, this applies for the down-cycle as well.

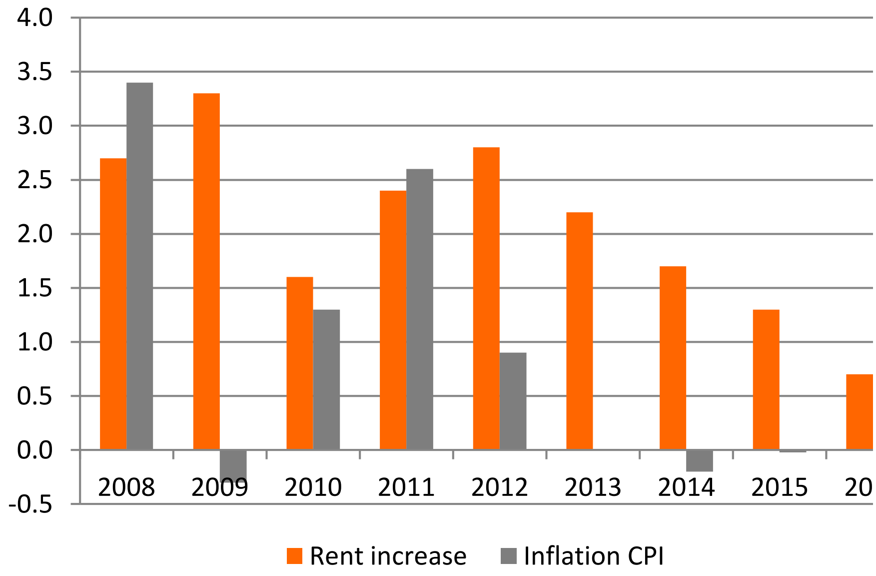
Leading rent indicators

Higher demand and lower supply leads to higher prices. The change in occupancy rates and vacancy rates could be said to be a leading indicator of future rent changes and so can the net lettings, defined as new rentals less terminated rental contracts, measured in the yearly rental revenues from those net lettings.

Nice real growth 2009 to 2015

Overall the rents for Swedish residential apartments have been raised by an average of 2.1% per year since 2008. During the same period the CPI saw an annual increase of about 1.0%.

Picture 8.19. Rent Increases Residential Apartments



Source: SCB

LFL – Like For Like = same store

Over time and on an aggregate scale rents increase with a rate somewhat higher than inflation. To get a fair picture of the rent development of one company it is advisable to look at like-for-like (LFL) rental growth (called “same store” rental growth in the US – even outside retail properties). The LFL numbers show the rental development for an unchanged property portfolio and is as such not affected by made property transactions.

8.3.2 The Transaction Market

Trading assets

The transaction market involves acquiring and selling real estate. It is a part of global capital markets and as such affected by the current growth expectations, pricing of risk capital and risk attitudes. At its core the pricing on the transactional real estate market depends on the balance between supply and demand.

Segmented sub-markets

It is convenient to talk about a transaction market, but in reality we are discussing the supply and demand of many different types of properties situated in a multitude of local markets. Since an office in Luleå isn't a convenient near-term substitute to a residential dwelling in Jönköping or a warehouse at the port of Gothenburg, we are really looking at multiple segmented sub-segments that make up an aggregated market with its supply-demand balance.

This supply-demand balance, and by this the pricing, to a large extent depends on the expected future earnings from the rental market in each segment so the two markets are clearly connected.

Picture 8.20. Interconnected Markets

Δ rent & Δ yield drives Δ property prices

$$\frac{\text{Rent}}{\text{Yield}} = \text{Value} \quad \Rightarrow \quad \frac{\text{Rent}}{(\text{Rent/Value})} = \text{Value}$$

Source: The author

Feedback loops

Since value generally is defined as the market price, rents make up most of the earnings and the yield is defined as earnings divided by the market price this is in effect the same circular reasoning as when the price of a stock in general is determined by multiplying the company's earning by the PE-ratio, where the "P" in the ratio obviously is the price that we wanted to determine in the first place.

Today's price level is always right…

What we are really saying in both these equations is that in relation to a company's earnings (rent or EPS) all companies/stocks should be valued as all other companies/stocks right now – until the market values them in a completely different way. Obviously research analysts along the way make qualitative add-ons like, "I think company x should be valued higher/lower than average due to y".

Because rents and rental growth typically are more stable than many other types of profits in other sectors the property transaction prices, judging from the above-pictured relationship, could be expected to be very unchanging as well. Unfortunately there are other factors such as risk appetite, expected return on alternative investment plus, importantly, the pricing and availability of capital that chip in when deciding the present pricing.

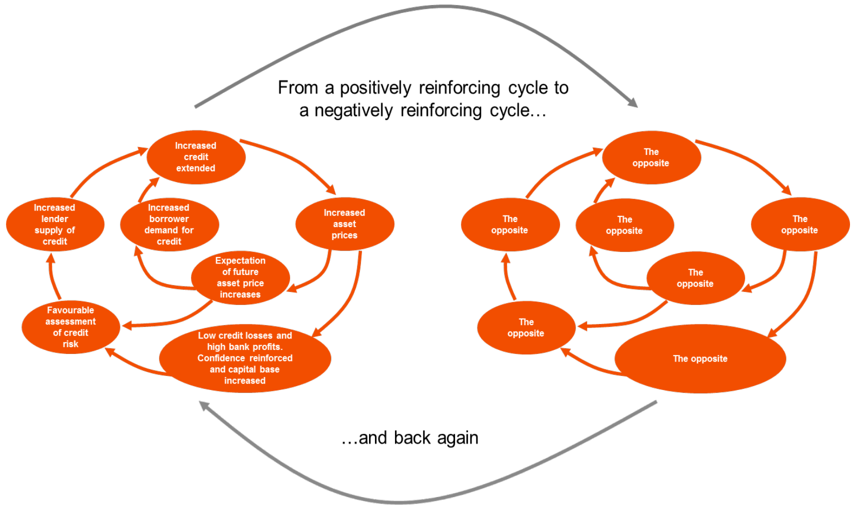
…until a new one is right

More so than the rental market, the transaction market and property valuations are tied to the credit cycle's positive or negative spiraling. As such the state of banks and real estate companies are intertwined.

In a bullish phase more credit is extended at lower interest rate spreads and lighter covenants leading to higher property prices. The higher prices lead to lower credit losses - and by this higher profit - for the banks and reinforced confidence in the real estate sector.

Picture 8.21. Reinforcing Spirals in Credit

The tough task is knowing when the switch between spirals occur



Source: The author. Inspiration penningsystemet.wordpress.com

How many laps left?

The higher prices also raise the expectations of further price increases, driving demand for credits and they further increase the collateral values allowing further loans without increasing LTV limits. The next logical step is naturally to extend even more credit with even lower interest rate spreads and lighter covenants and then the reinforcing spiral makes the next lap – until something happens and it starts spinning in the opposite direction.

Buys when have money and feels good

Looking at historical transaction values there is, as in all M&A, a clear pro-cyclical pattern where the deal volume for example was much larger when the market was expensive in 2007 and then the deal volume was very small in the subsequent less expensive market of 2009. Some of the swings are due to the changes in property prices but some are due to the rise and fall of the animal spirits of investors and of the bankers giving credit to the investors.

