

REcap

THE COMMERCIAL REAL ESTATE
PERSPECTIVE



Investors select real estate investment managers to oversee properties and earn returns. They seek “*performance*,” historically defined in terms of “*experience*” and a “*track record for financial results*.” But many investors fail to understand that past financial results are not indicative of long-term operating performance—they fail to recognize the difference between ten years of experience and one year of experience that has been repeated ten times.

COVID is an all too real example of a world that experiences unexpected, abrupt, and tumultuous change. The post-COVID world urges investors to change their historical perceptions of how to pick the most capable real estate investment manager.

Because short-term thinking wrecks long-term results.

REAL ESTATE MANAGEMENT IN A POST-COVID WORLD

APRIL 6, 2020

kirk cypel
Managing Director

kc@rouadv.com

CASE

INCESSANT CHANGE IS THE SOLE CONSTANT

Twenty years ago, grocery-anchored centers were the real estate “gold standard” and in high investor demand. As success gave way to more centers being built, some added cheap gasoline to draw customer traffic. When oil prices declined, cheap gas later became less of a draw. Supermarkets later saw new competition from untraditional retailers, such as Target and Walmart, seeking to boost unit revenues. Oversaturation reduced store volumes and led many traditional grocers to failure, including the likes of A&P, Earth Fare, Fresh & Easy, Wild Oats, and Winn Dixie.

As stores closed, landlords struggled to re-tenant these large retail boxes. Designed to accommodate single large tenants, these spaces could not be efficiently demised into smaller units. Meanwhile, new market forces undermined landlords’ efforts to fill these large vacancies. Online shopping and retail market saturation gave rise to growing large retail tenant bankruptcies, among them CompUSA, Kids R Us, Builder’s Emporium, Crown Books and Sports Authority. Even when landlords found prospective tenants, re-tenanting costs were substantial relative to their neighborhood centers’ values. The negotiating leverage of the few remaining large tenants forced landlords to bear most of these costs. The market had changed: While grocery anchors were originally the key to success, they now led to many neighborhood centers’ failures.

And then came CORONA. Mandatory closures and social distancing required many shops to close. Practically overnight, retail centers that had found new life by replacing supermarkets with gyms, trampoline parks, and bingo parlors are now threatened with potential demise. Ironically, grocery anchors are now the reason why some neighborhood shopping centers are managing to survive. How could anyone predict this chain of events and the speed of such change?

LOOKING TO THE FUTURE

Today's real estate pundits advise that medical uses are a strong investment sector because of healthcare's projected stability within a growing and aging population. But in the current crisis, state health departments are shutting down nonessential medical services like general dentistry. Previously looked upon as stable and "*internet-resistant*," many medical tenants are now seeking rent relief.

Future reforms in insurance and healthcare, issues actively in debate, may change how we use real estate. Telehealth, the ability to videoconference with your doctor, is an emerging system of care that does not require traditional offices. Some people are even reluctant to visit an office building with medical tenants for fear of catching some disease. Nobody can predict, with any certainty, how legislation, technology, and public perception will impact the future of medical real estate.

The real estate market changes constantly, sometimes suddenly and with profound effect. Responsible investment managers understand that you cannot rely entirely on the past or predict the direction of current trends.



MANAGEMENT NEEDS A CHANGE OF ATTITUDE

This past decade has seen a general rise in commercial real estate prices. The Green Street Advisors Commercial Property Price Index, at a low of 61.2 in May 2009, peaked at 135.2 in February 2020, indicating more than a doubling of prices over this period.

Success, however, breeds complacency. Given past successes, many investment managers believe they "*know*" how to manage real property investments. They've done it for years, seen it all before and nothing is materially different between one property and hundreds of others. Favorable markets delude managers into thinking they've done something right. In a fast-changing world, this attitude is fraught with failure.

