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Creating Value in a Recovering RE Market

An executive summary of the PrivcapRE thought-leadership series “Strategies for Driving Net Operating Income”

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Creating Value in a Recovering Real Estate Market

Key Findings

1. Valuations aren't always tied to net operating income (NOI)
2. The focus is on keeping tenants, not just finding new ones
3. Vacancies in today's market can be a blessing rather than a curse
4. Younger companies and technology are driving space demands
5. RE investment managers measure their impact in different ways

The Panelists

Alan James
Industry Principal
Yardi Systems

Chris Macke
Senior Strategist
CBRE Global Research and Consulting

Peter Merrigan
CEO and Co-founder
Taurus Investment Holdings

1. Valuations aren't always tied to net operating income (NOI)

"There's been a huge appreciation just in pure valuations that don't seem to be tied terribly to NOI or even to…cap rates in the past 12 months," says Peter Merrigan of Taurus Investment Holdings. In major markets like London and New York, the mood has shifted, and valuation increases are strongly outpacing NOI gains.

People are pricing in a recovering U.S. economy, and as a result, they're pricing in significant rent growth. It's a flashback to 1999, when people were paying more for vacancy at a per-square-foot price, Merrigan says.

If interest rates rise, it will be due to a stronger economy, which will in turn help drive NOI growth. It's a Goldilocks scenario, says Chris Macke of CBRE Global Research and Consulting.

2. The focus is on keeping tenants, not just finding new ones

Limited partners have expectations that the operators of their assets will manage them with the greatest efficiency in terms of expenses, as well as with capital expenditures and use of funds, says Alan James of Yardi Systems.

Another expectation is that operators will maximize revenue through leasing and renewals. And that means focusing on keeping existing tenants rather than hav-

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ing to go find new ones.

"Some of the institutions that we work with that are using third-party managers are focused on renewals and how effective the manager is in keeping tenants," James says.

Renewals will become more challenging, because people want different kinds of space than in the past, says Merrigan. And they don't want to sit in that same space while it's being reconfigured.

To address this issue, some LPs view a renewal as moving a tenant from one of their buildings to another that they own, James says. They will repurpose or gut the space and, rather than losing the tenant completely, will reposition them in another piece of their portfolio, if possible.

3. Vacancies in today's market can be a blessing rather than a curse

In the post-recession recovery, the cost of vacancy has gone down as demand for space has increased. The market is back to pre-crisis vacancy rates—lower in some asset classes—and in some cases a premium is being paid for vacancies.

"You're not really being penalized for vacancy right now," Merrigan says. "You're actually being rewarded in some ways, because, again, people are pricing in a big rent spike. So you can't access the rent spike if your building is stuck in a long-term lease."

This strange dynamic is similar to 1999 and 2000, he says, when vacancies in certain buildings actually paid the owner a big price per foot. That same dynamic could crop up in growth markets in the U.S. If a healthy recovery continues, those paying more for an asset with vacancy will have a longer time to lock in tenants for long-term leases, leading to value creation.

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Cutting Energy Costs

There are multiple ways to drive net operating returns (NOI) on a building. Reconfiguring the space to suit potential tenants is one, and an even easier option is boosting the energy efficiency and cutting utility costs.

Getting LEED certification on new buildings or retrofits for older buildings is an option, but there are also simple things that can be done.

"We do a lot of apartment investing, and what we found is that some of the older projects...you can go in and [do such] simple things as insulating boilers and making sure that you have proper windows in place. It's not terribly complicated, but a lot of people don't do them," says Taurus Global Real Estate Investment's Peter Merrigan.

Making sure heating and cooling systems work properly is another small step that can lead to savings. Those savings can be significant in multifamily properties where sub-metering technologies have been adopted. Technologies to monitor consumption of energy in commercial spaces have also evolved, and savings can be made in properties after hours, with the potential for utilities to be shut down rather than left to run continuously.

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Acquisitions Start NOI Growth

There are multiple opinions on how to drive NOI growth, and firms' tactics vary. Some look at having an inventory that is appealing to tenants, and others count on creativity and innovation.

Chris Macke of CBRE Global Research and Consulting considers finding the right acquisitions to be the best way to drive NOI growth.

"I just think it's important that we don't overlook the fact that you start driving your NOI growth in acquisition," Macke says.

It's also important to pay attention to where individual property sectors are in the NOI growth cycle, he says.

"It's understanding how some of the submarkets are changing," Macke says. "That's how you really begin the process of driving your future NOI growth."

Overall, looking to third-party management or leasing can give owners access to the broadest view of the market.

"They have the pulse of the market and what tenants are looking for," says Macke.

4. Younger companies and technology are driving space demands

The amount of space needed in an office is not the same as it used to be, as technology makes it possible to work remotely.

"Going to an office every day is not necessarily 'in' anymore," James says. "So the amount of space that we need today is not the same as it used to be. We have mobile devices, we have iPads.... We don't have to work in our offices."

There are also more open-plan offices and high-end finishes in common areas, Merrigan says. More people are being squeezed into square footage that previously would have been filled with cubicles.

"The technology is driving so many changes in what tenants are requiring," says Macke.

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>
> *– Alan James, Yardi Systems*

5. RE investment managers measure their impact in different ways

When looking at what gives the biggest bang for your buck, there are different aspects to look at: revenue, expense, and capital expenditures. Revenue is straightforward—getting tenants into the right space at the right rates, James says.

"On the expense side, it's doing everything you can from an operations perspective to maximize how that asset is operating," he says.

The easiest way to boost revenue and cut expenses is looking at utility costs and making a building as energy-efficient as possible, says Merrigan.

"You're playing around in the margins with those types of things," Merrigan says. "It's not a huge impact that you can squeeze out of it, generally speaking. But on the energy side, if people aren't investing in the projects in the form of capex, etc., then you can create value there." ◆

Expert Q&A

with Alan James
Industry Principal
Yardi

What sets Yardi apart in the way it works with real estate firms?

At Yardi, our philosophy is to provide a single stack of solutions that cover the entire real estate spectrum, from acquisition all the way through disposition and all the disciplines in between. The alternative option would be that a company would have to go out and buy point solutions to cover those different disciplines and then integrate those together.

Is real estate a laggard in terms of adopting technology for performance tracking and measuring?

I've been doing this for a long time. I would say yes, unfortunately, real estate has historically been a laggard on the use of technology. When I say that, I'm not talking about back-office accounting technology but rather business intelligence, predictive analytics. What's going to help the marketplace is [the use of technology such as we're seeing] from the consumer's side. Things like using iPads and smartphones in our personal lives is starting to carry through to our professional lives. The escalating use of those technologies within the real estate sector will help the marketplace.

Where is the technological innovation for real estate going to come from?

Today we hear all about "big data." The key there is putting information in the hands of the stakeholders and the consumers of that information in a way they can understand it, read it, and disseminate it.

This is not only about capturing the historical data or performances, it's taking that information, along with forecasting assumptions, to look at where we may be. The number one thing we look at in real estate is risk. The second issue we look at is where technology is going. When you have key performance indicators [KPI] you're tracking that are tied to big data, you want to be able to collaborate that information, and that's starting to happen through a social media-type discussion thread. These are discussion threads on that KPI you can share internally or externally within the organization to enable people to track what's going on with a particular metric, and why. ■

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