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Privcap/ Report

Cutting-Edge Value Add

/ Strategies for driving and protecting returns in a toppy real estate market

WITH EXPERTS FROM:

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Cutting-Edge **Value Add**

Managers are going to have to work harder to hit mid-teen returns

Distribution warehouses; the suburbs; students; "echo boomers"; life science laboratories; age-restricted housing...

Ten years ago, these topics were not necessarily of interest to value-add fund managers. But given that the U.S. real estate market has reached a late stage in the cycle, these rather unconventional plays now are squarely in the mix of winning strategies.

To be sure, the hallmarks of a value-add real estate strategy remain in place: low-to-mid-teen target returns, moderate leverage, and development and sub-lease strategies. But it no longer is enough to rely on cap-rate compression, rental appreciation, or financial engineering.

Soultana Reigle, a managing director and senior portfolio manager with PGIM Real Estate, says that near the end of an investment cycle, the best managers in general start shifting away from traditional value-add approaches. "You might start looking at suburbs versus urban core, which can be quite expensive at this point in the cycle," she says. "You might start looking at different parts of the capital stack, investing in preferred equity or mezzanine, as opposed to traditional equity. Or you may start looking at different niche strategies, like self-storage, or age-restricted housing, which could fall into the category of either multifamily or even manufactured housing."

Of course, such strategies depend upon deep sectoral knowledge, operational expertise, and plenty of hard work. As Manjul Ramchandani, managing director of capital advisory firm Greenhill & Co., puts it: "To an extent, for those with in-house expertise that can roll up the sleeves with hands-on operational work, I think opportunities are available focused on driving value from the real estate."

Data seems to illustrate the move toward value-add becoming more focused on specialist strategies. According to Preqin, the trend has been towards value-added funds on average becoming smaller. In 2007, the average size was $336 million, compared to $260 million in 2016. The number of funds being raised seems to have fallen. Susan Swanezy of placement agent Hodes Weill offered her analysis: "The smaller fund sizes could be reflecting some of the niche strategies being promoted. It could also reflect the fact that many U.S. limited partners have less allocation available for value-add managers, as their existing value-add fund managers have a lot of dry powder."

Investors with an appetite for further value-added returns can opt for a commingled diversified fund or a much more sector-specific or regional vehicle. For PGIM Real Estate's Reigle, though, running a commingled fund that can invest across property types presents an advantage: "That we can shift our strategy. We can both react to what we see going on in the market, but also be very proactive," she says.

Value-add typically appeals to investors because the strategy offers income and defensive qualities so important when concerns remain high that a downturn or market correction is looming.

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According to advisors contacted by Privcap, a list of plays currently in their respective value-add playbooks includes:

- **Development, particularly industrial and multifamily**
- **Old-office conversions into more-modern space in up-and-coming markets or submarkets**
- **Demographically driven strategies, such as age-restricted housing**
- **Niche asset classes, such as self-storage and life-science-related clusters**
- **E-commerce-driven sectors such as infill/ last-mile logistics**
- **Repurposing regional shopping malls to offset competition on the e-commerce side**
- **Net lease funds where the credit quality of the tenant can be enhanced**
- **Recapitalizations of portfolios whose NOI can be further improved**
- **Mezzanine debt or preferred equity for some of the strategies above where the underlying real estate is under transition**

"A core manager runs the risk of using its liquidity to help others get out."

–Peter Hobbs, BFinance

London-based Peter Hobbs of investment advisory firm BFinance recently completed a pan-U.S. search for a value-added manager. He reports that he found a "huge spectrum" of what can constitute value-add strategies, with targeted returns ranging from 10 percent to 15 percent. "I think it is a good time to be investing in the low-risk core-plus to value-add space," he said. "At this point in the market, a core manager runs the risk of using its liquidity to help others get out. At the same time, you wouldn't want to be too high up the risk spectrum."

Hodes Weill's Swanezy adds: "There is not an expectation of cap-rate compression. Similarly, investors are avoiding strategies based on strong rental growth. So they are looking at the manager and their operational ability to create value and to grow NOI. There is also an expectation that the U.S. real estate market will have to experience a correction. No one knows when, but logically investors feel duration of cash flow that could be sustainable during a downturn is attractive."

For PGIM Real Estate, development is a significant part of its value-add strategy. It is among managers who have consistently created real estate from retail, industrial, and office to self-storage and multi-family. And today there still remains an opportunity, particularly in the multifamily and industrial sectors. However, because land prices have risen, Reigle warns that managers should accept lower return expectations or begin to look at suburban locations, where land prices are not as expensive. Newer strategies would include looking to build less-dense properties. "That might be a new opportunity that we weren't as focused on over the last few years," says PGIM Real Estate's Reigle.