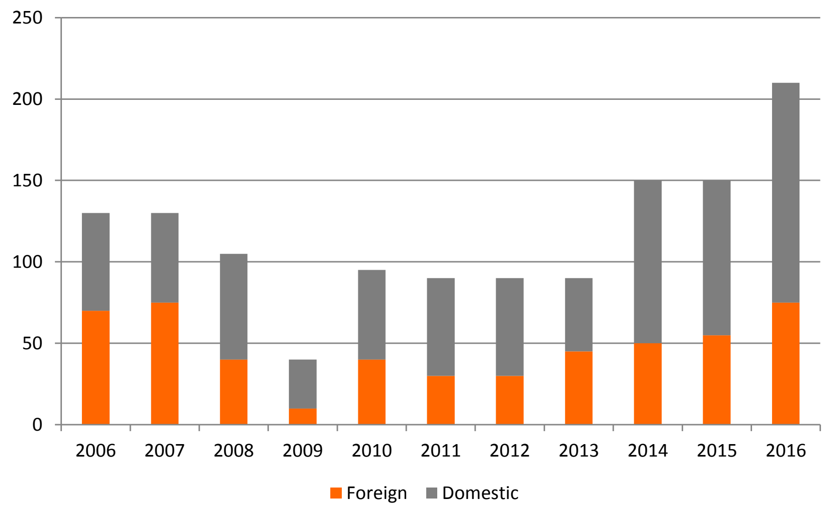
Brexit worries

The big transaction markets in Europe are simply in the large countries in Europe. Traditionally the UK has been the largest market with Germany and France thereafter. After the Brexit decision the UK transaction market has to some extent been put on hold and this caused the European 2016 volumes to decline 8% from the year before.

650% up

The transaction volume on the Swedish market is about 10% of the European volumes and in 2016 it saw a volume of SEK 210b, which is an increase of 40% over 2015 and 425% over the 2009 figure. Foreign buyers have increased their transaction volumes with 650% since 2009.

Picture 8.22. Transaction Value, Sweden, SEK billion



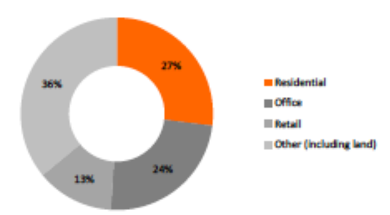
Buy high (and sell low?)

Source: Jones Lang LaSalle

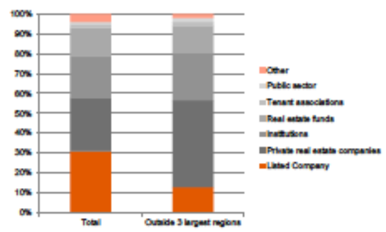
Moving out of CBD, Central Business District

The largest transaction segments in 2016 in Sweden was residential and office. About 35% of the volume was from transactions in Stockholm, Gothenburg or Malmö. Offices remain a priority target for the acquirers and last year the portion of transactions outside Stockholm, Gothenburg and Malmö CBD (central business district) increased significantly which is often a sign that the cycle has entered a later stage. The largest buyers were listed real estate companies, private real estate companies and institutional investors.

Picture 8.23. Segments Transaction Market



Picture 8.24. Segments Transaction Market



Source: Jones Lang LaSalle

As in all markets there are temporary conventions and fashions on how to invest in real estate markets that develop during a period and then suddenly get revisited. This gives opportunities for the contrarian investor who dares to stand aside from the crowd.

A pendulum

For example, during a period all investors want to be in the prime CBD locations in the principal cities, leaving the less attractive locations severely underpriced compared to their qualities. At some point in the cycle suddenly the trend reverses and “everybody” looks to less central locations or even suburbia and smaller towns etc.

It's not only the availability of capital that affects the transaction market. Historically the yield (~ e/p-ratio) has lagged changes in financing costs by 1-2 years. So at least marked changes in financing costs will affect the pricing of the transaction market. A sometimes used rule of thumb is that the initial yield (see the valuation section) plus expected long-term growth rate in rents must be higher than the financing cost.

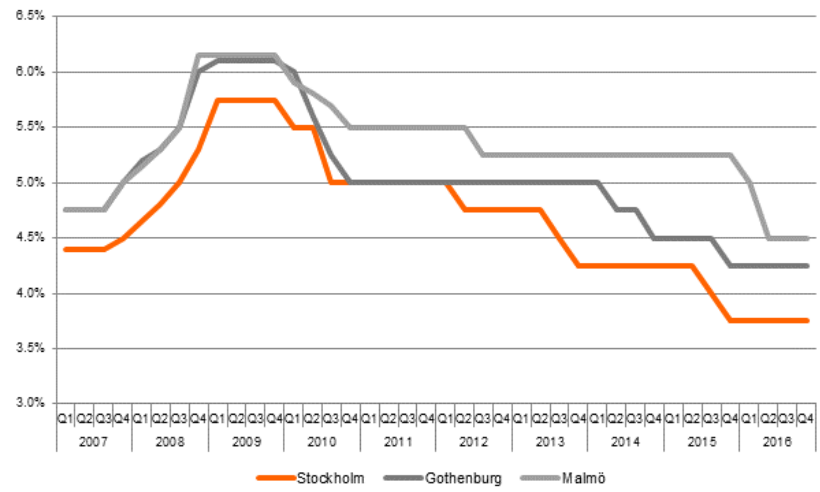
Swedish financing costs have declined

The financing cost for real estate companies is made up of one part cost of equity and one part cost of debt. The cost of debt at one specific maturity to a large extent consists of the financing cost for the banks at that same maturity plus the required lending margin of the banks. Since real estate companies can issue bonds the bank's lending margin must stay competitive in comparison.

Cost of financing = (cost of equity * proportion of equity) + ((financing cost banks + lending margin) * proportion of debt)

Since late 2009 average Stockholm office yields have declined from 5.75% to 3.75% at the end of last year. This is lower than in 2007 but the interest rate levels are lower as well. Gothenburg yields have gone down from 6.10% to 4.25% and in Malmö the previous yields of 6.15% are now about 4.50%.

Picture 8.25. Average Office Yields, CBD



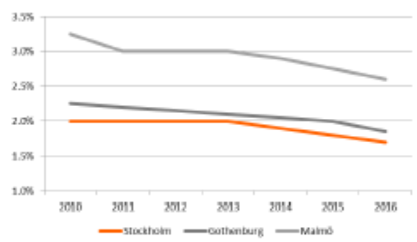
A 2 percentage point decline to 3.75% in Stockholm gives a much larger effect on property values than the almost 2 pp decline to 4.25% in Gothenburg

Source: Jones Lang LaSalle

The prime yields for residential properties in the larger Swedish cities have also come down considerably the last few years and in an international comparison Swedish residential yields overall are low – although there are countries with even lower ratios.

