REAL ESTATE

Low-constraint investors, which have large capital reserves and long investment horizons, have unique advantages and objectives, write Bill Schwab and Thomas Wiegelmann

Understanding low-constraint investors

As the global economy generates ever-larger pools of capital, there has been a growth in large, low-constraint investors (LCIs). They are important drivers of real estate market activity today and they are likely to be even more important ones in the future. They can behave differently to other investors and it is important to understand what drives their behaviour so as to better anticipate their impact on the market.

LCIs have large pools of capital, which can include sub-pools, and commonly have an objective to maximise total returns over an investment horizon that spans a complete real estate cycle or longer. This investment horizon and its low-constraint capital profile differentiates it from other investors.

The least constrained investors have high cash-flow coverage of their normally recurring liabilities, large liquidity reserves relative to their potential needs, and capital contributions significantly greater than capital distributions over their investment horizons. Their long investment horizons mean they are unlikely to need to make unwanted adjustments to their investment programmes.

Examples of LCI capital pools and sub-pools can be found among pension funds, insurance companies, sovereign wealth funds and large family offices.

To optimise their investment performance, LCIs benefit from skilled investment teams with the necessary sophistication and capabilities to take advantage of their capital profiles. Given their capital profiles, LCIs are the natural holders of the underlying risk of investments that command high illiquidity premia (including, among others, volatility, duration, complexity, scale, and uncertainty). Investments offering these high illiquidity premia usually require skilled, intensive and

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dynamic investment and asset management to realise the high potential returns.

LCIs can focus on maximising their total returns over a real estate cycle rather than managing short-term volatility. Optimising end-period wealth should be a key investment objective, not the management of mark-to-market valuation or cash flow volatility, to the extent that such volatility will not force unwanted changes in the LCI's balance sheet, cash flow management or investment strategy. LCIs are the investors best able to implement investment strategies in an unconstrained manner across asset classes, regions, capital structures, public and private markets, development stages and so on. They are well suited to pursue absolute-return strategies.

Often, underlying the LCI investment management programme is a risk-management approach that is different from those of the 'normal' investor. Such normal investors are usually mean-variance optimisers over relatively short time horizons. Many normal investors generally calculate value at risk (VaR) and treat volatility as a key risk while targeting some constant risk levels. In contrast, LCIs can embrace volatility and uncertainty for the high-risk premia they offer and focus on managing two different key risks:

- The permanent impairment of capital for those investments written off and abandoned over a real estate cycle;
- Rescue capital needed to sustain portfolio investments during an adverse market environment.

Both risks can be quantified and managed by estimating their impact over a real estate cycle and committing capital reserves and allowances at the start of an investment programme to fund their expected requirements over a cycle. Individual investments can be underwritten in the normal way and the expected portfolio returns can be modelled under stressed market (probable worst case) scenarios with deductions for the costs of providing for the funds to manage the two risks.

These deductions can be made as annualised charges for the risks – for example, 20-30 IRR bps for each risk or 40-50 IRR bps in total per year may be representative for LCIs using lower leverage levels (40% loan-to-value and 10-12% debt yield on stabilised cash flow as a representative example) so that the investment programme is self-contained as to expected write-offs and eventually required rescue capital requirements over an investment cycle. Portfolio-wide returns are underwritten on the basis of a projected after-loss/after-rescue capital charge.

LCIs should use quite long timeframes for their assessments of portfolio risks in line with their investment horizons. Thus, their risk perception is aligned with the nature of real estate investment per se. The true risk for the LCI is that fundamentals change unpredictably rather than volatility itself, as volatility is unlikely to force unwanted changes to their investment strategies and programmes.

Diverse investment strategies

LCIs are in a position to pursue a diverse range of investment approaches and strategies. But they can be categorised into three principal approaches – passive-passive (PP), active-passive (AP), and active-active (AA).

PP returns are based on passive real property management and passive portfolio management. Typically, PP return investments focus on a diversified, stabilised asset pool representative of 'average' real estate exposure giving 'market' returns. They tend to generate the lowest average realised returns.

AP returns are achieved with active portfolio management strategies (exposure to various weighting decisions) combined with passive real property management. AP return investments tend to return mid-range realised returns.

AA returns are generated at the property and the portfolio levels. As such, AA returns require active portfolio management and their associated active real property/asset management correlates. AA return investments tend to return the highest average realised returns. AA returns are of greater investor

FROM PASSIVE-PASSIVE TO ACTIVE-ACTIVE

Risks	Real estate	Portfolio
BothPass (PP)		
Diversified returns representative of 'average' real estate exposure; passive management of portfolio and assets	Passive real estate management	Passive portfolio management
PortAct/RealPass (AP)		
Investment over- and under-weights across sectors, regions, cycle timing, public/ private markets, among others; passive at real estate level	Passive real estate management	Active portfolio management
BothAct (AA)		
Active property / business process management. Strategy drivers include operating businesses, development, repositioning, releasing, tech upgrades	Active real estate management	Active portfolio management

R&D focus

- Drives investment into new sectors, regions, partnership structures, leverage structures and other new investment approaches.
- Readies the company for future opportunities through development of investment knowledge, staff capabilities and market connections.
- Positions portfolio and company for market evolution /emerging trends and opportunities early on before they are fully priced.

interest in a low-return world as AA returns are an increasing percentage of a decreasing amount of total available returns.

