

METROPOLITAN REAL ESTATE
EQUITY MANAGEMENT, LLC

U.S. Real Estate Perspectives

Core, Non-Core, and Cycles

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INTRODUCTION

Commercial real estate is an asset class that includes a wide range of strategies and approaches, all of which can be segmented into a few simple categories. The most important segmentation is core versus non-core, or properties with stable income versus unstabilized ones. Some investors consider four loosely defined classifications: core, core plus, value-added, and opportunistic. Our “core” category includes both core and core plus strategies, and our “non-core” category includes both value-added and those opportunistic strategies that are real estate based rather than corporate. The distinction between value-added and opportunistic essentially refers to how unstable the income is, but there is not a consensus on where on the continuum the definition changes. Most things considered to be value-added have some income component, whereas opportunistic assets can have none (i.e., empty buildings or new developments).

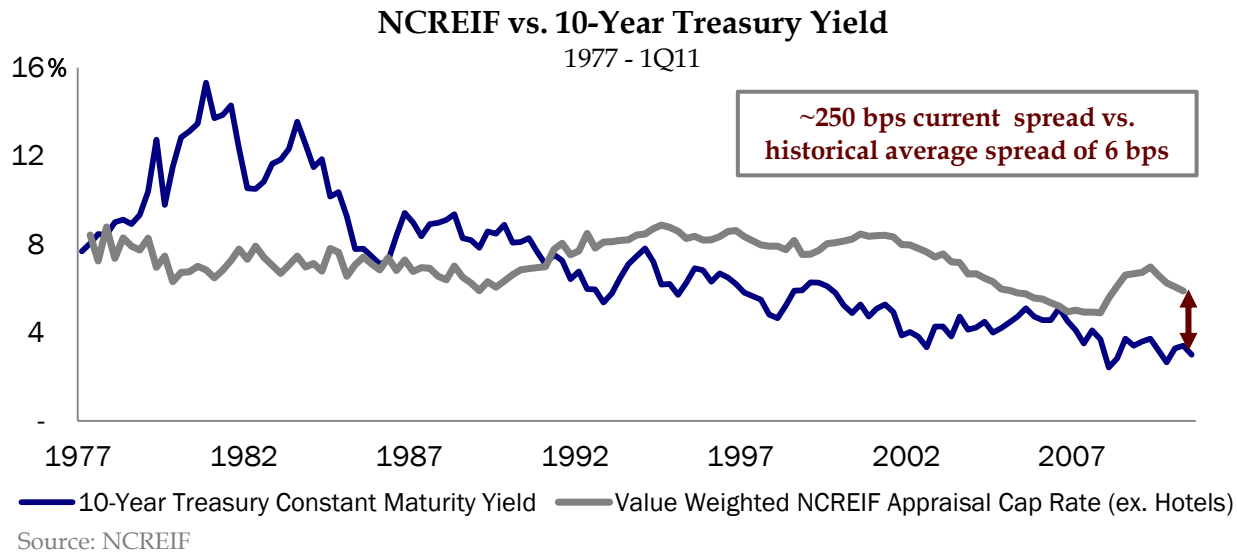
This paper offers some perspectives on core and non-core investing, and includes a brief discussion of cycles and how they can affect both types of investing.

CORE

We define “core” broadly to include any property that is reasonably fully leased and has a stable, predictable income stream. This includes large properties in major markets, which is the most narrow definition of core. It also includes smaller assets and smaller markets, provided they

are well located, well leased without near-term rollover exposure, stable, and traditional in property type. Core can be unleveraged or leveraged; the term “core plus” most often refers to core properties with leverage of 30-50%. The existence or the amount of financing does not change the nature of the core asset. Any asset that is not a core asset is a non-core property by definition.

Core properties are the real estate equivalent of bonds because of their relatively stable income characteristics. The bulk of institutional real estate dollars, particularly allocations by pension funds, are in core portfolios and their primary role is to provide income. The income tends to exceed actual bond income over time, which is appropriate since these portfolios do have a moderate amount of real estate operating or equity risk. Initial real estate yields have historically been slightly above Treasury yields, plus, on average, well-managed properties enjoy enhanced cash flow (and therefore enhanced yield) over time.



While core property income rises, on average, over time, income from individual core properties will rise or fall in the near- and medium-term depending on the specific rent roll and where we are in the property cycle. That said, large movements in net operating income are fairly rare in well-managed properties (poorly managed properties or those deprived of capital can all too quickly become income-impaired, non-core assets). Due to the stable nature of core assets, real estate managers have few opportunities to significantly enhance their value. Values will certainly rise (and fall) over time, but the fluctuations will be much more a function of the market than the manager. Active managers of core portfolios can add some value in property selection, but most portfolios tend to hug the core index. The dispersion in returns among core managers should be much less than in non-core strategies. In other words, core tends to be a beta play, with little opportunity for alpha, and the vast majority

of the return (especially over long time periods) is from income and not capital gains.

