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Last Updated: July 2, 2014 10:30am ET

EXCLUSIVE

Applying Value Investment Strategies to CRE

By [Natalie Dolce](#) | Commentary



CRE value investing is a niche strategy that requires patient capital, expertise in construction and renovation and the ability to see value where others see detriment, says Ori.

WALNUT CREEK, CA—The most successful stock/bond investors like **Warren Buffett** of **Berkshire Hathaway**, **Seth Klarman** of **Baupost**, **Chris Browne** of **Tweedy Browne**, **Ben Graham**, **Peter Lynch** of **Fidelity**, **Bill Ruane** of **Sequoia Fund**, **Walter Schloss** and others, are value investors. Value investors seek to buy stocks/bonds at 50-60 cents on the dollar and use rigorous fundamental analysis to discover these hidden gems.

It is a very difficult business because these value investors don't follow the heard of Wall Street and institutional investor mentality and many times take contrarian positions. Sometimes they buy a security at a discounted value and have to wait years for the true intrinsic value to be realized.

Seth Klarman, founder and principal of **the Baupost Group**, is one of the best value investors around today and wrote an excellent book in 1991 about his value investment strategy titled, "Margin of Safety, Risk-Adverse Value Investing Strategies for the Thoughtful Investor". The book is a collector's item and expensive to buy at around \$2,000, but you may be able to download a copy. One of his main comments on value investing is that the nature of Wall Street works against investors because they make their

money on transaction volume, not good deals, upfront fees, underwritings over secondary market transactions and they have a short term, bullish biased focus. Many of these same value investing attributes can be applied to the CRE industry.

The value investing philosophy can be applied to CRE deals to generate higher alpha type returns. There are numerous successful companies applying this strategy in the industry today. Here in the Bay Area of CA, TMG Partners, which acquires, renovates and releases B&C office properties and Sutro Management Group, which acquires and renovates B type apartment properties are two very successful CRE value investors. These firms seek to acquire distressed, poorly managed, unleased or undervalued real estate, apply sometimes significant renovation programs and then aggressive leasing and management techniques to create real estate alpha value.

The CRE industry is becoming more efficient and it is difficult to acquire discounted assets other than in certain distressed periods or situations. Additionally, low interest rates have resulted in a lot of capital chasing deals. A large portion of the returns made in the last several years were the result of cap rate compression and the low cost of capital, not value added or opportunistic strategies. The riskiest time to buy commercial real estate is when the economy is booming and interest rates are low as exists today. An environment of cheap capital pushes up assets prices and reduces current returns. Investors who buy today are playing the futures market by wagering that they will be able to sell the property at the same cap rate and credit market, even though the risk for higher rates and tighter credit are much greater. This type of real estate market is also difficult for the value investor as there are fewer discounted turnaround opportunities.

Successful CRE value investing can provide higher returns, but sponsors must undertake contrarian strategies that include construction, redevelopment, retenanting, lease-up, entitlement, refinancing, tenant and interest rate risks. A key component of a successful value investment CRE strategy usually includes a construction or redevelopment component and the investor must have solid in-house expertise or working relationship with an experienced contractor to complete the renovation. Most valued added investment strategies in CRE include this redevelopment component and therefore this is critical to creating value. Most institutional investors do not have or do not want to "get their hands dirty" in a redevelopment deal and usually do not consider this type of CRE investment.

CRE value investing strategies typically include the following:

- Major or minor redevelopment of the property.
- Substantial renovation of apartment units or commercial space.
- Retenanting a high vacancy property.
- Demolishing and rebuilding a property in which there is a higher and better use for the site.
- Expanding a property with additional units or rentable sq. ft.
- Converting a property to different use, i.e., office to hi-rise apartments or retail center to office service.
- New management program and strategy that can increase current rents and occupancy.
- Developing new sources of revenue, i.e., bill tenants for water, trash and sewer and RUBS submetering program for apartments.
- Investing in areas that are out of favor or heavily distressed, i.e., City of Detroit.

There are three central elements in a value investment philosophy, as detailed in the Margin of Safety book, that also apply to CRE value investors as follows:

- It is a bottoms-up strategy requiring analysis of the real estate asset first, then the local market, MSA, national market and finally the economy.



- Value investing requires absolute performance not relative performance. CRE value investors seek to earn higher risk adjusted returns as compared with their own investment goals, not the returns on various indexes like NCREIF, FTSE Equity REITs, etc.
- CRE value investing is also a risk adverse approach that requires the sponsor to evaluate not only the potential return but the risk of not achieving that return or losing all or a portion of the equity investment.

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CRE value investing is a niche strategy that requires patient capital, expertise in construction and renovation and the ability to see value where others see detriment. However, if applied successfully, it can generate significant alpha returns.

Joseph Ori is executive managing director of Paramount Capital Corp. The views expressed in this column are the author's own.

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Natalie Dolce, national executive editor of GlobeSt.com, is responsible for working with editorial staff, freelancers and senior management to help plan the overarching vision that encompasses GlobeSt.com, including short-term and long-term goals for the website, how content integrates through the company's other product lines and the overall quality of content. Previously she served as editor of the West Coast region for GlobeSt.com and *Real Estate Forum*, and was responsible for coverage of news and information pertaining to that vital real estate region. Prior to moving out to the Southern California office, Natalie was Northeast bureau chief, covering New York City for GlobeSt. Dolce's background includes a stint at *InStyle Magazine*, and as managing editor with *New York Press*, an alternative weekly New York City paper. In her career, she has also covered a variety of beats for *M* magazine, *Arthur Frommer's Budget Travel*, *FashionLedge.com*, *Co-Ed* magazine and the *Daily Orange* newspaper. Dolce has also freelanced for a number of publications, including MSNBC.com and *Museums New York* magazine.

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