Hitting the Ball in Commercial Real Estate Investing

By Fred F. Caldwell, CCIM, SIOR (1661 words)

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Fred Caldwell is a founding partner of Caldwell Watson Real Estate Group located in Houston, Texas. He specializes in the marketing, investment, and development services which are focused on land, office buildings, industrial buildings, and residential subdivisions. Caldwell Watson owns and manages more than 3,500,000 square feet of industrial and office buildings.

A successful major league baseball player has a keen sense of timing when hitting a baseball thrown at more than 90 miles per hour. The timing and ability to hit the ball is the result of hundreds of practice hours, a desire to succeed, and God-given ability. Likewise, in the commercial real estate investment arena, success follows effort and mental acumen. To achieve consistent returns in commercial real estate investments, many investors cite a three-pronged strategy:

- adopt a long-term, value investment approach;
- be aware of movements or shifts in institutional capital; and
- have in-depth, first-hand knowledge of the region surrounding the investment option.

Value Investing – for the Long Term

Warren Buffet, arguably the most successful value investor of our time, stresses that the true value of a publicly traded company has little to do with its current stock price. Truly, the intrinsic value of a company's business could be below, equal to, or greater than the market's current stock price. Value investors strive to locate companies where the stock price is undervalued by the market—companies that have strong fundamentals but have not yet attracted the attention of institutional capital. By digging deeper and concentrating on intrinsic value rather than on market price, value investors will often select these companies with little regard to short-term stock price movements.

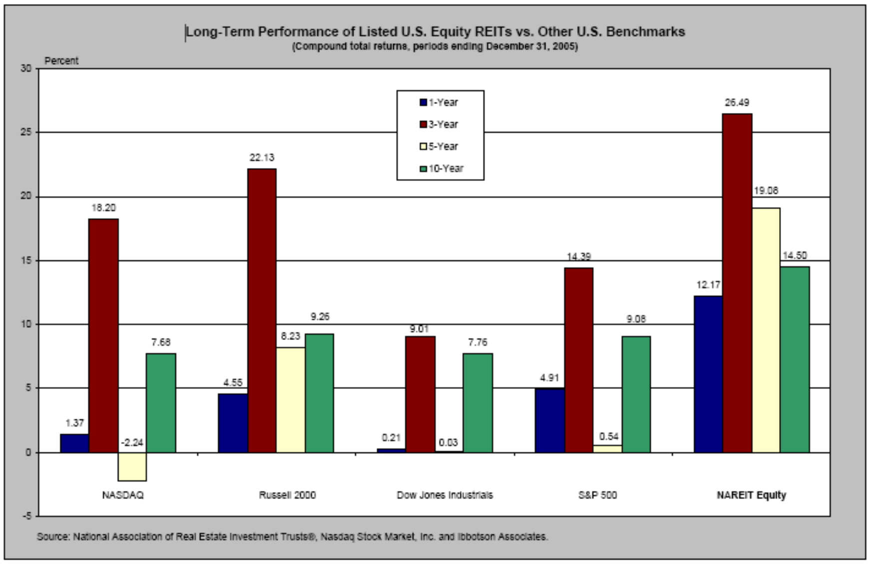
Another component of the value investing approach is the buy-and-hold strategy. There are numerous studies and papers to substantiate the fact that trying to time the market yields smaller returns over time than adopting a buy-and-hold approach. Returns on trading strategies are always reduced by trading costs. Real estate has a large trading cost premium that substantially penalizes trades.

So how does one determine the intrinsic value of a stock? It takes hard work involving financial analysis coupled with an understanding of the broader economic outlook. The analyst must not only understand the company's financial strength, business strategies, and management capabilities but must also be able to determine the company's relative market-place position. In commercial real estate, with the various property options, lack of information can make the task more complex than in equity markets. The inefficiency of the real estate markets, particularly in terms of information, creates the opportunity for value-oriented investors to make successful investments that will outperform equities. It may be hard to obtain information about particular sub-markets, making it difficult to compare one market to another. The successful investor must work hard to obtain all the information necessary to make an informed buying decision. The value creation starts with obtaining relevant and useful information. Real estate value is always affected by location. The specific issues that determine a great location vary by product type and by area. For example, what appears to be a great industrial site in a suburban market may actually be an opportunity for a residential play that will outperform an industrial investment. A successful investor, like a batter identifying the pitch, must be able to make a decision on what product type is demanded in any sub-market and for a given location. Beyond identifying value and selecting location, other factors come into play, such as institutional capital interest in specific product types and economic conditions in surrounding areas.

