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CHAPTER 1

Fundamentals of Real Estate Investment

Commercial real estate has been increasingly recognized as an asset class by institutional investors over the past 15 years because of its high current cash flow, diversification benefits, and as a hedge against inflation. Broadly speaking, the universe of commercial real estate investment opportunities can be divided into four categories based on whether the properties are held in public or private market vehicles, and whether the investment structures are equity or debt. This Four Quadrant Model, shown in Exhibit 1.1, illustrates the range of real estate investment opportunities available to investors today.

In each strategy, the fundamental revenue source is derived from leases paid by tenants who occupy commercial real estate properties. This income revenue is potentially augmented by capital appreciation of the asset realized at the time of sale. Private equity investment involves the purchase and management of commercial buildings, including office buildings, industrial warehouses, multifamily apartment complexes, hotels, and retail shopping centers. This investment may be made through direct property, closed-ended, or open-ended commingled funds, and separate accounts. Most real estate investment in emerging markets falls within the private equity quadrant. Public equity investment involves the purchase of shares in real estate investment trusts (REITs) and real estate operating companies (REOCs), providing investors with exposure to real estate via publicly traded securities. Private debt investment includes the origination and acquisition of senior debt (whole mortgages) on commercial properties. The public debt market includes the origination and trading of commercial mortgage-backed securities (CMBS).

The four sectors can be differentiated by their relative risk and liquidity profiles. Debt assets provide a senior claim on future rents at a specified rate and over a specified period. These investments sacrifice some potential return

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	Equity	Debt
Private	Direct Investment in Real Estate	Direct Investment in Real Estate Mortgages
Public	Real Estate Investment Trusts (REITs) Real Estate Operating Companies (REOCs)	Commercial Mortgage Backed Securities (CMBS)

EXHIBIT 1.1 Four Quadrants of Real Estate Investment

in favor of predictability. Equity investments, on the other hand, are higher risk because the claim on future rents is subordinate to the debt position. The benefit of the equity position lies in an enhanced ability to control the property through active management and to benefit from the growth of future rents and property appreciation. Private equity real estate investors generally anticipate relatively higher returns than public equity, reflecting the lower liquidity and higher risk of the private market, compared to the public equity markets. While REIT shares can be actively traded through an organized, efficient, and transparent market where abundant information exists, private equity transactions are conducted between individual buyers and sellers with less information.

The debt markets have evolved to provide an increasing number of sophisticated financial products to investors. Public debt investing, predominantly in the form of CMBS, emerged as a strong global trend beginning in the early 1990s. The liquidity provided by trading CMBS in a public market, as well as the ability to securitize large income streams and tranche loans into various risk profiles, helped to make CMBS an increasingly attractive investment opportunity. While the current upheaval in the capital markets has severely impacted the origination and values of CMBS tranches, we nonetheless expect an eventual return to long-term origination and trading volumes. Private debt, which for many years was the primary vehicle for commercial debt investment, has taken on an increasingly prominent role recently as the CMBS market has "seized" in the current crisis. Exhibit 1.2 illustrates the various risk and liquidity characteristics of some of the major commercial real estate investment vehicles. Investors are able to craft portfolios based upon their needs for liquidity and risk, while balancing the risk and return profiles.

This chapter focuses mainly on investment strategies for private equity real estate investment, as this is still the main way of investing in emerging markets. Private equity has historically also been a cornerstone of most