Even lower in Italy

Picture 8.26. Prime Residential Yields Sweden



Picture 8.27. Residential Property Yields 2015

Source: Newsec,. Source: MSCI,

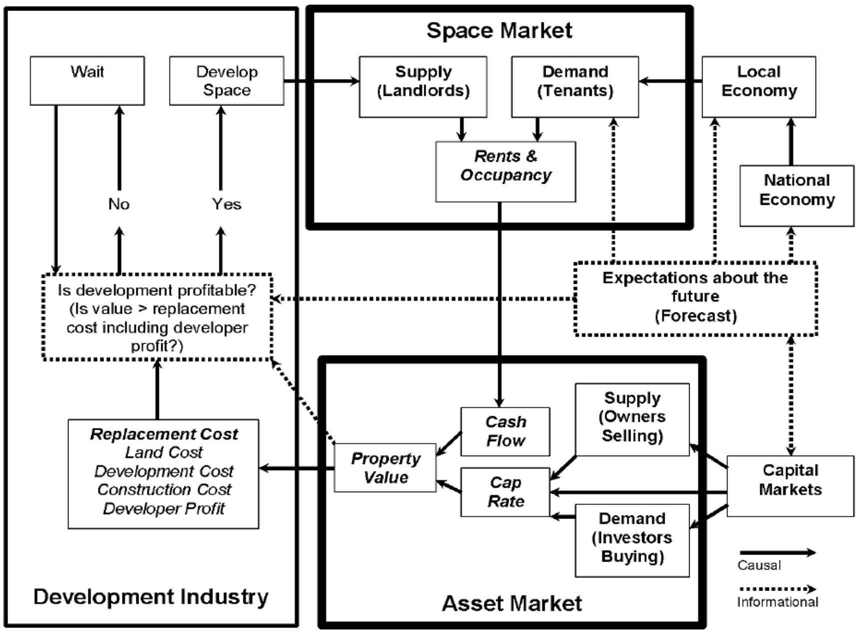
8.3.3 The 4Quadrant Model

Three markets?!?

On top of the rental market and the transaction market it could be argued that the construction industry is a third separate market and the fact that all these markets are interrelated creates a dynamic and volatile interplay. In the picture below the rental market is called the space market and the transaction market is named the asset market.

It's all connected

Picture 8.28. Interconnected Markets



Source: After DiPasquale and Wheaton, 1992

In the picture above we can see how the asset market is connected to the space market through the rent level. We can further see how property values determine the decision to develop new properties and how the supply of newly constructed space in turn has an impact on rent levels.

4Quadrant Model

One model that tries to picture the interplay between the various markets is the so-called 4Quadrant Model shown below. It consists of 4 diagrams paced together to illustrate snapshot equilibrium situations on the markets.

Q1 – rental market

The first quadrant (Q1) to the upper right has rent per unit of space on one axis and the supply of available space on the other. The curve represents the demand for space and at a lower price more space will be demanded.

Q2 – property valuations

The second quadrant (Q2) has the same rent per unit of space on one axis and the transaction price per unit of space on the other axis. The line represents the yield that investors demand to make investments. Hence, at a given level of rents and a given yield there will be a specific price for properties.

Q3 – New construction

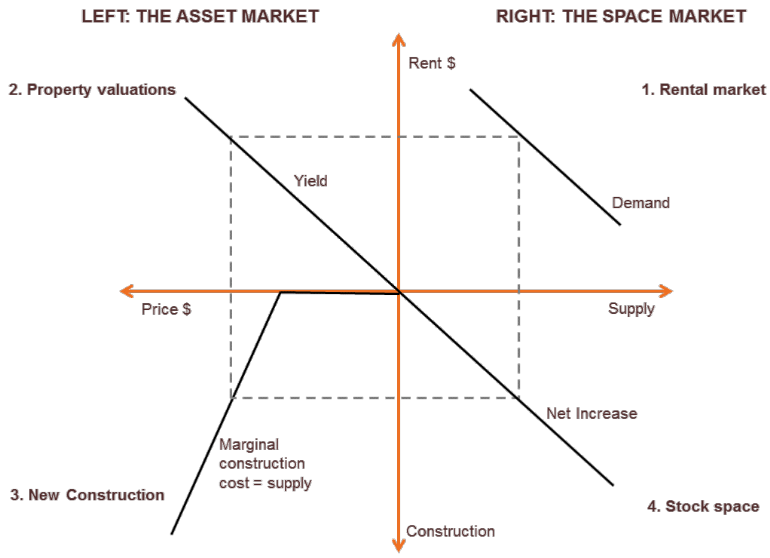
The third quadrant (Q3) pictures the construction industry with the same price per unit of space as above on one axis and the amount of supply of newly constructed space on the other axis. The line shows the marginal construction cost for the developed space. The line is kinked as below a certain price new construction is unprofitable and with nothing being built there will be no costs incurred.

Q4 – Stock of space

The forth quadrant (Q4) converts the flow of new construction in Q3 into the amount of available stock of available space. The line represents the net increase in the total amount of space. The origin of the graph represents a point where there is no net increase in space (new build minus demolition).

Picture 8.29. The 4Quadrant Model

A temporary equilibrium



Source: After DiPasquale and Wheaton, 1992

The dotted frame links the quadrants to each other

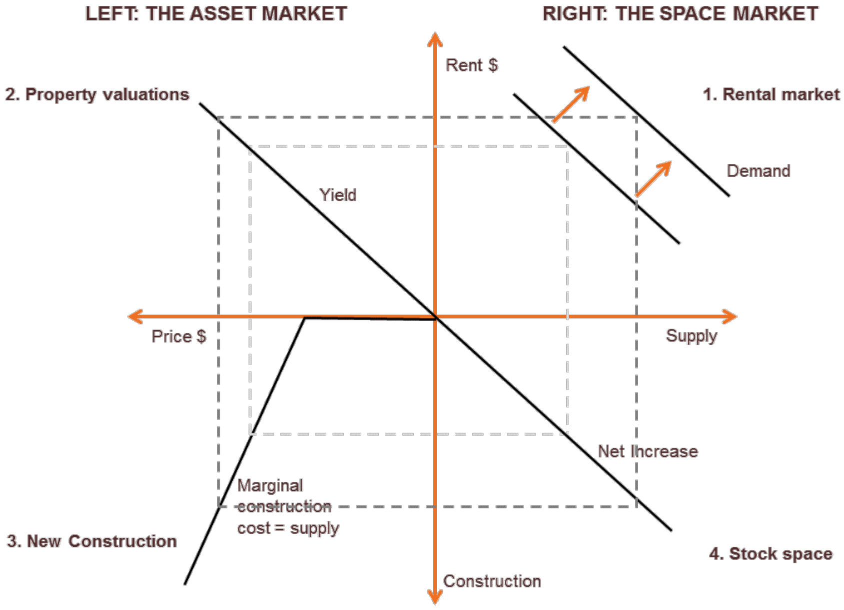
The dotted quadrant pictures the interplay between the markets. At one level of demand (Q1) the rent will be set at a level that given the current yield (Q2) determines a market price for properties and depending on what this price is this will drive a certain amount of new construction (Q3). This new construction will increase the stock of space available (Q4).

Increasing demand

The model can also be used to track the effects of changes. Say that demand suddenly increases since the economy is given a significant boost making tenants wealthier. Quite naturally this will increase rents (Q1), which will boost property valuations (Q2), increase new construction by a fair amount (Q3) and this will add to the supply of space (Q4) – making the rent increase lower than it otherwise had been. The process is a somewhat lengthy one as construction takes time.