Be Aware of Shifts in Institutional Capital—and don't follow it

In today's commercial real estate market, it is possible to find value investment opportunities. A first step is to look where the institutional capital is not. In the stock market, capital tends to go where capital already is. Why? Investing alongside other institutional investors is typically seen as prudent because other analysts have already approved similar investments. Protection of principal is a primary driver for many real estate investment funds, and therefore there is a built-in desire for safety. Perceived safety is higher if others are doing the same thing. We've all said this as kids, "Johnny is doing it, so it should be okay for me too." If the situation goes bad, we blame Johnny, "I made the decision because Johnny was doing the same thing, and we all know what a good kid Johnny is."

The technology bust of 2001 is a perfect example of following institutional capital. As more and more institutional funds put large amounts of capital into the technology sector, many technology stocks became significantly overvalued. After the technology bubble burst, many fund managers began to note that the commercial real estate industry had generated impressive returns over previous years. When comparing 15- and 30-year periods, REITs had outperformed the S&P 500 by a steady two percentage points per year, according to the National Association of Real Estate Investment Trusts. More recent data from the same source ending in 2005 (as shown in the graph below) is even more remarkable. The NAREIT equity index surpassed the S&P 500, Dow Jones Industrials, NASDAQ and Russell 2000 for 1-, 3-, 5- and 10-year periods.



As a result of REIT returns, more and more institutional capital is now being allocated to real estate investment options. Five years ago, the traditional portfolio for a large fund might have had a 10 percent real estate allocation, but today the allocation may be closer to 20 percent … and it could very well reach 30 percent in a number of years. The higher allocations to real estate may, in fact, be a permanent shift. Institutional fund managers may continue to hold larger stakes in commercial real estate for years to come. The increased real estate allocation seems warranted, given the past 10 years' real estate performance. In an economy that is more significantly driven by service sector business, hard asset plays are less available in equity investing. Real estate seems to be becoming the hard asset play that historically would have been made in manufacturing and equities with significant hard assets.

For the value investor, the increase in institutional investing creates a more challenging investment environment. The higher level competition or demand for investment options means that as prices are bid up, multiples increase, and yields go down. These factors combine to make it more difficult for value investors to access investment options where the intrinsic value exceeds the market price. Therefore, real estate value investors must look outside the arenas that attract institutional capital.

Understand the Macro View of the Region

The third facet in the strategy for achieving consistent returns in commercial real estate investment is to have a macro sense of the economic conditions and trends, not only in the local area but in the region as well. Infrastructure issues such as roads and utilities as well as economic development, job growth, new home starts, and good school districts should all be important factors in any real estate investment decision. In addition, a few of the key national considerations are the overall economic climate, current interest rates, and the trend in federal monetary policy. It is crucial to examine the economic conditions of a certain area and then draw conclusions on what is likely to happen over the next few years.

To thoroughly support and enhance this macro view of your region, it’s a good idea to get involved in the community. Close interaction with community officials, stakeholders, and civic leaders provides the unique advantage of having an actual voice in important infrastructure decisions within the local community instead of simply hearing reports of these changes.

Land, Office-Condos, Metal Buildings: An Open Field

Keeping in mind the three-pronged approach—using a long-term value approach, not following institutional capital, and understanding the region—the question is, what assets make viable investments for private equity investors? One avenue is land. Even with the influx of institutional capital into the general commercial real estate market, land may be one of the better investments in the current environment. One important reason is that few institutional funds invest in land holdings, due to the lack of yield. Land multiples are therefore attractive compared to other investment options. A land multiple for comparing land sites can be determined simply by taking the potential NOI for the developed property as a percentage of the land cost. For example, if the land will support a development that will yield $100,000 in NOI against a land value of $200,000, the multiple of potential NOI to land value is 50 percent. Similar ratios can be developed for multiple land sites when evaluating feasibility.

Other investments not favored by institutional capital include office-condos, metal industrial buildings, and unique assets like marinas and other specialty real estate properties. In making any investment outside the mainstream of capital, the value investor has to be concerned with and fully evaluate exit strategies and the longer potential holding period.

When investing in land and other assets, it’s important to consider all the factors mentioned in this article. Location is still key: Frontage on a main freeway and access can be important factors. Capital for a long-term holding period is essential. Other factors to understand before the purchase include potential changes to the surrounding infrastructure and holding costs, including property taxes.

So in searching for real estate investment options, you must see and understand the entire playing field. What are the prices, multiples, and rents on all the options, such as office, industrial, retail and land? Where is the institutional capital, and where is it not? Find the niche that provides the best combination of high intrinsic value, low bid price, and has the highest potential for return. Or to paraphrase Willie Keeler explaining his .432 season in 1897, “Keep your eyes clear and hit ‘em where they ain’t.”