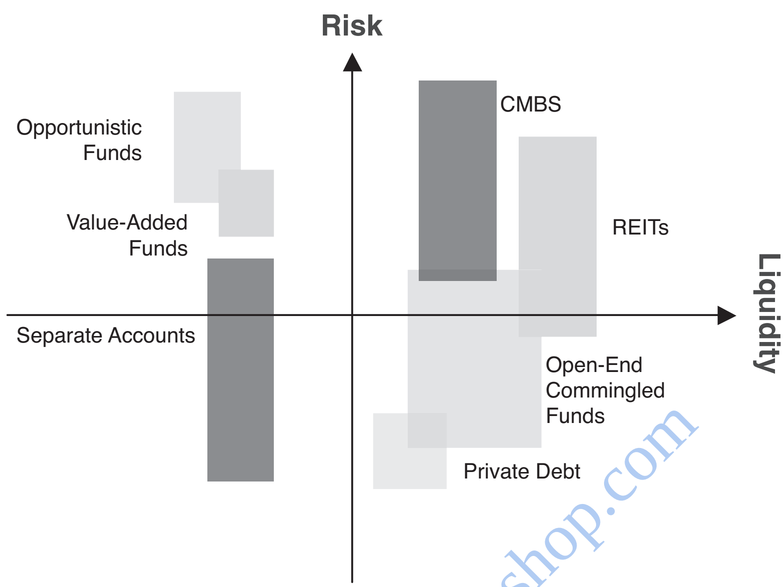

EXHIBIT 1.2 Real Estate Investment Vehicles Risk and Liquidity Spectrum
Source: ING Clarion Research & Investment Strategy.

institutional portfolios, and we believe it provides a good foundation for understanding the additional strategies.

INVESTING BY PROPERTY SECTOR

Private equity real estate investments are generally focused on the five main property sectors: office, industrial, multifamily, retail, and hotel. Investment preferences may vary depending on current and forecast economic conditions, lease types, professional management requirements, and other characteristics unique to each sector. For example, the benefits of a generally low vacancy rate in the multifamily sector are balanced against the requirement for intensive, active management. We believe, therefore, that local market knowledge and management experience are particularly important in the multifamily sector to maximize returns and mitigate risks. Similarly, while the hotel sector has historically been the most volatile in terms of returns, it is also typically the first sector to recover after an economic downturn, presenting the potential for high returns with careful market timing.[1]

In the United States, institutional-quality real estate investments are tracked by the National Council of Real Estate Investment Fiduciaries

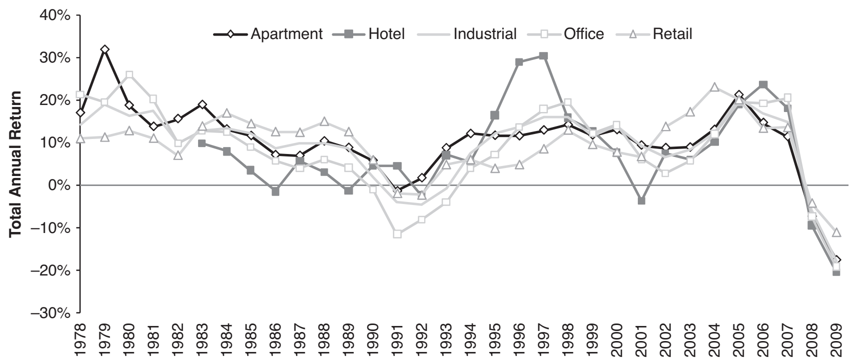

EXHIBIT 1.3 NCREIF Property Index Annual Total Return by Property Sector
Source: ING Clarion Research & Investment Strategy, NCREIF, as of 2009Q4.

(NCREIF). The NCREIF Property Index (NPI) is a good representation of investment performance for the five core property sectors over several market cycles (see Exhibit 1.3).

Globally, International Property Databank (IPD) tracks real estate returns for dozens of countries and has recently begun publishing a global index. While the global returns data series is not as lengthy or robust as the U.S. series, it does suggest that the property sectors appear to follow similar patterns globally as what we see in the U.S. NCREIF data (see Exhibit 1.4).

Office

Office sector properties are generally categorized based upon location and quality. Buildings may be located in Central Business Districts (CBDs) or suburbs. Buildings are also classified by general quality and size, ranging

EXHIBIT 1.4 IPD Global Property Index Annual Total Returns by Property Sector
Source: ING Clarion Research & Investment Strategy, IPD, as of 2009Q4.