Core properties can be accessed through private vehicles (direct ownership, separate accounts, pooled funds) or through public securities known as REITs (REIT is the common term for a public real estate securities, and we will use it as such here, though it is something of a misnomer because there are also privately held REITs). REITs should perform like comparably-leveraged privately-held core portfolios, but with higher volatility. The volatility comes partly from their linkage to the broader stock market (inclusion of REITs in the leading stock indices enhances this), though over longer periods of time REITs can be expected to perform more in line with the direct real estate market. Some REITs add additional value from time to time by effectively performing “capital markets arbitrage” on behalf of their shareholders. That is, when the stocks are trading at a

premium to private market values, capably managed REITs can sell stock and buy property, creating NAV per share (and vice versa). Volatility also arises because the total market cap of REITs is minor relative to both the total equity and direct real estate markets, yet they are the only way to quickly add or remove real estate exposure, so there can be sizable capital flows in short periods relative to the small base.

Institutional investors who want to participate in the core part of the property market can either try to time this cyclical asset class (easier to execute with REITs due to the liquidity, but difficult to do consistently) or maintain a permanent allocation to the sector. With a permanent allocation, as with most investors' permanent allocation to long only equities or high grade bonds, sector weighting can be adjusted as industry price levels change. Over a long period of time, core properties should generate 6-8% unleveraged returns (with correspondingly higher returns and risk as leverage is added). Long term results fall between fixed income and equity; certain hard asset characteristics lead to somewhat lower risk/return than other equity types.

NON-CORE

Anything non-core, by definition, does not have a stable, predictable income stream. Non-core properties can have significant vacancy, or they can be "fully leased" but with vulnerable, sub-optimal income stream due to age, management, or other property-

specific aspects. Non-core includes a wide range of situations, including:

- Properties with a meaningful vacancy or those in need of renovation, which can range from upgrading shabby or dated lobbies to more significant physical work such as installing new elevators and windows.
- Properties in need of repositioning, which means they are achieving lower rents than they should achieve. This may occur because of the need for physical renovation, but also usually involves mis-marketing or simple failure to keep up with the marketplace. Repositioning may entail a change of use.
- Redevelopment (removing part or all of what is there and building anew) or new development.

For these assets, active management will typically produce a change in the value of the asset. Managers who know the leasing and capital markets well and understand the property cycle can add significant value by filling vacant space and raising rents (often in conjunction with making improvements to the property). On the other hand, managers that jump into a transitional asset without the experience to successfully execute the property level strategy can see meaningful deterioration in cash flow and value, as these assets are often on a downward trajectory when purchased. Therefore, an investor in non-core assets will earn a return with two components - one component tied to the change in rent, occupancy, and value for

that market as a whole, and one component that results from the manager's skill in increasing value relative to the market. In other words, there is beta plus meaningful alpha potential.

Investors who want to outperform core returns need to participate in the non-core part of the business, with its higher risk/return parameters. There is also the issue of price, which creates another source of alpha. The property market is relatively inefficient, in large part because the assets are not fungible and trade in relatively small, private auctions. Two very similar buildings can trade at similar times for very different prices. This feature is magnified in the non-core world because impaired assets are harder to price. Bidders need to correctly price the cost of repairing/building the asset, leasing it to stabilization, and carrying it until it is stabilized. They can lose by underestimating and gain by overestimating the actual costs; local market experience plays a big part in correctly underwriting and managing these costs and improves the odds of underpaying. Many investors are drawn to non-core assets specifically because of the relative inefficiency; they view the potential alpha caused by inefficiency to justify the resources needed to successfully implement an investment program in this space.

There are a number of challenges involved in non-core investing. The results hinge on successful management, so manager selection, motivation, and alignment of interest are very important. Investments in

transitional assets require sufficiently long time horizons; stabilizing an asset is typically a multi-year process. It also requires patience with respect to interim accounting results and willingness to look through to the final product. While a manager is in the process of leasing and/or renovating a property, it is not terribly liquid and is very difficult to value. In fact, its value may temporarily be less than the acquisition value if part of the strategy is to turn and upgrade the tenancy. Also, given the relatively high property specific risk, exposure through a diversified portfolio is even more important than in the core space as a risk mitigant. Closed-end, illiquid partnership structures with an expected life of 7-10 years have proven to be very effective vehicles for investing in non-core assets because they address many of these challenges.