LCIs can target passive market-average returns (PP), or target returns linked to sector, timing and other over/under-weighting factors (AP), or returns linked to business-process management such as asset development, repositioning and major re-tenanting initiatives (AA). At a property level, LCIs may employ a range of investment strategies.

The current investment market presents a dilemma for many real estate investors since they have experienced significant yield compression while operating under ambitious return requirements and deployment pressure. In this environment, the investment market is characterised by various trends, which can essentially be attributed to two different strategies:

- Taking more risk with AP and AA return investments to stay in line with the investor's return expectations;
- Taking the same risk with AP and PP return investments and accepting a reduction in the investor's portfolio return expectations.

While LCIs compete with all investors for AA returns, LCIs' capital profiles are more robust than those of most other investors, making them the natural holders of AA return investments, as the impact of adverse investment performance on an LCI is much less than it is on that of smaller, less robust investors.

LCI investors can improve returns by capturing AA returns which are generated at the property level and the portfolio level. Building and owning a superior real estate investment team which is able to align team capabilities with AA return investments is a key opportunity for LCIs.

Given a superior real estate team, an LCI can partner with best-in-class operators and local investment and asset managers or co-investors as their partner of choice. They can also develop value-add business plans and execute them in a superior way, and invest in dynamic real estate opportunities that might be inaccessible for other investors.

With low investment constraints, LCIs are the natural holders of certain asset risks. Assets with high option values are key to achieving AA returns. LCIs can invest in, among other things:

- Transitional assets with 'permanent locations', such as land and standing assets with redevelopment and repositioning potential;
- Deep-discount value investments, such as turnaround, workout and distressed assets with negative cash flows, and troubled public companies;
- Capital-structure arbitrage strategies, including preferred equity, mezzanine financing, participating debt;
- Opaque markets;
- Volatile emerging markets;
- Large-scale and complex development and redevelopment projects.

Such opportunities typically provide high-risk premia that help LCIs maximise investment-period returns and end-period wealth.

Timing is crucial in achieving significant positive AA returns. AA investments are particularly attractive at points of low valuation in a real estate cycle when option values are high. From our perspective, LCIs could have about 40% of their portfolios invested in a mix of AA risks (operating businesses, development, platform reorganisation) at appropriate points of a real estate cycle and a lower proportion at less favourable points.

Challenges for LCIs

Investment timing and the alignment of LCIs with their operational partners is crucial to the LCI profiting from its capital profile. Historically, most investment programmes have been relatively short-lived and focused on satisfying the need of non-LCI investors that have had limited ability to absorb cash flow and mark-to-market pricing volatility. The investment programmes of non-LCI investment partners are not designed to take the illiquidity premia for which LCIs are the natural holders. Hence, LCIs face significant opportunity costs when investing in 'average' investment opportunities when paired with average investors.

When investing in common programmes with non-LCI investors, LCI returns often suffer. For example, investment opportunities might be limited by constraints not relevant to LCI investment programmes including: time constraints (often forcing capital into markets at high prices or out at low prices); restrictive investment policies; strategy failure to evolve through market cycles; and opportunity costs and inefficiencies because of small scale. Therefore, it is advisable for LCIs to align with those investors with similar capital profiles and investment missions.

While LCIs are best positioned to take tail-risk in a market (they can 'sell' that risk-absorption to the market when adequately compensated for it by the returns they receive), they have often been constrained in the past to invest in parallel with 'buyers' of that risk-absorption.

Historically, it is as if an insurance company was aligned with the interests of the insured when in fact their tail-risk absorption capacity is at either end of the risk spectrum (by design) and they should be investing in opposite sides of the insurance trade – one side selling insurance protection and the other side buying it. This incoherence between the capital profiles of LCIs and other investors means that they should not be investing in similar risks as often as they do.

Aligning external partners' interests with programme goals is a further crucial element for optimal LCI investing. This can involve the creation of new compensation arrangements, such as combining high annual pay with more modest promotes (where those modest promote percentages start at low IRRs, or even at 0%) and remaining flat over the return profile. This avoids some of the significant principal-agent alignment problems seen with existing asset management models. Provision of re-contracting rights (in other words, commitment 'kill switches') can help with maintaining principal-agent alignment.

It is important to build the internal LCI investment team's capabilities with regards to cyclical market opportunities and to align internal team incentives with the investment mission. Often, internal teams were incentivised to achieve short-term returns, not to match investors' time horizon. By increasing the incentives for management of process (annual cash pay) and decreasing those for management of results – at least for short-term results (investment promotes) – internal management can be aligned with pursuing the best investment interests of the LCI, which are often long-term and subject to short-term volatile financial performance.

LCIs should avoid using hedging instruments, as they are the natural sellers of hedge protection and should profit from holding volatility and other illiquidity risks that the market effectively pays them to hold.

So how can one benefit from understanding the capital profile, investment missions, strategies and capabilities of LCI investors? Depending on who you are, you can partner with LCIs, sell to them or finance for them while utilising their superior ability to hold investments with significant illiquidity premia as described above.

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