Picture 8.30. The 4Quadrant Model – Increased Demand

New construction reacts heavily beyond a tipping point



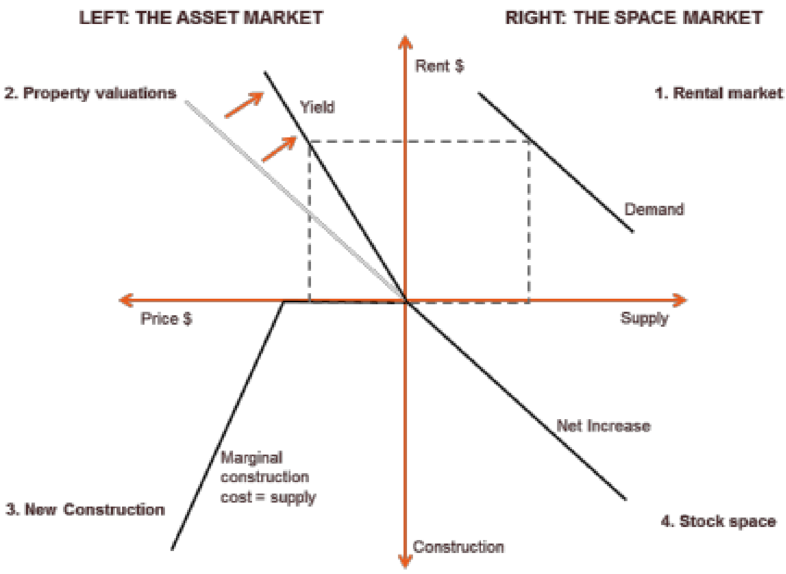
Source: After DiPasquale and Wheaton, 1992

Bearish investors

Let's instead say that the animal spirits of the transaction market are cooled off for some reason and the yield requirements increase. This will change the slope of the line in Q2 with the effect that property prices will decline. If the decline as in the picture below is large enough it will not be profitable to construct new properties (Q3) and the stock of properties will be static (Q4).

Picture 8.31. The 4Quadrant Model – Lower Risk Tolerance

Construction grinds to a halt



Source: After DiPasquale and Wheaton, 1992

With the slope of the marginal construction cost curve it is visible how construction is the most volatile part of the three interrelated markets. In the example above there will be no construction. If instead factoring in a similarly sized yield decrease this would cause a building boom.

8.4 Segments

Commercial & residential

Real estate can be divided into two principal categories; commercial and residential. Commercial real estate can in turn be divided into segments like offices, retail space, industrial buildings and so on. Residential real estate refers to dwellings, i.e. housing where people live.

Good tenants…

This part of the text will focus on property segments but it is also important to notice that the well-being of a landlord is tied to the health of his tenants. Hence, it matters if the tenants are in a business in secular decline or if it is seeing strong profitable growth; likewise if they are an established private company, a start-up or a public organization.

…with good economic trends

Thus, the demand for any property segment quite naturally depends on the current economic wellbeing of the type of customer who rents the space. As such the rent development and the profit growth of real estate companies is tied to the state of different customer categories and customer industries.

Segments

Over time there has been an increasing specialization among real estate companies where they have come to focus on specific types of properties. Since different segments have more or less favorable occupancy rates and rent developments at different times these specializations will matter for the current profit development of companies.

Lease terms

The lease terms of the property segments vary in terms of length. The shortest term is in the residential apartment sector (a few months up to a year) while the longest contract terms can be found in the retail mall sector where anchor tenants can have contracts stretching 20 years. As a general rule short contracts can be seen as more risky than long contracts.

WAULT – Weighted Average Unexpired Lease Term. Note that in the residential segment leases are often seen as eternal – even if the notice often only is a few months

Still, in positive economic cycles when rents tend to rise, shorter types of contracts can give opportunities for faster rent increases than long ones and vice versa. In Europe the maturity of leases is measured by what's called the WAULT, weighted average unexpired lease term, which is measured in years. The same ratio is in the US called WALE, weighted average lease to expiry.

Construction time

In any segment the supply of premises will depend on factors like the expected rent development plus the cost and availability of funding. However, the construction times of different types of properties are very different, meaning the fast construction of a warehouse or of industrial premises is less risky than the lengthier construction of shopping malls or prime location offices. With longer lead times comes the risk that the economy has deteriorated when the project is finished, bringing lower rents and higher vacancy rates.

8.4.1 Residential

Picture 8.32. Architect Sketch of Residential Building

The Sims 5?

Source: Panorama Architect

The main driver of apartment demand is job growth as this directly affects vacancy rates, rent levels and by this also revenues. Job growth in the 20 to 35-age range is especially beneficial as this is the prime target group for renters as such younger persons have a higher propensity to rent.

Job growth

In a downturn when unemployment increases the marginal tenant tends to trade down, share apartment with others or even move back with parents or other family members to save money. Typically, there is a lag of 6-9 months before changes in unemployment rates affect apartment fundamentals.

Keeping occupancy up

Too many empty apartments significantly lower the attraction of an apartment property that could lead to further vacancies. Therefore, most hosts try to keep the occupancy above 94-95% even if this means giving temporary concessions to some tenants in the form of discounts on rents (for example one rent free month the first year etc.). In Sweden the occupancy has obviously been much higher.

Broad usage = …

All people tend to want to have somewhere to live. All segments in society that involves more or less all potential voters in an election such telecoms, electricity and residential housing, attract the interest and regulatory zeal of politicians. Thus, depending on country the residential rent development but also the new build development and the transaction market related to residential dwellings is regulated.

…political tampering

Swedish residential rents got regulated during the World War II, but in contrast to the pricing of many other items that subsequently were de-regulated the rental development has stayed controlled. The first day of any economics class teaches you that if the price of an item artificially is set below where the unconstrained supply-demand balance would dictate, there will be less supply. Hence, Sweden predictably has got a severe shortage of affordable housing and the queuing time for a rental apartment in the city of Stockholm is now over 20 years – longer than the queuing time of 12.5 years for a Trabant in former East Germany.

Picture 8.33. Well Worth Waiting For

Let's see if the building boom can change the situation

Source: pinterest.com

Urbanization

As with all properties the residential property markets are local and the worldwide urbanization favors the property owners in the faster growing larger cities. In many such densely populated urban markets potential supply is also more constrained due to the relative lack of exploitable land.

GFC – global financial crisis

The demand for rental apartments is also affected by trends in relation to other types of housing. For example, post the GFC there has been a long trend away from individual house ownership towards apartment rental in the US. In Sweden a large number of rental apartment properties has been reconstituted to tenant owned co-op properties since this freed up values locked up by rental regulations.

8.4.2 Retail

Picture 8.34. Shopping Mall

From clothing outlet to amusement park?

Source: pinterest.com

Largest segment

The retail segment includes shopping malls, shopping centers, high street retail, outlets and so on. Among global REITs this is the largest property type. The segment has been favored thanks to less volatile rents and property yields and often low vacancy rates.

There is no clear distinction between a shopping mall and a shopping center but the shopping mall is always of a relatively large size, it's inward facing containing many small shops inside. The shopping center could be a shopping mall but it is really just a shopping destination that could range from the very small to the very big. The shopping center could also be outward facing and just contain one or a few shops.

Drivers

The revenues in retail are tied to the affluence of the area and to changes in consumer spending. The consumer confidence indexes are well worth monitoring. Very small parts of the rents are variable depending on the sales figures of the customers, but weaker spending drives increased vacancies due to bankruptcies and reduced store openings. Also, weakening sales can lead to lowered rents when the lease contracts are renegotiated. Store closures before the lease expires that don't relate to bankruptcies often come with a termination fee compensating the landlord.

OCR – Occupancy Cost Ratio

The tenant naturally seeks locations where he can generate the greatest amount of sales per space rented. The ratios to keep an eye on for the landlord are the sales per square meter for his tenants and the occupancy cost ratio (OCR), which is a store's rent plus service charges as a percent of the tenant's store sales.

MSU – Medium Square Units

Traditionally malls have consisted of 60% anchor tenant space with stores that were the major draw to the mall and because of this paid low rents but had long lease contracts of 15-20 years. The remaining 40% consisted of more specialized and varying tenants called medium square units (MSUs) and standard shops that payed the largest part of the rents but had shorter leases of 6-9 years.