Relative returns

How much extra return should an investor expect from non-core (versus core) to accept the illiquidity? There is no simple answer, but in our view the potential excess returns are interesting enough to justify a "permanent" allocation to non-core strategies as part of an investor's real estate portfolio. The following examples provide some representative numbers:

Case 1: Value-added apartments

Most markets include a range of core and non-core apartment assets. Many of the non-core assets can be converted to core assets through some combination of physical upgrade, repositioning, and better management and leasing. As a rule of

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thumb, managers expect to earn 100-150 basis points of extra yield by completing a substantial upgrade of an older property. If successful, this could deliver a 6.5-7.0% yield on cost (after the value-add is complete) versus 5.5% for a comparable “core” property. Assuming 60% leverage, some reduction in cash flow during the renovation, market growth in rent and expenses of 2.5%, and a seven year hold, the modeled gross property level returns are as follows:

Unleveraged core	7.5-8.5%
Leveraged core	11-13%
Value-add	16-18%

Case 2: Value-added retail

Today there are many newly built shopping centers in attractive markets such as coastal California that were unable to lease up and stabilize prior to the recession (or subsequently became more vacant during the recession). Talented retail specialists have the opportunity to buy these assets out of foreclosure at a large discount to both construction cost and the expected stabilized value. The caveat is that substantial leasing has to be done and leverage is limited and expensive. In our view, managers that specialize in retail leasing and select assets in solid, long-term infill markets will successfully increase occupancy rates. The big unknown at this point in the cycle is how long that process will take. The excess returns, however, can be substantial, so we find this strategy quite attractive. Similar to the apartment example

above, let’s look at a core asset, a leveraged core asset, and a value-added asset.

Assume that stabilized cap rates are 6%, and the yield premium upon stabilization is 3-5% (that is, when the value-added asset is finally fully leased and stabilized, the yield on cost will be 9-11%). Further assume that the value-added asset is 60% vacant at acquisition and can only be leveraged 30% (versus 60% leverage for the core asset).

Unleveraged core	7-8%
Leveraged core	10-12%
Value-add	17-20%

These two examples illustrate the range of potential excess gross return from an active value-add program, for both a relatively less risky apartment renovation and for a riskier retail lease up strategy.

CYCLES

Commercial real estate is a cyclical asset class. From a fundamentals perspective, the trough of the cycle (our position as written in mid 2011) is characterized by above average vacancy rates and rents well below “replacement cost” levels. Replacement cost rents are rents that provide a yield on the cost of new construction sufficient to generate new development. As demand increases and in the absence of supply constraints, rental rates increase to the point that new construction begins, and in an ideal world, rents would stabilize at replacement cost levels. Excess supply can tip the cycle back to a position of falling rents. These numbers vary by market and property type, and over a long period of

time they tend to rise with inflation in construction costs.

As an example, it costs about \$1,000 per square foot to build a new office building in Midtown Manhattan. Replacement cost rent would be in the \$100 range (gross, before operating expenses); operating expenses are around \$30 per square foot; and the yield on a new development would therefore be about 7%. As it happens, Manhattan is a supply constrained market, so there is the very real potential for rents to exceed and remain above replacement cost levels in the long term for prime submarkets. This is not a likely possibility in unconstrained markets such as Phoenix and Dallas, where replacement cost rents represents a ceiling on sustainable rent.

It is also important to consider the capital markets cycle, which can decouple from the fundamentals. Fundamentals tumbled in many markets following the dot com crash in 2001, yet many investors were blissfully unaware of this because abundant capital cushioned the blow. Many U.S. markets were ripe for new development in 2008 from a fundamentals point of view, but the lack of debt capital forestalled building in most markets; availability of debt capital can materially accelerate (e.g., the 1980s) or hinder the development cycle. In the past year, despite relatively slow expected recovery in fundamentals, core properties have seen a resurgence of investor demand in the U.S. and globally, and prices are rising. Due to the need for yield in their broader portfolios, investors remain very cautious about unstabilized assets in a weak

economy, so non-core has not seen nearly the same price recovery. Additionally, there is a growing wave of non-core assets for sale, and to the extent it exceeds the available investment capital (which it is very likely to do), prices will remain below what the fundamentals imply.

Where one is in the cycle when an investment is made is one of the strongest drivers of return. This is often expressed in terms of good or bad vintage years. While the length of time between trough and the next peak varies and the steepness of recovery varies, historically, investors who invested near the bottom of the cycle, managed their assets reasonably, leveraged prudently, and were able to sell into the strong later part of the cycle earned attractive relative returns. Of course, beta is a major driver, but in cyclical troughs there tend to be many more non-core assets available for sale (often forced sale) and the overall dislocation expands the alpha potential.

In summary, there are two broad categories of assets in the commercial real estate business: core and non-core. Core investors at this point in the cycle should expect relatively stable income that gradually improves as property fundamentals continue to recover. Non-core investors with successful managers should expect growth in income and total return that is driven by both market fundamentals and the value-added by the hands-on manager.

Metropolitan Real Estate was founded in 2002 and is a privately owned, registered investment advisor that constructs and manages vintage year U.S., non-U.S., and global funds-of-funds focused on investments in value-added and opportunistic private real estate funds.