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from highest-quality and generally large-scale Class A buildings to below investment grade Class C buildings; institutional investors tend to focus on only Class A or B buildings. So-called trophy office buildings are generally found in supply-constrained markets such as Manhattan, London, Shanghai, and Mumbai; typically, they are of the highest quality with notable architecture and outstanding locations.

The longer duration of office leases, which typically run 5 to 10 years, helps to mitigate the office sector's historic volatility.[2] It is generally understood that the complexity and size of many office projects contribute to long construction timelines. This limits the developer's ability to pull back on projects when the economy deteriorates, sometimes leading to the delivery of new space in a time of weak fundamentals. In addition to long construction timelines, CBD office properties are capital-intensive, requiring a high capital outlay to purchase the property as well as significant levels of expenditure for renovations and tenant improvement when leases roll over.

Industrial

Industrial properties are generally categorized as warehouses, research and development (R&D) facilities/flex space, and manufacturing.[3] NCREIF returns for the industrial sector illustrate generally less volatility than in the other property sectors, suggesting investment in this sector as a relatively more defensive strategy.[4] The shorter construction timeline—typically six to nine months for warehouse properties—allows the sector to be much more responsive to changes in demand, helping to avoid significant overbuilding. Industrial properties typically require relatively modest capital expenditures for maintenance and tenant turnover. The triple-net lease structure, common to the sector, helps the owner to mitigate many of the risks associated with rising expenses. However, industrial properties tend to have lower total values than the other sectors, and constructing a sizable and diversified industrial portfolio one property at a time may be difficult. As such, portfolio acquisitions have been relatively more common in the industrial sector than other sectors.

Apartment or Multifamily

Multifamily properties are generally defined as having five or more dwelling units. There are three main types of multifamily product—garden (mostly one-story apartments), low-rise, and high-rise. Typically, institutional-grade apartments consist of at least 20 or more units. The apartment sector is similar to the industrial sector in that both feature relatively short construction periods and may be developed in phases, making them more responsive to

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changes in demand. Apartments typically have the lowest vacancy rates of any sector—rarely above 10% even in economic recessions.[5]

Retail

The retail sector is comprised of five main formats: neighborhood retail, community centers, regional centers, super-regional centers, and single-tenant stores. Like the hotel and apartment sectors, retail properties also require a high degree of active management. Location, convenience, accessibility, and tenant mix are generally considered to be among the key criteria for successful retail investments. Retail leases tend to range from 3 to 5 years for smaller tenants and 10 to 15 years for large anchor tenants. Leases, particularly for anchor tenants, may include a base payment plus a percentage of sales. The cost of upgrading and renovating retail properties can be significantly higher than for the other sectors, and upgrades may be required on a more regular basis to maintain functional utility. Overall, returns on retail investments tend to closely track the economy—both local and national. Income and population density are generally considered to be key drivers of local retail demands.

Hotel

We believe that hotel investment is best understood as both a real estate sector and an operating business. Generally characterized as a noncore asset class, the hotel sector exhibits the highest volatility of the five main property types according to NCREIF returns. This is primarily due to the extremely short effective lease terms, as hotel rooms are essentially leased on a daily basis. As such, hotel owners/operators are able to adjust their rates quickly in response to economic activity. As a result, hotel revenue has been largely correlated with gross domestic product (GDP) activity. Hotel demand is derived from business travelers, meetings/conventions, and leisure travelers. Although hotels are the most volatile of the five sectors, they can offer the highest return potential during an economic recovery.

Mixed-Use

Mixed-use, as the name implies, is a combination of uses (sectors) within one property. Mixed-use properties may include multiple uses in a single structure (vertical mixed use) or multiple uses within close proximity of one another in an integrated development (horizontal mixed use). This development style has become much more popular in recent years due to the renewed popularity of urban living, urban redevelopment, and brownfields renewal efforts, which all aim to maximize development potential and density on increasingly expensive land. Mixed-use is also much more prevalent in emerging markets due to greater urban densities and the need to optimize land uses. This product type often combines high-density residential, office, and retail in one site. Integrating the various components of a mixed-use project demands a higher attention to design than the other property sectors, generally increasing costs. These types of projects have historically been large in scale and located in high-profile urban areas, but the increasing popularity of these projects has resulted in a growing number of smaller projects in suburban locations as well.