Monopoly power in a bottle

Picture 8.35. A Swedish Anchor

Source: sollentunacentrum.se

Time and experience

The anchor stores are situated so that the customer traffic (sometimes called "footfall", aka persons entering a store) must pass through a large part of the mall. There is a very strong positive correlation between visitor spending and so-called dwell time. Still, the money people spend in a mall isn't just related to walking distances but more generally to the customer experience of the visit.

E-commerce

Just as retail stores themselves are affected by changing patterns of consumption so are retail property companies. Within all the property segments the most hotly debated topic the last 5 years or so has been the vulnerability of retail property assets due to the risk that physical "bricks and mortar" stores would get out-competed by e-commerce and online shopping. The retail segment has been challenged for a number of years and when possible, space is often redeveloped into other uses.

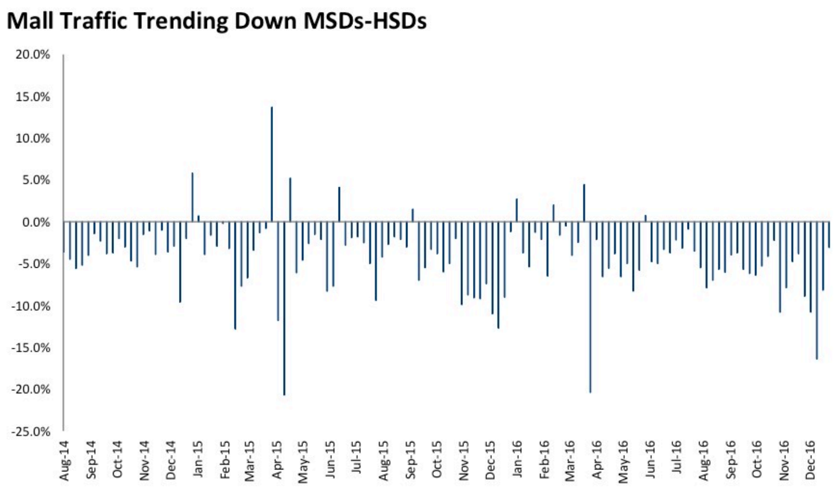
US malls and European high street

The below shown monthly trends in US shopping mall traffic vividly illustrate the dire competitive position of the physical store compared to online shopping. At the same time this specific example might to some extent also illustrate the starting point, where the US has 2.18 sqm of physical retail space per person.

The number 2 and 3 on the global top list, Canada and Australia, has 1.52 sqm and 1.03 sqm of retail space per person respectively. Sweden has 0.43 sqm of retail space per capita as a reference. The mix also differs between countries as the US and Australia is more biased towards shopping mall space and Europe has more high street retail space.

Picture 8.36. US Shopping Mall Traffic

Poor footfall = footfalling? Or footfail(ing)?



Source: businessinsider.com, monthly change y-o-y

Binary fates

The headwinds will mean a larger divergence between winning retail space and losing. The consensus as of now is that the winners are either the large destination shopping malls that draw traffic from a large area or small-scale convenience stores benefiting from the proximity to where people live and work. The convenience shopping often relates to food but it could relate to anything that requires a product or service immediately.

For shopping malls there are clear economies of scale in the operations since large size gives the ability to dominate a catchment area and a growing number of shops draw un-proportionally larger traffic. To become a destination that customers willingly travel to the customer experience must be better than in other malls.

Omni-channel

In reality the picture is less binary than online vs. offline and omni-channel is often the format label used when describing the future development. Customers both want to be able to browse and compare online before shopping in the store ("webrooming") and browsing and testing in the store before making the purchase online ("showrooming").

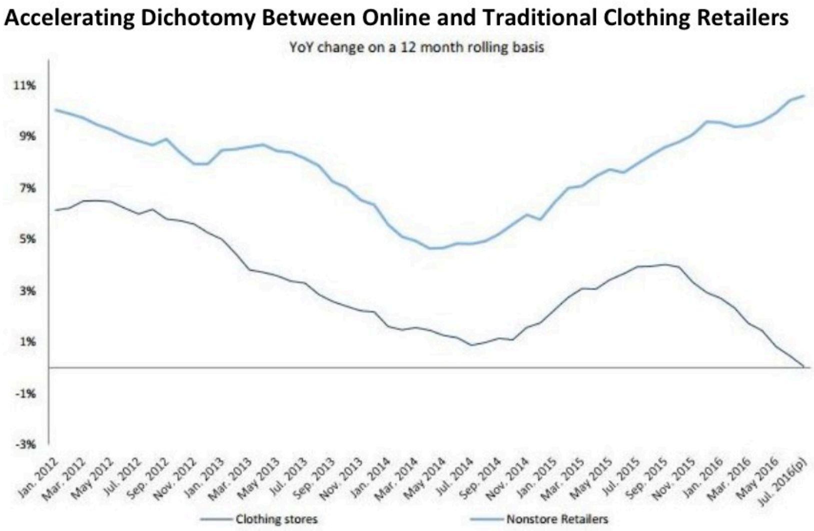
Further, for enjoyable and less bulky items like cosmetics customers sometimes want to purchase online but pick-up in store while larger items preferably are delivered home. And if purchased items are to be returned, stores are often a good place to hand them in. In a world of mixed channels, "click & collect" or "click, deliver & return in store" will all coincide. Hence, there might be less need for retail space in some segments but this doesn't mean that all space will be redundant.

More entertainment and…

The digitalization trend has also changed the composition of the tenants and some of this plays into the hand of the larger malls. For example, global brands like Nespresso or Apple concentrate their presence to fewer but larger flagship locations. Further, to improve the experience and increase the dwell time malls have re-focused away from clothing retailers who struggle with online competition towards a catering and leisure offering. "Eating out" is largely internet-proof. Unfortunately, food operators tend to pay less rent than apparel stores.

Picture 8.37. US Shopping Mall Sales

…less apparel



Source: businessinsider.com

Consolidation

To muster the segment challenges caused by online shopping and to counterbalance the bargaining power of large retailers there has been an ongoing consolidation of international real estate companies focusing on retail the last few years. The second largest listed real estate company in the world today is US Simon Property Group focusing on retail properties.

8.4.3 Offices

Picture 8.38. Office Building

The HQ

Source: byggindustrin.se

Office properties generally fall in two primary categories: central business district (CBD) and suburban. The first typically means high-rise buildings in urban areas and the latter stand-alone office buildings or office parks outside the city center. Office rents tend to be more volatile over time than other types of rents.

CBD vs suburban

The development costs, operating costs and rents are lower for suburban offices while they also face higher supply risk given the easier access to land for new construction. In some locations office properties come with the added benefit of an optionality to redevelop the premises for other uses such as residential housing (and vice versa).

Driver is white-collar job growth

The main office space demand driver is white-collar job growth, since more people employed require more space, but important is also general GDP growth and business expansion that increase tenants' ability to pay their rents. Low turnover is clearly preferable as it limits vacancy periods. Old vacated office space generally also looks very tired and without extensive refurbishing and customizations for the next tenants it risks being obsolete.

The leases in the office segment are relatively long which locks in the income stream when the economic climate worsens. On the other hand, in bad times when the negotiating power of the landlord decreases the property maintenance expenses and costs for office improvements tends to increase and vice versa.

Open landscape

One often discussed question is if the cost-induced fashion of using open-landscape design of offices has led to a decline in used square meter per employee during the last decade and if this hurts the total demand for office space. It isn't a trend that is clearly visible.

