You are here: Home > Commentary > The Art of Creating CRE Alpha

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EXCLUSIVE

The Art of Creating CRE Alpha

By Joseph Ori, executive managing director, Paramount Capital Corp. | Commentary

The Alpha return in CRE is primarily generated by the investment owner/manager through its control of the real estate asset, says Ori.

SAN FRANCISCO—In modern portfolio theory, Alpha is the excess return of an investment above the market or benchmark return. In the capital markets, Alpha is the excess return of common stocks above a benchmark like the S&P 500 Index or the excess return of a portfolio of corporate bonds above the Barclay's Capital Aggregate Bond Index. The Alpha for REIT stocks would be the return in excess of the FTSE NAREIT Index. In CRE, Alpha is the excess return generated by the investment owner/manager above a market return like the NCREIF NPI Index. The Alpha return in CRE as opposed to stocks and bonds is primarily generated by the investment owner/manager through its control of the real estate asset. This hands-on control of the real estate asset, leases, income/expenses and capital structure enables the owner/manager to generate an Alpha return.

Each type of CRE, whether an office building, shopping center, industrial property or apartment complex has distinct income and cash flow properties. These properties primarily derive from the tenant leases that encumber the property. The type of lease, duration, rental rate, expense reimbursements and other lease provisions plus additional property income, determine the effective cash gross income of a property. Cash property operating expenses typically include repairs and maintenance, real estate taxes, insurance, management fees, salaries, utilities and administrative costs. The net of the effective gross income and operating expenses is the net operating income or NOI. NOI is considered one of the most important metrics in CRE and is used to apply the capitalization rate to calculate real estate value.

CRE owners and managers can adopt various policies and strategies such as revenue enhancing capital improvements, altering the ownership and management structure and/or financial engineering to realize incremental NOI and Alpha value. Some of the most important policies and strategies to create Alpha for CRE are discussed in the table below.

Commercial Real Estate Alpha Strategies

Strategy	**Description**	**Alpha Influence**	**Example**
1. Capital Improvements.	Investing additional funds to improve the physical property above and beyond normal and recurring repairs and maintenance.	Can have a moderate effect on NOI and property value depending on the amount invested and direct benefit to tenants.	Renovation of an office building lobby or new appliances for an apartment project.
2. Capital Redevelopment.	Major physical change or redevelopment of a property due to high vacancy, outdated use, or severe disrepair, to attract or maintain tenants.	Can provide a substantial boost to NOI and value of a property, however, requires substantial new investment.	Complete rehabilitation of an older C apartment property into a B property or conversion of a vacant office building into a hotel.
3. Management and Leasing.	Selection of leasing/management agents and application of NOI enhancing marketing strategies.	There is a wide disparity in the quality of leasing and managing agents especially for apartments and hiring the right firm is critical to creating value.	Changing the management and leasing agents on a property in a small suburban market from one of the large global brokerage firms like CBRE or JLL to a small local firm.
4. Lease Structures.	Changing the lease structure to increase base rents, shift additional operating costs to tenants or	Depends on the property occupancy, local market lease customs and tenant retention, but can have	Include a CPI rent increase clause or change the lease structure to triple net from a gross lease.

	provide for inflation indexation.	a very positive effect on NOI and value.	
5. Income and Expense Management.	This relates to the management function, however, better income/expense management can be beneficial.	Most popular and easiest to implement strategy that can achieve 5%-10% increases in NOI.	Make investments in technology to reduce salary and leasing costs at an apartment project.
6. Market Arbitrage.	This relates to the arbitrage opportunity available from converting CRE ownership to/from public (REIT) and private ownership.	This strategy can generate very high Alpha depending on the valuations assigned in the public (REIT) versus the private market. The valuation of CRE is usually different in the public vs. private markets due to liquidity risk, economic outlook, interest rates and the availability of capital.	Converting a private real estate company or portfolio to a public REIT, wherein, most REITs are currently trading at significant premiums to private net asset value.
7. Ownership and Advisor Change.	This requires a change in the property ownership or advisor relationship. Some firms are just better owners/asset managers than others.	Many institutional real estate fund owners/sponsors do not possess the best operating, investment, capital strategy and intellectual capital and therefore, realize lower returns.	A public pension fund replacing an underperforming advisor with a new firm.
8. Financial Engineering.	This involves the structure of the property capital stack including or the amount, percentage and cost of the first mortgage, mezzanine debt, subordinated debt, preferred equity, owner equity and securitization opportunities.	This is probably the riskiest strategy and a major contributor to the current 2007 CRE bust, however, can provide the highest value increase.	Selling the land under a major office building in a long term sale leaseback or capitalizing a project with only 5% equity, multiple layers of non-recourse debt and subordinate financing in a declining interest rate environment.
9. Cap Rate Arbitrage.	This is similar to market arbitrage above and is usually dependent on the level of interest rates, inflation and the economy.	A drop in cap rates from acquisition to sale can generate the largest boost in value. A 1% cap rate decline from 6% to 5% can increase a property's value by 20%.	Acquiring CRE at high cap rates and selling at low cap rates due to the decline in interest rates or cap rate compression.

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