INVESTING BY STYLE

A range of investment styles allows real estate investors to pick a preferred level of risk. There are three main investment styles: core, value-added, and opportunistic. These strategies offer a continuum of options along the risk-return spectrum, as indicated in Exhibit 1.5.

Core Strategy

Core real estate has historically accounted for more than half of all real estate commitments.[6] It is generally understood to represent a long-term, low risk/low return strategy. Investors are typically attracted to core real

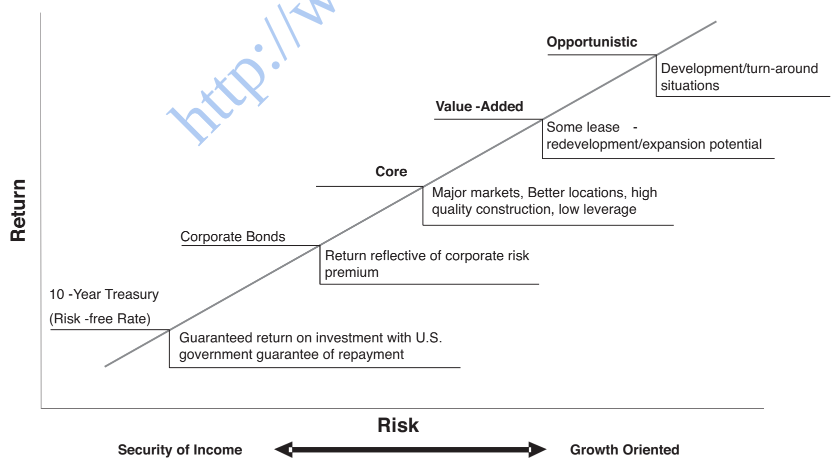

EXHIBIT 1.5 Real Estate Investment Strategies
Source: ING Clarion Research & Investment Strategy.

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estate because of its high yield, stable bond-like characteristics, diversification, and inflation hedging benefits. Investment in core real estate focuses on the acquisition of existing, well-leased and high quality properties in established markets. Investments are focused in the four primary property sectors: office, industrial, retail, and multifamily. The hotel sector is often not considered to be a core sector, given its high volatility and the fact that it is extremely management-intensive. Core properties typically demonstrate stable and predictable income flows from strong credit tenants. A high proportion of the anticipated total return in this strategy is generated from current income and cash flow. Property appreciation plays a lesser role, but the stability of the properties helps to provide more predictability of future property values and potential purchasers. Low-to-moderate leverage is used for asset acquisition, further minimizing risk. The target total returns are in the 7–10% range.

Value-Added Strategy

The value-added strategy spans the spectrum from less risky core-plus style to higher risk and more opportunistic plays. In its most fundamental form, value-added real estate investment involves buying a property, improving it in some way, and selling it at an opportune time for a capital gain. Capital appreciation normally comprises a significant portion of the investment's total return. Properties with management problems, operational issues, or ones that require physical improvements are prime candidates for this strategy. Significant expertise and experience in re-tenanting and rehabilitating the properties are required for successful execution. The value-added strategy normally uses 40–70% leverage and the target total returns are in the 13–17% range.

Opportunistic Strategy

Opportunistic investing represents the highest risk/highest return strategy available in private equity real estate. In the past, most institutional investors had minimal exposure to opportunistic investments in their portfolios. However, the search for higher returns in recent years spurred growing interest in this strategy. Opportunistic investments are made based on their return potential with little or no consideration given to diversification, either by property type or by geographic region. Opportunity funds target distressed assets (property or debt), development projects, and emerging markets. In general, these investments are more complicated and risky and could involve nontraditional/specialized property types, complex financial restructuring, highly leveraged transactions, ground-up development, and international

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markets. Opportunistic investing often uses high leverage (>70%) and target total returns start at 20% and above, with a limited income component.