People are packed tighter

No doubt people in an open-plan solution are packed tighter together than when working in separate offices and according to research from IPD blue ship tenants used 17% less space per employee in 2015 compared to 2005 - but total demand is still strong in most countries.

Picture 8.,39. Less sqm/Employee But More Employees Needed?

Search for “Julian Treasure – The 4 ways sound affects us” on TED Talks

Source: metropolismag.com

Headphone with birdsong will do the trick

A large number of studies show that while an open design fosters a feeling of a laid-back and innovative atmosphere the design is also damaging employees’ attention span, cognitive ability and creativity with the result of higher sick leave, lower work satisfaction and decreased work productivity. It turns out that the more overloaded our mind is the more work is needed to achieve a given result. Ironically, open-landscape designs could theoretically mean a demand for more employees and a larger total demand for office space.

Not trusted/trustworthy yet?

Some 10-20 years ago there were fears that office space demand would suffer a similar or even worse fate than retail space demand. If all people can work online why would they go through the predicaments of commuting to an office? As it has turned out the social interaction needed to perform (and enjoy) a job and the control needs of line managers with regards to “seeing people working” have prevented this from happening. Working from home is still a complement for the few rather than the first choice of the many.

8.4.4 Other

Picture 8.40. Industrial Premises

At least it’s quick to build

Source: aaditgrp.com

All indoor human activity requires some sort of premises so this other group is very diverse and we cannot mention all types. Further, real estate doesn't just include land with houses on it; it could refer to land only or land with other types of constructions on it such as mobile phone towers or even mining pits. Two of the three largest listed real estate companies globally are so-called tower companies managing wireless and broadcast communications infrastructure worldwide.

Not just houses

Industrial

Industrial properties are a broad segment that includes distribution centers, warehouse space, manufacturing facilities, R&D facilities and attached office space for related administration. The premises are often located within industrial or warehouse parks. They generally require lower levels of maintenance capex given the relatively coarse state of the property.

Demand for space and rents are very strongly correlated to the GDP cycle but also to consumer demand changes and import/export activity. Leading indicators like ISM are worthwhile to follow to understand the changes in demand.

Less manufacturing but more warehousing

The structural trend in the Western World has been a declining demand for manufacturing premises but a growing demand for warehouse and logistics properties often hosting third party logistics tenants and enjoying the upside of e-commerce. A recent trend is that areas that contain warehouses and industrial premises have attracted a growing amount of professional retail space.

The properties frequently only have one tenant increasing the risk but they are often, but not always, fairly generic allowing new letting without large investments. The transaction volumes have historically been quite small but with the growth within warehousing/logistics this has changed somewhat.

Health care

Health care facilities include senior housing facilities, nursing facilities, hospitals, medical office buildings and other life science facilities. The main driver of demand for this segment is demographics but also geographical location since there is a wish for proximity to relatives.

Lodging

Lodging premises relates to the business of hosting hotel properties operated by a third party hotel operator. Since REITs must generate the majority of the profits from property management they cannot operate hotels directly.

RevPAR – Revenue Per Available Room

Hotel revenues are highly cyclical due to the extremely short-term leases (nightly – hopefully not hourly) which leads to swings in occupancy levels and room rates. At the same time many operating expenses are fixed or at least semi-fixed leading to large earnings volatility. The key metric monitored is called RevPAR, revenue per available room for a specific period. The revenues mirror the pricing and the occupancy, while the room is a proxy for the relatively fixed cost level.

Picture 8.41. Cool buildings: Park Royal, Singapore

Singapore again

Source: dailymail.co.uk

8.5 Operations

Slower or faster capital turnover

Schematically the operations of a real estate company could be described as first setting a strategy and then purchasing, managing and selling properties to satisfy this strategy. Some companies have a bias towards buying and selling and recycle their capital faster while others focuses more on the managing part but all these activities are pieces of the execution of a strategy. We will cover the transactional area further in the next section.

Picture 8.42. Real Estate Company Operations

Like most portfolio management really

Source: Swedbank Capital Markets

Chose what to do and not to do to reach the **wanted position**

Setting a strategy largely means deciding what one wants to achieve and then choosing what to do and what not to do to reach the wanted position. The strategy could include which geographies, property segments and tenant types to focus on. Further, the amount of development projects performed, the expected turnover of the property portfolio and the type of financing used are important variables. Since the world is not static, neither should the strategy be - it should be reviewed periodically.

Just do it!

Most of the operational efforts of real estate companies involve the less glamorous day-to-day management of the real estate currently owned. Each major property should have a property-specific business plan describing how to build value and then it is down to execution.

Picture 8.43. Execution

Property management like clockwork

Source: Texas Tech University

Will they pay?

For the profitability of a real estate company it is important to keep the vacancy rates low by bringing in new tenants as old ones leave. At the same time it is obviously equally vital that the tenants that exist actually pay their rents. As such the financial strength of tenants is key and one of the duties of the host would be to do a proper screening of the applicant tenant's credit history and financial status (plus criminal history if it is a person) to judge the ability to pay. Only, then should contracts be signed and premises leased out.

Handle payments

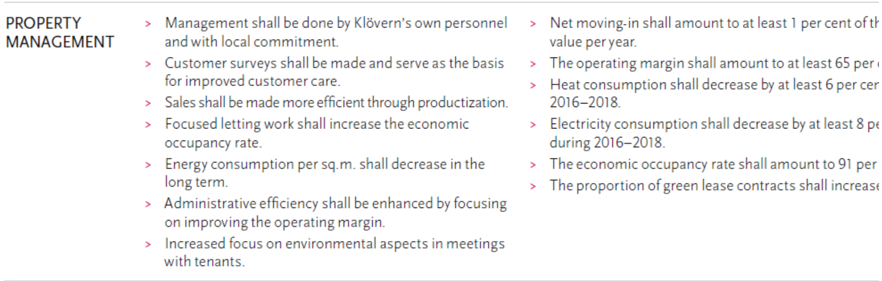
Further, there should be an effective process in place to collect rents and handle other payments or security deposits. A cash management process ensures that cash flows are collected and pooled to accounts that both ensure the availability of funds when needed but also the appropriate generation of interest income.

Happy? -> raise rents

As in any service business real estate companies often measure customer satisfaction and look to trends in this to gain insights to their future actions. All real estate companies generate the majority of their revenue from rents that are determined by the going rate in the respective markets where the company has properties – but no property is exactly the same as the other. More satisfied customers could potentially give opportunities for increased rents in the future.

Picture 8.44. Strategy (left) & Goals (right) 2017, Klövern

Not sure what the productization entails



PROPERTY MANAGEMENT

- Management shall be done by Klövern's own personnel and with local commitment.
- Customer surveys shall be made and serve as the basis for improved customer care.
- Sales shall be made more efficient through productization.
- Focused letting work shall increase the economic occupancy rate.
- Energy consumption per sq.m. shall decrease in the long term.
- Administrative efficiency shall be enhanced by focusing on improving the operating margin.
- Increased focus on environmental aspects in meetings with tenants.

- Net moving-in shall amount to at least 1 per cent of th value per year.
- The operating margin shall amount to at least 65 per
- Heat consumption shall decrease by at least 6 per cer 2016–2018.
- Electricity consumption shall decrease by at least 8 pe during 2016–2018.
- The economic occupancy rate shall amount to 91 per
- The proportion of green lease contracts shall increase

Source: Klövern Annual Report 2016

Handle payments

The repair and maintenance tasks required to keep the premises in its current expected standard can be done by in-house staff or it can be outsourced to an external party. To ensure a cost efficient maintenance the service appointment scheduling is important and it is beneficial with many properties in close proximity to each other to ensure profitable logistics.