Many investment managers fail to realize that management's function involves far more than supervising property staff and leasing agents. Real estate investment management is creating a harmony among property finance, facilities, marketing, leasing, legal, accounting, the day-to-day, and future planning.

The smart investment manager is humbled by what she *doesn't* know. She replaces a "*know it all*" attitude with a commitment to learn and improve. That is the most rational way to deal with future uncertainty.

DO NOT CONFUSE PAST SUCCESS WITH OPERATING EXPERTISE

PICKING AN INVESTMENT MANAGER BASED ON A FAVORABLE TRACK RECORD IS SHORT SIGHTED

If the world is changing, investment managers must not be evaluated solely on the basis of prior financial returns. Traditional “Best Practices” may not apply and prior financial success is certainly no indicator of future performance. Understand that a manager’s prior success may be more reflective of a period of general economic stability than of any purported management expertise. A less competent manager can be wildly successful by copying competitors and riding a trend.

There’s a tendency to rate investment managers solely on past results, while ignoring how those results were achieved.

Do not rely on past financial results. Evaluate management’s efforts to keep properties relevant and hedge the downside risk of a market failure.

The smart investor picks the manager who kept cool in crisis, applied creativity to solve problems, and demonstrated the courage and tenacity to work through adversity.

TWO MANAGER CANDIDATES

Meet our two investment manager candidates, John and Mary. John buys property during an upcycle using high leverage. In a rising market, his leveraged assets produce impressive results. Mary, entering late in the cycle, buys property using the same exact strategy. When the cycle turns down, leverage works against her and results suffer. Having bought earlier, John’s overall lower property basis leaves him better positioned to survive the downturn. Mary, meanwhile, bought late in the cycle and now finds her properties valued at less than what she paid.

Some say Mary was foolish to enter late in the cycle. She should have seen the reversal coming. That’s unrealistic. In 2008, liquidity dried up long before anyone saw the depth of that recession.

Black Swan events teach us not to confuse financial results with performance, not to confuse expertise with following trends. Based on financial results alone, John is the better manager. But John and Mary are really just the same, two peas in a pod. Given ample time, their results will be identical.

The real issue is that their common strategy will ultimately prevent their long-term survival.



*Luck is what happens
when preparation meets
opportunity.*

—Seneca ca 4BC-AD65
Roman philosopher, statesman

**SEEK INVESTMENT MANAGERS WHO
PREPARE TO BE LUCKY**



DEBT ADDS RISK

As leverage rises, a property's risk profile becomes increasingly unbalanced. Small and foreseeable changes in effective rents and occupancy may lead to the inability to pay debt service. With higher debt, the probability of total loss accelerates. The return profile becomes increasingly asymmetric. Even with viable projects, excessive debt is the primary reason for investors' losses.

Avoid high debt.

If you're investing in real estate, let the real estate work for you. Don't expect financial engineering to create real estate returns.

HIGH LEVERAGE MISLEADS RESULTS

Debt boosts the appearance of returns without fully considering risk. By selecting managers based on past or projected returns, investors encourage higher debt.

It's a vicious cycle: Sponsors press lenders for more leverage; lenders sacrifice underwriting discipline to make more loans; more leverage raises projected returns and attracts investors; sponsors seek higher debt levels to attract even more investors; lenders become more aggressive to win more deals. A black swan appears, collapses the cycle, and investors suffer loss. The market eventually stabilizes and sponsors bring new deals. These first deals are hard to close because lenders pulled back. But as time passes, restrictions ease and the cycle repeats. Investors get trapped in this cycle. They may lose years of profit in a single downturn.

High-leverage loans also misrepresent who is managing your property. Loan covenants restrict the manager's ability to sign new leases, renegotiate deals, re-tenant vacancies, make renovations, use insurance proceeds or raise additional money to fund unexpected large-ticket capital projects. Prepayment prohibitions may prevent refinancing or sales during a favorable market window. Lenders also move slowly and have difficulty approving creative ideas that fall outside of bureaucratic guidelines. In times of duress, the least qualified persons to manage the project—lenders, servicers, trustees—tend to assume operational control.