She further explains: "For both multifamily- and industrial property, risk is being mitigated by demand drivers. On the apartment side, the millennial and baby boomer demographic suggests demand is expected to keep up with supply, at least for three to four years. That will be positive for multifamily. Meanwhile, industrial property, which has been so heavily in favor as a property class, is witnessing a secular shift of e-commerce demand. E-commerce made up between 30 percent and 40 percent of industrial demand in 2016, and if that continues as many think it will, it should support industrial development for at least the next few years." ■

‘Work Hard for Every Basis Point’

A veteran value-add investor explains the current market environment

Soultana Reigle
Managing Director,
PGIM Real Estate

Privcap: In general, what is your take on the state of the real estate value-add opportunity?

Soultana Reigle, PGIM Real Estate: We’re in an environment in which cap-rate compression is over. I think the cap-rate compression over the last few years was able to generate some attractive returns across the industry, whether you were a core investor or a value-add investor. We’re now in an environment in which we’re focused on income and asset management, where we need to anticipate what the market wants to buy. As value-add investors, we’re going to have to work very hard for every basis point of return.

Does that mean that the value-add strategies of today would not be appropriate for the market of, say, 10 years ago?

Reigle: As the cycle progresses, you shift the strategy. You might in the early cycle be focused on development and more growth-oriented strategies. Later in the cycle, like now, you may be shifting to income-oriented strategies, or you might start shifting geographically.

I run a commingled value-add fund, which can invest across property types. We can react to what we see going on in the market, but can also be very proactive. It’s a discipline of trying to look around the next bend in the road and be very anticipatory as far as where we see opportunities coming and what we think will enhance our fund return and play into our strategy.

What is your view of development in today’s market, and in what circumstances is it appropriate for your opportunity?

Reigle: Development has been our bread and butter in the fund that I manage, and it has been across property types. We’ve developed retail, industrial, office, self-storage, multifamily. Development remains an opportunity for us, particularly in the multifamily and industrial sectors. What we have to do now is recalibrate our return expectations. Profit margins were 50 percent, now they’re 25 percent, which on a historical normalized basis is about right. On the apartment side, the millennial and baby boomer demographic demand is continuing to keep up with supply, and we think will be a factor over the next at least three to four years, that it will be positive for multifamily. And on the industrial side, there is the secular shift of e-commerce demand. We don’t see that changing in the near term, and I think it’s really going to be something that supports industrial development for at least the next few years.

> “We can react to what we see going on in the market, but can also be very proactive.”

Please explain your relatively higher interest in suburban investing.

Reigle: The millennials who’ve been our apartment dwellers for the last few years are now looking to get married. They’re having children later, but ultimately they’re looking to move out into the suburbs, but maybe not ready quite for home ownership. We definitely see that as something that will be a positive influence on the suburbs over the next few years.

And what makes the current environment more attractive for debt-like investments?

Reigle: Banks have really tightened up their construction financing based on regulations imposed on them, and capital charges that they face are quite punitive. There has been a pullback in terms of both the number of construction loans and the level of proceeds. It’s created a gap in the capital stack between where the senior lender is prepared to offer a loan and the borrower is prepared to fund their equity. We are able to take advantage of this capital market dislocation and fund that gap piece of financing, whether it’s preferred equity or mezzanine. We find that really attractive. As a value-add investor, what it means is that you’re making an equity-like return for a more conservative part of the capital stack.■

Industrial Value-Add

PGIM Real Estate's Soultana Reigle tells why she likes newly built warehouse properties

"The way we view industrial right now on the value-add side is really focusing on development. That development could be either in the form of a big-box warehouse-type space, which might be 500,000 to a million square feet in size, or it might be a smaller infill/last-mile location, from which the e-commerce providers are trying to meet a very quick delivery time frame. They want their distribution hubs to be as close to the population base as possible. The majority of our industrial investment over the next few years will probably be concentrated in the warehouse space. In the capital markets environment now, industrial is a favored asset class, and you can get very competitive pricing. And so when you have the ability to offer a large industrial park of scale, newly built, very modern with stabilized occupancy, it's extremely attractive.

"In situations where you have an infill location and it's being repurposed towards a higher and better use to industrial, first of all you're going to have some administrative challenges going through entitlement and making sure you can get the approvals that you need to construct what you want. Overall, going from the point of entry, where you're identifying the asset, through the construction phase can be more expensive than the big-box warehouse, because your land cost is higher. It's significantly riskier for a much smaller investment, compared to these big-box parks that you might develop." ■

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