Picture 8.45. Efficient Property Maintenance

Brilliant picture

Source: amandaonwriting.tumblr.com

Digitalization

Real estate companies are increasingly efficient as business operations. To achieve economies of scale companies try to sign master agreements for anything from elevators to gas delivery and white goods. Like in many other sectors the digitalization is also making inroads into property management. With property automation the electronic systems of a building can be optimized, as the heating, the air quality, lighting etc. are synchronized over networks.

Saving energy

Hence, sustainability and energy efficiency isn't only a way to attract tenants but also a way to cut costs. Decreasing the energy consumption per square meter could give meaningful contributions to the bottom line. In some locations the cost of heating or cooling can be significant and as such varying weather can affect the cost levels temporarily.

Triple net leases

For some type of premises like senior housing or hospitals and some offices or industrial premises the standard is so-called triple net, meaning the landlord passes on the operating costs to the tenant (not to be confused with the so-called triple net NAV covered later). Hence, triple net is "net of real estate tax, net of insurance and net of repairs and maintenance". Since the tenants pay for the majority of the maintenance capex they generally want to reap the benefit of these expenses so lease terms are long, typically 10-15 years.

Picture 8.46. Strategy (left) & Goals (right) 2017, Klövern

Happy employees -> happy customers -> happy shareholders

PERSONNEL	> Annual development interviews with individual goals linked to the level of remuneration. > Systematic annual follow-up staff surveys at management level with an action plan towards set goals. > Close collaboration with prioritized schools and a systematic approach to dealing with enquiries from universities and other institutions of higher education on essay topics and working for Klövern.	> The Satisfied Employee Index (NMI) shall in the long term be at least 75 per cent. > The Attractive Employer Index (AAI) shall in the long term amount to at least 80 per cent

Source: Klövern Annual Report 2016

Some aspects of the day-to-day property management are related to the management of the real estate firm itself. What happens on the ground level with each property builds the company bottom-up. For example, accounting bookkeeping must be performed to enable the later financial accounts; the necessary records for legal and tax purposes must be prepared and maintained.

8.6 Acquisitions and Projects

Build value

Properties can be of different value to different owners. This can be due to the properties' fit with other properties in a portfolio with regards to geographical location or property type. Since there in theory is a best owner of each property this gives a rational for a transaction market. With both the buying and selling of properties and the development projects, the task is to generate a high return on investment on the actions taken and by this build the value of the company.

Picture 8.47. Strategy (left) & Goals (right) 2017, Klövern

6% yield requirement

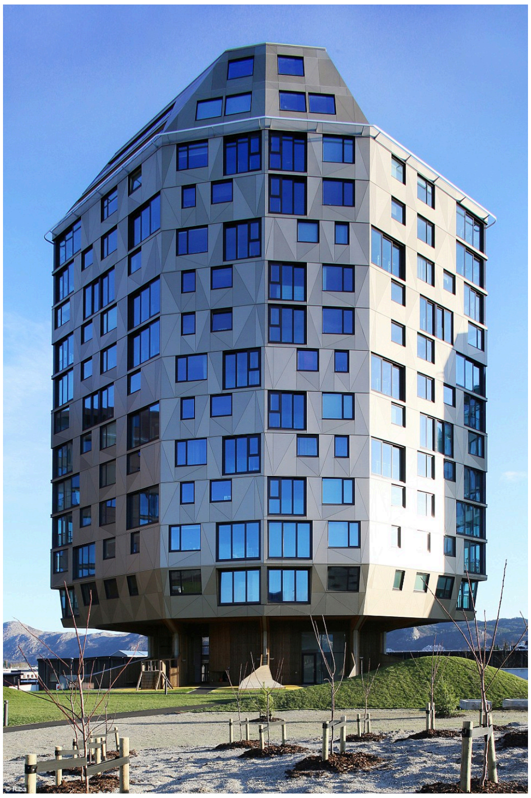
TRANSACTIONS AND PROJECTS	> Acquisitions and divestments shall be focused on geographic concentration with a view to creating effective management at prioritized locations. > Prioritization of projects with a high return. > Create values by making use of building rights or new production projects for own management or for divestment.	> Acquired investment properties shall on average have a long-term yield of at least 6 per cent per year. > Project investments shall give a return on equity of at least 15 per cent.

Source: Klövern Annual Report 2016

Management matters

In our view what differentiates real estate companies is the quality of the executive management as the operations is a type of asset management on an illiquid and imperfect market, making skill very valuable. First and foremost the management must be shrewd in buying and selling properties and secondly they also need to be skilled in creating values in projects and further be skillful landlords.

Picture 8.48. Cool buildings: Rundeskogen, Norway



Source: dailymail.co.uk

Perhaps not beautiful but definitely cool

Takes time…

To fulfill the strategy and create value properties must be acquired. Finding properties to buy that both satisfy the strategy of a company and are attractively priced could be a lengthy procedure and the purchase process including due diligence could take anything from 2 to 6 months. Hence, it is a cumbersome process but it must be allowed to take time or else the risk is that poor properties are acquired.

…and money

Just like M&A overall, the buying and selling of real estate can both create and destroy significant shareholder values and just as in M&A the transaction costs can be substantial. To succeed the company must have access to market intelligence and a deal flow through good connections and access to capital.

Good and cheap

As in all investments, acquisitions of properties balance the quality of the asset with its price. Companies look for targeted geographical exposures or property type/tenant type exposures with a good future balance between supply and demand and that aren't deemed as overpriced.

Priced below price

Since no property exactly equals another there is no one market price at any point in time for real estate like in the stock market. Hence, the well-connected astute negotiator can over time purchase properties at lower than average prices.

M&A possible

Economies of scale in real estate are relatively limited, but even if it is a less common practice and the tax effects might be an issue, corporate acquisitions can in theory be an alternative to purchasing property assets outright. In this case the real estate portfolio comes with additional staff and a corporate culture significantly complicating the takeover of all assets.

Sell it!

When a property in the portfolio is deemed to have too low potential or no longer fits with the strategy and other external parties value it higher, the property should be put up for sale. Again, with a less perfect market the skilled salesman can over time sell properties at higher than average prices.

Picture 8.49. Cool buildings: The Bull Ring, Birmingham, UK

It certainly didn't look like this when I studied in Birmingham in the 1990's

Source: matadornetwork.com

Projects – DIY value creation

In a low interest environment where it might be hard to raise rents and build shareholder values that way, development projects offers an alternative route to value creation. By using their financing capabilities and initiating projects in good locations companies can build property values through internal measures.

Management teams have varying degree of experience of development making the projects more or less risky. One key management skill with regards to projects is to have the competence and the right contracts to maneuver through the regulatory jungle. To start a project the appropriate official body often must grant planning permission.

Handle officials

For some land the permitted use may not have been decided so the project requires zoning, i.e. a process where land is divided into zones within various uses are permitted. Due to the risk related to the process, purchased unzoned land generally carries zero value in the net asset value of a company. After the land is zoned and possible to use for an intended project the value increases significantly.

Tennant secured?

Further, projects can vary in quality and their speculative qualities. Some projects might even only be justified employing higher leverage. Refurbishing and renovation projects sometimes border to property maintenance and are less risky, but sometimes the undertaking can be much larger. Expansions and extensions of buildings border to having the same character as construction of new buildings. The risk in all these later type of projects can be mitigated if there is a contracted high quality tenant prior to the project starts, compared to if it is completed on speculation.