These problems are far less prevalent among low-leverage loans.

THE MYTH OF RISK ADJUSTED RETURNS

Beware of the real estate manager who promises “*risk adjusted returns*.” This lie makes the absurd promise that a projected financial return will compensate investors perfectly for taking increased risk. It’s a fancy way to say that if the investor loses its investment, the initial “*promise*” of a higher return was worth the risk. The term, originating in modern portfolio theory, means that if you made this investment repeatedly, an infinite number of times, you would receive an appropriate premium over the market. This is pure nonsense.

There is no way to correlate real estate risks and returns with mathematical precision. Although we routinely compare the potential of competing investments, these comparisons are educated guesses, a subjective assessment of relative strengths and weaknesses. Only hindsight can tell if the manager made a reasonable front-end choice.

Too many investment sponsors use financial models to justify a speculative financial result. Financial models do not create financial returns. We may find sophisticated modelling reassuring, but, as renowned statistician George Box observed, all models are wrong and only some are useful.

Real estate is a business and every property is a unique business. Attentive management handles risk while providing for financial returns. The smart investor will focus on the manager’s business plan, including the time, resources, and effort needed to realize that plan. The manager who can intelligently discuss both the risks and opportunities associated with a property is far superior to one who produces stacks of projections.

PRETENDING TO DEVELOP FINANCIAL RISK PROJECTIONS WITH MATHEMATICAL PRECISION IS INSINCERE

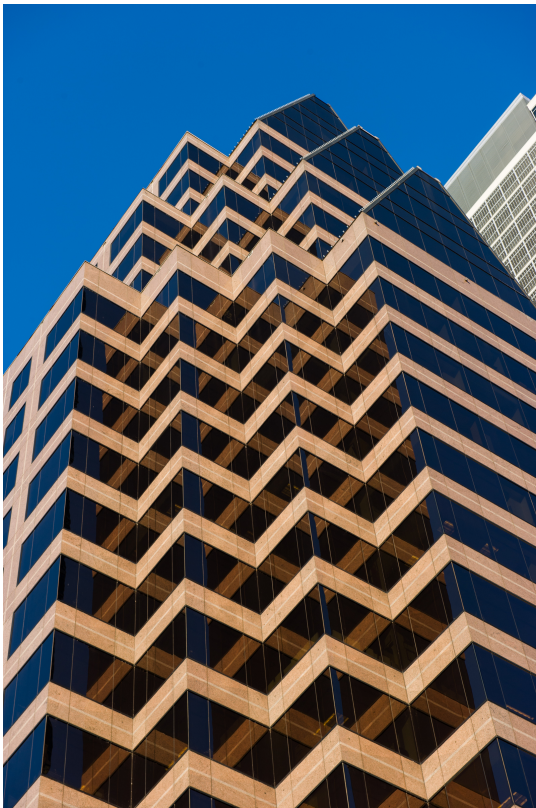
”

There are two types of decisions: those that should be made with mathematics, and those that cannot.

The key is knowing the difference between the two.

—W. Edward Deming 1900-1993
Statistician, Management Visionary,
Quality Consultant

**VISION AND EFFORT OUTPERFORM
ROTE FINANCIAL ANALYSIS.**



REAL ESTATE IS AN OPERATING BUSINESS

There are a surprising number of real estate executives who cannot fly into a city and find their own properties without the assistance of Google Maps or UBER.

Real estate is materially different from marketable securities, options trading or venture capital. Real Estate is an *operating business* that largely serves localized needs. It's a business that requires ongoing attention and an understanding of the local dynamic.

PERFORMANCE PRODUCES RESULTS NOT FINANCIAL ENGINEERING

Performance reflects the effort invested in making a property successful.