INVESTING BY PHASE

Investors can also choose to invest in a specific stage of the property life cycle. The three basic stages are (1) development, (2) stabilization, and (3) repositioning/redevelopment. This approach allows the investor an additional opportunity to balance the level of risk and reward.

Development

Development is typically part of an opportunistic strategy. In a market with significant barriers to entry, development can be justified if existing properties regularly sell at a premium to their development cost. High barrier-to-entry markets are often characterized by strong demand fundamentals (high occupancies and rents) and low capitalization rates (cap rates).[7] In markets characterized by low barriers to entry, new properties run the risk of being priced close to or at their development cost, which generally does not justify the risk premium for development.

Stabilization

Stabilization occurs when the construction phase is finished and leases are in place to reach a target occupancy level. These types of properties are the focus of a majority of investment activity, partly because the risks of owning stabilized buildings are partly mitigated by the clear record of historic operating income and expenses. This stable income allows for a more accurate projection of future income. Stabilized properties generally demand a higher price (a lower cap rate) than development or redevelopment properties, given the lower relative risk. As such, stabilized properties also generally have lower total returns. Stabilized investments are typically preferred by large institutional investors. A typical strategy for stabilized assets is to hold for income returns and sell when the spread between return on investment and the cap rate is the greatest.

Repositioning/Redevelopment

This is also known as the value-added phase. When stabilized properties command large price premiums in high barrier-to-entry markets, repositioning/redevelopment is a logical investment strategy. Poorly managed or

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EXHIBIT 1.6 NCREIF Historic Return Correlations

NCREIF Historic Return Correlation	10-Year	30-Year
S&P 500	0.21	0.11
Barclays Capital Aggregate Bond Index	−0.17	−0.07

Source: ING Clarion Research & Investment Strategy, S&P, Barclays Capital, as of March 31, 2010.

cash-strapped properties with high potential are typical targets in repositioning/redevelopment investments.

ASSET ALLOCATION

According to Modern Portfolio Theory, the inclusion of low or negatively correlated assets in a diversified portfolio can minimize overall portfolio risk. Real estate as an asset class exhibits low to negative correlations with equities and bonds (see Exhibit 1.6). We believe that an allocation between 10% and 20% of real estate assets into a mixed asset portfolio can potentially enhance investment returns and reduce portfolio risks over a long-term investment horizon.[8]

Real estate has typically been underweighted in mixed-asset portfolios.[9] We believe that there are a few reasons for this. First, real estate is perceived to be risky. Second, many investors feel that real estate is relatively illiquid and inaccessible to small investors. As we have seen above, this has been changing with the proliferation of real estate investment options.

NOTES

1. General conclusions based upon a review of historic returns data in the U.S. from the National Council of Real Estate Investment Fiduciaries (NCREIF), historic returns data, 1978–2008.
2. W. Wheaton, "The Cyclic Behavior of the National Office Market," *American Real Estate and Urban Economics Association Journal* (1987). Volume 15, Number 4, December 1987, pp. 281–299.
3. Manufacturing space tends to be a small focus for investors, as it typically is owned directly by end-users, not investors.
4. National Council of Real Estate Investment Fiduciaries (NCREIF), historic returns data, as of Q4 2008.

5. For example, according to Torto Wheaton Research, the national vacancy rate has not topped 8.2% since 1994. Torto Wheaton Research, Outlook XL Online, Apartment Sum of Markets, as of Q1 2010.
6. Real Capital Analytics, Q1 2010.
7. A capitalization rate is calculated as the expected net operating income divided by the current property market value, either for the previous year or for the first year of ownership.
8. T. Bellman, M. Paradinas, and S. Taylor, "The Case for Real Estate: Asset Class Performance at the Cusp of Recession," ING Real Estate Internal Publication (2008).
9. P. Sivitanides, "Why Invest in Real Estate: An Asset Allocation Perspective," *Real Estate Issues* (1997). Volume 22, April 1997, 30–37.