The profitability of a development project can be analyzed by management using a cash flow analysis. To be able to balance the risk/reward of development projects when evaluating them most companies use some sort of multi-layered cost of capital adjusting the cost for the degree of a number of risks. One example is the Norwegian real estate company Entra. Starting with a base rate they further factor in the property type, the location, the tenants, the WAULT and the perceived project risk to set a project's required rate of return.

WAULT – Weighted Average Unexpired Lease Time

An alternative more crude way of evaluating projects is to look at the so-called development yield. The measure takes the net operating income (rents minus property maintenance costs) as expected after the project has been stabilized, divided by the total expected development cost. As in all projects it is always a risk that the cost ends up being higher and that the time it takes to finish the project becomes longer than initially estimated.

Development yield

To succeed with larger development projects such as redevelopments, expansions and new constructions, skill and experience of project management is critical. The two dominating costs of new construction projects are land costs (30-40%) and construction costs (45-55%). The developer cannot control these but he can try to time the development of them.

Land and construction costs

Land needs to be acquired when it isn't overpriced – but not too early as it ties up capital if not utilized. If the firm has been purchasing land that improves the density of the land portfolio this can be valuable in itself and it is a value that is only available for the buyer. A good balance must be struck between securing some tenants early at lower rents and saving the appropriate amount of space on speculation and above all the cost control is critically important.

Don't buy too late or too early…

The timing of the project will make or break it. First, the timing of the project will affect construction costs. Raw material costs, labor costs and the contracted construction companies required profit margin vary over the cycle. Secondly, the timing must be so that the project doesn't finish during a weak economic period with low rents and high vacancy rates. When it comes to rents in volatile property types like offices, they can differ 25% from where they were when the project started. With long lead times this is a difficult venture.

…and please don't finish in an economic slump

Picture 8.50. Cool buildings: Burj Al Arab, Dubai

Source: smashinglists.com

"Home is where the anchor drops"

But we need low rent housing as well

A special type of development projects is the gradual renovations of low-end rental apartments that for example Victoria Park and D. Carnegie engage in when a tenant leaves the apartment. The apartments are renovated to a new standard both allowing higher rents, which drives topline, and giving lower maintenance costs. With the current shortage of housing in Sweden this should be a relatively un-cyclical method to drive the value of a company.

Go where the money is

When discussing the transaction market above we noticed that properties in sub-markets weren't necessarily good substitutes to each other in the near-term. With regards to development projects the key word here is near-term. Properties in the same geography can, with some time, investments and development skill, be converted from one use to another and by this cater to a new set of – preferably higher paying – tenants.

Offices -> dwellings

This is happening at a rather large scale in many fast growing residential areas such as Stockholm at the moment. With skyrocketing residential prices the development investments to convert space from offices to housing is motivated and Pangea Property partners estimates that 300,000 sqm of office space will be converted to housing the next few years at the same time as there will only be 220,000 sqm new office space constructed.

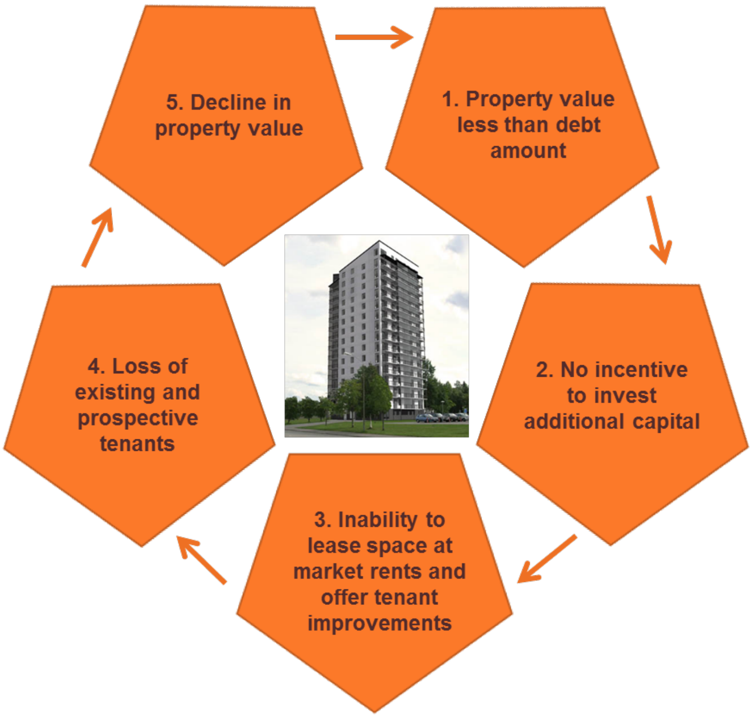
A lot of people working from home?

Hence, in a situation where Stockholm is growing rapidly and the Stockholm office vacancy rates are 2%, office space for about 15,000 persons will disappear. This will probably drive office rents upwards consequently leading to renewed interest in supplying offices – possibly by conversions from other property types – and so the pendulum swings back. Companies with foresight and a feeling for timing can exploit the fluctuations to make money.

Utilize better financing

Properties can also be of different value to different owners because of the owners' varying financial situation and this could open up for development projects. In the situation that the debt attached to a property is higher than its current property value it risks entering into a vicious spiral as the owner often has no incentive or no ability to invest new capital to improve property or attract and retain tenants which means further deterioration of the value.

Picture 8.51. Zombie Real Estate



Source: Swedbank Capital Markets

Break the circle

If a new owner with better finances can buy the property cheap, recapitalize it and start a positive repositioning and upgrade cycle with refurbishings and improved occupancy this "breaking of the cycle" can often unlock significant values.

Location, location, imagination

The oft-repeated tagline of the parameters to factor in when it comes to selecting properties (and the name of a UK TV-show) is "location, location, location" with the thinking that everything else can be altered but the location of the real estate. However, what constitutes a good location isn't static and can change both due to external forces but also thanks to the efforts made by the real estate company itself.

New public transport…

Transport improvements due to new roads or expanded public transport can significantly change the attractiveness of an area. One example was when the London underground Jubilee line was extended to Canary Wharf in the late 1990s, the discount on Canary Wharf prime rents relative to London City prime rents went from 50% to 25% in two years. Constructions of new schools, larger shopping malls, expanding office districts or parks and other recreational areas can have similar, if not equally dramatic, price effects.

Picture 8.52. The Entrance to a Profitable Tube Station

…can change the location

Source: earthsquare.net

What about later?

The property owner must look to the potential future of the area – how will the area look in 5 or 10 years? By repositioning and making structural changes to an area, so-called "place-making", it can also be re-rated (or gentrified as some perhaps would call it) and the community spirit can improve.

Cooperate to improve

The property owner can in cooperation with other property owners and the local government in the area take an active role in bringing in restaurants, cafés, gyms etc. to improve the attractiveness of an area. Hence, other landlords' willingness to participate in the improvement of the area is essential. The repositioning can bring in more affluent tenants who in turn improve the attractiveness of the area in a positive spiral.

All properties can be improved

In all development (and acquisition) of properties there is a large element of creativity and imaginative foresight involved. All properties can be profitably improved in some way. Premises can be extended or right-sized. Vacant land or land used for parking lots can be put to more profitable use. Perhaps the view of the property can be improved by some simple measures such as changing the location of windows? Or perhaps the planting of luscious trees can block the view of a highway? Would it be profitable to install balconies to a residential building? – And so on.

The rest of this real estate primer is published within short in part II.