Real estate cannot be left to mechanical caretaking guided by last month's financial reports. Backward-looking reports cannot describe the unique and evolving aggregate of tenant needs, nor can they devise creative operational adjustments for the future.

Management is a fine balancing act among understanding individual tenant needs, implementing strategies meeting the broadest spectrum of those needs, maintaining resources, and earning a profit.

Management is an ongoing discovery process that requires constant attention.

”

*The greatest obstacle to
discovery is not ignorance,
it is the illusion of
knowledge*

—Daniel J. Boorstin 1914-2004
American Historian

**REPLACE THE MANAGER WHO
KNOWS IT ALL WITH ONE WHO HAS
THIRST TO LEARN AND IMPROVE**

FIVE ESSENTIAL QUALITIES OF THE INVESTMENT MANAGER

CHARACTER

It's *ALL* about character. People want to do business with those they can trust. Individuals—not organizations—possess character. Find managers who have performed honorably under adversity.

AGILITY

Since we don't know what the future holds, investment managers must have the mental ability to handle ambiguity and the flexibility to act quickly and decisively.

RELATIONSHIP

Strong relationships support success. Strong managers have positive personalities, large networks, and the “*mojo*” to get either favors or the inside scoop on a deal.

KNOW-HOW

People with broad industry knowledge, deep understanding of real estate operations and connected disciplines know how to get the job done.

ROBUSTIFICATION

A process that is committed to continuous improvement. This is what ultimately positions a property to position for the long term, produce current returns, hedge downside, and exploit opportunities when they arise.

Robust strategies may appear to lower future returns by traditional measures, but projections are merely numbers on paper. *Robustification* prepares for the unexpected.

OUR MANAGER PICK

Meet Zoe, our third management candidate. Zoe has a different strategy. She uses conservative leverage to provide ample debt service coverage, cash flow and additional potential borrowing capacity if needed. She knows her tenants and understands their needs. Her budgets leave room for discretionary improvements that heighten value perceptions.

Tenants regularly see property improvements, large and small. Her rents are comparable to the general market, maybe a little higher, but tenants feel they are getting value. If the market turns, she still feels the pain, but her property is better positioned to weather the storm, make lease concessions, and maintain viability. Her management style earns the confidence of lenders and encourages their cooperation if times get very rough.

Her robust strategy allows her properties to maintain higher occupancy and rent levels relative to the competition during lean years while presenting greater opportunity during recoveries.

IT'S ALL ABOUT

REsults

THE RE PROCESS

Investment managers must understand that the future of the real estate industry is about operating comfortably with change. In dealing with change, successful investment managers must follow a cycle of learning and improvement: Observe, Analyze, Plan, Budget, Implement, and Repeat.

Focus on the **RE**. **RE** is an ongoing process of **RE**inventing a property and oneself to adapt or anticipate change. It does not always require large investment. Small adjustments can have large impact. And, sometimes, **RE**wards come free. The future of **RE**al **RE**state relies on the **RE**.

RElationship **RE**spect

REcapitalize **RE**ality

RElate **RE**cognize

REbuild **RE**fresh

REpair **RE**position

REvitalize **RE**develop

REexamine **RE**finance

REthink **RE**partition

REhabilitate **RE**new

REspond **RE**let

REpeat **RE**cap



ROULER ADVISORS

WE'RE ALL ABOUT **RE** SM

ROULER acquires and manages commercial properties for the long-term investor. We position properties for the future to sustain market cycles, generate consistent cash flow, and exploit opportunities when they arise. We don't engineer financings to obtain quick results. We implement tailored real estate strategies methodically to drive sustainable growth in value. We look ahead and re-invest to maintain our physical environments, anticipate evolving tenant needs and changing market conditions. Our most senior executives guide this process through their hands-on property-level involvement and extensive real estate knowledge.

We don't just want to win. We want to lead long after our competition is forgotten.

www.roulerllc.com